

Significant beneficial ownership rules: A net cast too wide and too soon

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The Ministry of Corporate Affairs notified significant beneficial ownership rules on 13 June, 2018 (**Rules**). The Rules created quite a furor in the Indian corporate ecosystem by placing stringent disclosure obligations on individuals holding a certain percentage of beneficial interest in Indian companies. The Rules aim to look-through corporate layers to reveal individual shareholders that ultimately derive economic benefits from and/or control a corporate entity in India.

Individuals holding 10% or more in the share capital of an Indian company (whether directly or indirectly) are obligated to disclose their identities by providing information (as mandated by the Rules) to the Indian companies in which they hold such percentage shareholding. The Indian companies in turn are required to file these disclosures, received from the individual beneficial owners, with the relevant Registrar of Companies (**RoC**). While the purported purpose of the Rules appears to be to identify “significant” beneficial owners who may have certain level of influence on a company, the threshold percentage of 10% of the shareholding of a company, as prescribed by the Rules, is too low a threshold resulting in inclusion of a number of unsuspecting minority individuals. Further, the Rules force significant beneficial owners to disclose personal information and makes such information publicly available (pursuant to the filings with the RoC). The Rules beg the question if such a reach is intrusive or reasonable?

Need for Regulation

The need for statutory enactment for identifying significant beneficial owners emanated from the recommendation of the Financial Action Task Force (FATF), an intergovernmental body that has developed a series of recommendations for member countries to adopt, in order to combat money laundering and terrorism financing. Many countries across the globe have adopted measures to identify individuals with significant beneficial ownership in corporate entities in the past. In May 2016, the US government issued certain rules mandating financial institutions to identify the ultimate beneficial owners (i.e. individuals holding 25% or more of a legal entity) of all the customers/clients of such financial institutions that are not natural persons. In 2017, several countries in the European Union adopted similar measures. France adopted rules for identification and registration of beneficial owners of corporations and other entities registered in France (i.e. individuals who own, directly or indirectly, more than 25% of the share capital or voting rights of a company registered in France). Following suit, Sections 89 and 90 of the Companies Act, 2013 (**Companies Act**) were amended. As per the amended Section 90, a significant beneficial owner is any individual holding beneficial interests of not less than 25% or such other percentage as may be prescribed or having the right to exercise significant influence or control over a company. Section 90 of the Companies Act empowered the central government to modify the threshold percentage for determination of significant beneficial ownership to any percentage as the central government deems fit. With the notification of the Rules, the above threshold has been reduced considerably. Thus, any individual holding a beneficial interest of 10% or more of the share capital of an Indian company will now be considered as a “significant beneficial owner” of such company.

The Rules are a sincere attempt by the Indian government to address issues related to money laundering, bribery, corruption, insider dealings, tax crimes, terrorist financing and other illegal activities. The lowered threshold limit and strict timelines are aimed at providing greater transparency and timely availability of beneficial ownership information. Though the underlying intent of the legislation is well justified, it is the width and scope of the reach of the Rules to implement the FATF recommendations that has attracted criticism of the investor and entrepreneurial world at large.

Too Wide

The FATF had recommended that countries adopt measures in a manner which are sufficiently clear, practical, workable and enforceable. However, the lowered threshold limit adopted by India is a significant deviation from the generally accepted norm of 25% across other developed jurisdictions and will have a far-reaching impact on the Indian corporate ecosystem. The new Rules question and in certain circumstances jeopardize corporate structures that have been followed for years. A number of individuals would fall under the category of significant beneficial owners even though they are holding an insignificant minority stake of 10% of the share capital of the company. The usage of the word ‘ultimate’ in the definition of ‘significant beneficial owner’ requires tracking down of beneficial owners up to the last level of ownership held by natural persons. It is well known that the shareholding pattern of Indian companies is generally far less diversified as compared to other developed countries. The Indian companies are mostly controlled by a more concentrated promoter groups and related individuals who typically are in the management and control of companies in India. A 10% shareholder is truly a passive minority stakeholder in a company with a little to no influence on the management of the Company. As such, the lowered threshold under the Rules makes little sense in the Indian corporate ecosystem.

These investors are now compelled under the Rules to disclose their identities and provide personal information. As things stand, the threshold is so low that it might lead to unnecessary harassment of companies and honest investors who invested their monies through investment agents and multiple channels thereby creating layers, whether knowingly or unknowingly.

