



Regulatory Alert Stay Ahead...

Restriction on number of layers of subsidiaries under Companies Act, 2013

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In this issue:

[Background](#)

[Highlights of the Notification](#)

[Conclusion](#)

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Background

To check misuse of multiple layers of subsidiaries for diversion of funds and siphoning off funds, the Companies Act, 2013 (2013 Act):

- (a) Prohibits prescribed holding companies from having layers of subsidiaries beyond prescribed numbers and
- (b) Requires that no investments can be made through more than two layers of investment companies.

These provisions were sought to be omitted from the 2013 Act on the recommendation of the Companies Law Committee (CLC) set up by the Ministry of Corporate Affairs (MCA). CLC felt that these restrictions may become too obtrusive and impractical in the modern business world, and have a substantial bearing on the structuring and the ability of companies to raise funds.

Subsequently, in view of reports of misuse of multiple layers of companies, where companies create shell companies for diversion of funds or money laundering, the government decided to retain these provisions and placed a draft notification of the Rules to be prescribed, for public comments in June 2017.

On 20 September 2017, MCA notified the Companies (Restriction on Number of Layers) Rules, 2017 (the Notification).

The Notification prescribes classes of holding companies who shall not have layers of subsidiaries (as specified in the Notification).

Highlights of the Notification are summarized in this Alert.

Highlights of the Notification

On and from 20 September 2017, no company shall have more than 2 layers of subsidiaries.

- A company may acquire a company incorporated outside India with subsidiaries beyond 2 layers as per the local laws of such country;
- In computing the number of layers, one layer which consists of one or more wholly-owned subsidiary or subsidiaries shall not be taken into account.

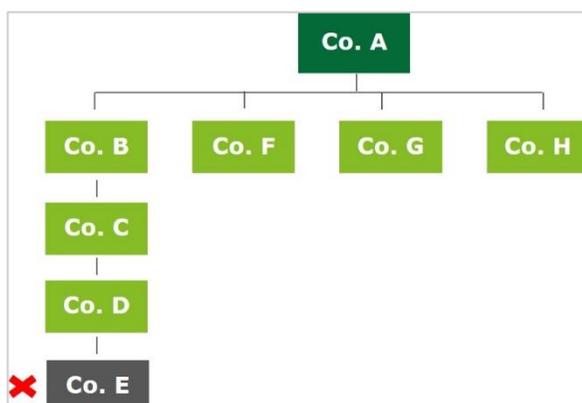


Illustration:

If Co. A is the holding company, it can have one wholly-owned subsidiary (Co. B) or subsidiaries (Co. F, Co. G and Co. H). Co. B in turn can have two step-down subsidiaries or layers of subsidiaries i.e. Co. C and Co. D. However, Co. D cannot have any subsidiary (Co. E). There is no restriction on Co. B having fellow subsidiaries which are

directly held by Co. A i.e. Co. F, Co. G, Co. H and so on. Similarly Co. F, Co. G and Co. H may have step-down subsidiaries.

- The following classes of holding companies are exempted from the applicability of the Notification:-
 - Banking companies
 - Systematically Important Non-Banking Financial Companies
 - Insurance companies
 - Government companies
- Existing companies having more than 2 layers of subsidiaries as on 20 September 2017 are required to ensure following:
 - File a return in the prescribed form with the Registrar of Companies within 150 days of 20 September 2017;
 - Shall not have any additional layer of subsidiaries over and above the existing layers on or after 20 September 2017; and
 - In case one or more layers of subsidiaries are reduced by such companies subsequent to the date of Notification, the number of layers permissible shall not be more than:-
 - Number of layers after such reduction; or
 - 2 layers
- In case of contravention of the Notification, the company and every officer of the company who is in default is punishable with fine up to ₹ 10,000 and in case of continuing default, with a further fine up to ₹ 1,000 per day of default.

Conclusion

The cap on layers of subsidiaries is expected to keep a check on usage of multiple layers of holding-subsidiary structures for siphoning off /routing of funds and will enable regulators/ authorities to identify the ultimate beneficiaries of complex corporate structures.

The carve-out made for regulated financial sector entities and ignoring one layer of wholly-owned subsidiary is a step towards facilitating business and provides flexibility in structuring sector/project specific SPVs.

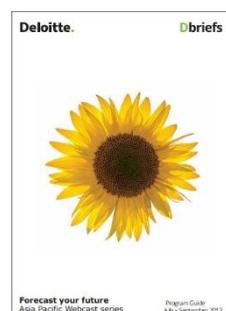
Source: Notification G.S.R. 1176(E) and Notification S.O. 3086(E) dated 20 September 2017 issued by MCA.

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