MCA proposes to notify the provisions relating to restriction on layers of subsidiaries under the Companies Act, 2013

14 July 2017

Background

The provisions (proviso to Section 2(87) and 186(1)) are aimed at monitoring misuse of multiple layers of subsidiaries for diversion of funds/siphoning off funds and ensuring minority investor protection. Currently, proviso to Section 2(87) is not notified but Section 186(1) is currently applicable to companies.

Subsidiary – current requirements of the Companies Act, 2013

Section 2(87) of the Companies Act, 2013 (2013 Act) defines the terms ‘subsidiary’ or a ‘subsidiary company’ in relation to any other company (that is to say the holding company). A subsidiary is a company in which the holding company:

a) Controls the composition of the board of directors, or
b) Exercises or controls more than one-half of the total share capital\(^1\) either at its own or together with one or more of its subsidiary companies.

Section 2(87) of the 2013 Act also contains a proviso which provides that specified class or classes of holding companies should not have more than a prescribed number of layers\(^2\) of subsidiaries.

Investment company – current requirements of the 2013 Act

Section 186(1) of the 2013 Act provides that a company is not allowed to make investment through more than two layers of investment companies. However, the restriction of two layers of investment companies is not applicable in the following cases:

a) A company acquires 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,

b) A subsidiary company having any investment subsidiary for the purposes of meeting the requirements under any law or under any rule or regulation framed under any law for the time being in force.

As per the explanation to Section 186(1), an investment company means a company whose principal business is the acquisition of shares, debentures or other securities.

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\(^1\) **Total share capital** means the aggregate of following:

- Paid-up equity share capital, and
- Convertible preference share capital.

\(^2\) **Layer** in relation to a holding company means its subsidiary or subsidiaries.

\(^3\) Proviso to Section 2(87) has not been notified by the Ministry of Corporate Affairs (MCA) yet.
Recommendations of the Companies (Amendment) Bill, 2016 (Amendment Bill) and the Companies Law Committee (CLC)

The CLC in its report issued in February 2016, proposed to remove the restriction on layers of subsidiaries and investment companies on the following basis:

a) **Proviso to Section 2(87):** If the proviso gets notified, it is expected to have a substantial bearing on the functioning, structuring and the ability of companies to raise funds.

b) **Section 186(1):** Sufficient safeguards have been built into the oversight mechanism of the Securities and Exchange Board of India (SEBI) and the stock exchanges.

In line with the recommendations made by the CLC, the Amendment Bill also proposes to omit such restrictions.

New development

The MCA has pointed out that it has been receiving reports that certain companies could create shell companies for diversion of funds or money laundering. Therefore, MCA decided to operationalise the provisions relating to the restriction on number of layers for holding companies (Section 2(87)) and retain the requirements of Section 186(1) regarding the number of layers of investment companies although the Amendment Bill proposes to remove the restrictions in these two sections.

Accordingly, MCA through a notice (no.3/3/2017-CL-I) dated 28 June 2017 proposed the following:

- Notification of the proviso to Section 2(87) of the 2013 Act
- Insertion of new sub-rule 5 ‘Restriction on number of layers for certain holding companies’ to the Companies (Specification of Definitions Details) Rules, 2014 (Definition Rules).

Comments to the proposals could be submitted up to 20 July 2017.

Overview of the proposals

Following is an overview of the proposals relating to restrictions on layers of subsidiaries:

- **Restriction on layers of subsidiaries by holding companies (Proviso to Section 2(87)):** The proposals seek following:
  - To allow a holding company to create up to two layers of subsidiaries only. However, one layer represented by a wholly owned subsidiary would not be taken into account for computing the number of layers.
  - The restriction regarding layers of the companies would not affect a holding company from acquiring a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country.

- **Restriction on layers of investment companies (Section 186(1)):** The requirement for making investment through not more than two layers of investment companies would continue to apply. The Section currently allows a holding company to acquire a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country. However, an investment company being a subsidiary of a holding company (covered under the proviso to Section 2(87)), would also be counted for the purpose of layer requirements.

- **Exemption from restrictions:** These above mentioned restrictions under both ‘proviso to Section 2(87) and Section 186(1)’ would not be applicable to the following class of companies:
  - A banking company
  - A systemically important Non-Banking Financial Company (NBFC) registered with the Reserve Bank of India (RBI)
  - An insurance company
  - A government company.

- **Disclosures in case of excess layers:** All holding companies, other than exempted companies, having layers of subsidiaries in excess of two on or before the commencement of the draft Rule 5 of the Definition Rules would be required to comply with the following requirements:
  - **Filing of return with the ROC:** A return in Form SDD-1 comprising details of the layers of subsidiaries is required to be filed with the Registrar of Companies (ROC) within a period of three months from the date of its deployment (as an electronic form on the Ministry’s MCA-21).
  - **No subsequent addition to the layer:** Such a holding company should not add any additional layer of subsidiaries subsequent to the date of notification of the draft restrictions.