Another important aspect to note is the design of the Companies Act which highlights the significance of holding more than 25% of the share capital of an Indian company. A shareholder holding more than 25% shares in an Indian company is empowered to block special resolution items (that require approval of shareholders holding 75% of the share capital) such as change in registered office of the company, alteration of memorandum and articles of association of the company, reduction of share capital, buyback of shares, removal of auditor, loans to directors, etc. With such clarity on the significance of a shareholding of 25% or more, embedded within the Companies Act and given the nature of the shareholding patterns typically seen in Indian companies, the 10% threshold seems out of place. It appears to be a net cast too wide specially in the absence of sound rationale for the 10% threshold that has been adopted by the Indian government. For a developing country like India, where businesses are in an expansion mode and there is a constant need of funding, these Rules might just discourage genuine investments. The objective of curbing black money, money laundering and countering terrorism financing would in that case be achieved but at a significant cost of losing genuine investments by bona fide investors.

Further, the applicability of the Rules to all companies without any distinction seems out of place, if not all together absurd. For the purpose of practical and effective implementation, the government could have considered adopting these measures in a more phased manner by distinguishing high-risk sectors such as financial and professional services sectors prone to money laundering/terrorism financing as opposed to certain sectors wherein the possibility of money laundering/terrorism financing is relatively low. Alternatively, the Rules could have prescribed a higher general threshold and a lower threshold for specific high-risk sectors.

Lastly, if individuals who are significant beneficial owner, as per the Rules, fail to furnish the required information within the stipulated time, the companies are empowered to make an application to the National Company Law Tribunal (NCLT) for imposing certain restrictions on the shares held by such individuals, including restriction on transfer of interest, suspension of right to receive dividend and suspension of voting rights. The NCLT thereafter could issue appropriate orders imposing such restrictions on the shares of the relevant significant beneficial owner. In our view, the enforcement mechanism prescribed by the Rules is not commensurate with the non-compliance. Restrictions of this nature on the shares held by a passive investor holding a minority stake in the company will completely erode the value of the asset (i.e. the shares of the Indian company) held by such investor. This becomes even more relevant for investors who invested in the Indian companies prior to the notification of Section 90 and the Rules, thereby affecting their investments retrospectively.

Too Soon

The timelines for compliance prescribed in the Rules are quite stringent in comparison to the timelines adopted by other developed jurisdictions. For instance, the US government issued its final rules with respect to significant beneficial ownership on 11 May, 2016 and provided time until 11 May, 2018 for compliance by financial institutions covered by the rules. France's decree mandating registration of beneficial ownership in French companies came into force on 1 August, 2017 which required only new companies incorporated after 1 August, 2017 to file documents related to beneficial ownership. However, French companies registered before 1 August, 2017 were given more than 9 months to comply with the beneficial ownership filing requirements by 1 April, 2018.

Contrast this to the Rules that came into effect on 13 June, 2018. The Rules mandate significant beneficial owners to make a declaration to the company within 90 days from the date of notification of the Rules (i.e. 13 June, 2018) and within 30 days in case of fresh acquisition or any change in ownership thereafter. The company is required to intimate the Indian authority i.e. the RoC, within 30 days of receipt of the declaration from the significant beneficial owners and maintain a register in relation to the same. Penalties have been prescribed in case of non-compliance by the company and the individuals. The broad applicability, lower threshold and stringent timelines are bound to put additional burden on the companies with respect to compliances and may result in unnecessary harassment of honest investors. The onus is on the companies to maintain adequate records and notify the authorities. Further, the process prescribed is not as straight-forward as any standard KYC process.

Conclusion

As enumerated earlier in this article, the FATF had recommended adopting measures in a manner which are sufficiently clear, practical, workable and enforceable. India's adoption of the Rules seems quite drastic and begs the question if these Rules are workable and enforceable especially in context of the Indian corporate ecosystem. The Rules which aim to curb money laundering and terrorism financing may have far reaching consequences in India and the manner in which these are implemented may counteract the government's initiatives for ease of doing business. Perhaps, it is a net cast too wide and too soon, trapping honest investors and unsuspecting passive minority shareholders, in the hope of revealing the identities of the intended individuals who ultimately control and enjoy benefits of ownership (even though the actual title of the shares remains in another person's name).

Authored by:
Rashi Dhir, Senior Partner;
Sumit Sinha, Partner; and
Divya Sharma, Senior Associate

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