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Govt restricts multiple layers of cos, norms to apply prospectively & exempt foreign acquisitions

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Mumbai/Chennai: The ministry of corporate affairs (MCA) has issued draft rules which seek to restrict the number of layers of subsidiaries that a company can have. Rule 5, which was issued on June 28, allows a holding company to have up to two layers of subsidiaries. It adds that one layer of wholly owned subsidiary (WOS) will not be counted for this purpose. The main objective is to curb misuse of corporate structures, as in the past multiple layers of shell companies have been created by some promoters for diversion of funds or money laundering.

To illustrate the draft rules: If Co A is the holding company, it can have one wholly owned subsidiary (Co B), which in turn can have two drop-down subsidiaries or layers of subsidiaries. Thus Co B would hold Co C, which in turn would hold Co D (Both Co C and Co D are referred to as drop-down subsidiaries). The restriction on investments through not more than two layers of investment companies, according to section 186 of the Companies Act, will also continue.

Pursuant to recommendations given by the Companies Law Committee, section 2(87) — which authorises the government to create restrictions on multiple-layered corporate structures — and section 186, as explained above, were sought to be omitted by an amendment bill. As reported by TOI earlier, the government decided to continue with this restriction and draft rules have now been issued for public comment.

These rules will come into effect prospectively. Existing companies with multi-layered structures have to disclose the same. After such a disclosure, they cannot create further drop-down subsidiaries. The proposed restriction does not apply in case of overseas acquisitions, provided the target overseas company has further drop-down subsidiaries according to the laws of that country. Banks, NBFCs registered with the RBI, insurance companies and government companies are exempt from the restrictions on multi-layered structures.

"Large groups typically involved in various activities with layered structures create shareholder havoc when there is a governance failure. Governments then feel the need to extend liquidity support of a financial safety net beyond the usual to prevent system-wide crisis. The restriction on layers could go some way to regulate the 'too-big-to-fail' companies," says Aarthi Sivanandh, partner, J Sagar Associates.

Girish Vanvari, national tax head, KPMG India, says, "A downside of the rules being prospective is that some promoter groups will not have to clean up their act by restructuring and limiting the existing layers of subsidiaries. In the past, a few promoters have used multiple layers of companies and intricate crossholdings to siphon off money from the last tiered company, transfer it to another promoter-held company and then resort to insider trading. Perhaps, instead of grandfathering such existing structures, the government could have given a 'cooling off' period of two-three years to enable corporate groups to restructure and limit the drop-down subsidiaries to acceptable numbers." According to Simone Reis, co-head (M&A practice) at Nishith Desai Associates, "The draft rules have rightly exempted foreign companies. Further, other laws, such as FEMA, are strong enough to curb any misuse. For instance, Indian companies are permitted to only invest in operating businesses outside India directly or through not more than one SPV (investing company)."

Ries adds that infrastructure companies, which enter into JVs for bidding on large projects, have a genuine business case for having multi-layered structures, in view of which this sector needs an exemption.

Vanvari says that genuine M&As will not be impacted as there is no limit on the number of subsidiaries a company or its WOS can have. It is the number of drop-down subsidiaries (or multi tiered layers) that have restrictions, not parallel or sister subsidiary companies.