4Format of Form SDD-1 has been provided in the Annexure to the notice.
Our comments

The draft proposals are likely to pose a challenge to companies that plan to have both organic and inorganic growth through multiple layers of companies. The restrictions (if notified) are expected to keep a vigil over the layers of companies.

The draft proposals do provide relief to the companies with more than two layers of subsidiaries currently by not requiring them to reduce the number of layers provided they file a return comprising details of their subsidiaries to the ROC and should not make any addition to its existing layer subsequently.

However, there are certain areas which requires additional consideration. These are as follows:

- **Section 2(87) restriction vs 186(1) restriction**: Proviso to Section 2(87) of the 2013 Act allows specified class of companies to have up to two layers of subsidiaries (excluding a wholly owned subsidiary) whereas, Section 186(1) provides that the company is not allowed to make investment through more than two layers of investment companies. Section 2(87) is a pervasive section and would apply to all classes of companies including investment companies (covered in Section 186(1)).

Currently, Section 186(1) allows a parent company to form two layers of investment companies while there was no restriction on the number of operating companies. However, post application of proviso to Section 2(87), a company cannot form more than three layers (assuming one layer is a wholly owned subsidiary) of companies for both operating and investment companies. If, however, first subsidiary is not a wholly owned subsidiary then the parent company cannot have more than two layers of investment and operating companies. Therefore, it is likely to be more restrictive in nature. This can be illustrated with the help of following examples.

Examples:

If the draft provisions are notified in the current form, then an investment company A, with three subsidiaries B, C and D where company B is a wholly owned subsidiary of A, B, an investment company is situated in Mauritius and D, another investment company is situated in Cypress while D is an operating company in the United Kingdom. Now as per the draft provisions, company A could continue with all of them as its subsidiaries (as B is a wholly owned subsidiary which is not to be counted for computation of two layers).

However, if company A owns only 95 per cent stake in company B, then in such a case, company A would not be able to hold one operating company D as it can only hold two layers of companies as per proviso to Section 2(87).

- **Implication on Merger and Acquisition (M&A) transactions in India**: The draft notification specifically exempts a holding company from acquiring a subsidiary incorporated in a country outside India, if such subsidiary has subsidiaries as per the laws of such country. However, the draft notification does not contain any exemption for number of layers of subsidiaries for M&A. transactions between Indian companies. There could be various
Our comments (cont.)

situations that a group could be organised in various layers of subsidiaries and if it considers to acquires another
group (with various layers of subsidiaries) then:

a) The purchaser would not be able to add a new subsidiary, it would be required to purchase through existing set of companies

b) The selling company would have to create a flatter structure in order to facilitate the acquisition.

This could pose significant challenge to M&A activity within the Indian companies including taxes and stamp duties on such transactions.

• Regulatory requirement to form subsidiaries or special purpose entities or businesses formed as a conglomerate: The draft provisions could also pose challenges to companies that are required to form various layers of subsidiaries or special purpose entities by certain regulations like infrastructure companies or real estate companies to claim certain concessions from the government. Additionally, large conglomerate business houses that operate through different verticals with step-up holding and step-down subsidiary companies would also need to consider the implications of these proposals.

The bottom line

Companies and other stakeholders are encouraged to provide their comments on the draft proposals.
The topics covered in this issue are:

- Business model analysis for loans and debt investments
- Key responsibilities of directors
- Application of substance over form under Ind AS – lease of land
- Deemed cost accounting under Ind AS
- Regulatory updates.

Missed an issue of Accounting and Auditing Update or First Notes

**Issue no. 11/2017 – June 2017**

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**MCA amends provisions relating to independent directors under the Companies Act, 2013**

14 July 2017

Recently, on 5 July 2017, the MCA amended certain provisions relating to independent directors and issued the following notifications:

- Companies (Appointment and Qualification of Directors) Amendment Rules, 2017
- Amendment to Schedule IV (Code for independent directors) of the 2013 Act.

This issue of First Notes provides an overview of the amendments made by the MCA in relation to independent directors.

**Ind AS - Practical perspectives**

KPMG in India's Ind AS - Practical perspectives through aims to put a finger on the pulse of India Inc’s adoption of Ind AS and capture emerging trends and practices.

Our impact assessment is based on Nifty 50 companies which would be the first group of companies to report Ind AS results. The Nifty 50 companies have declared their financial results for the year ended 31 March 2017. Out of the companies comprising Nifty 50 index, eight companies are banks, two are Non-Banking Financial Companies (NBFCs) and two companies follow a different date of transition to Ind AS. Therefore, our analysis would comprise the remaining 38 companies.

This can be accessed on KPMG in India website - ‘Ind AS: Practical perspectives’ webpage

Feedback/queries can be sent to aaupdate@kpmg.com

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