

India: New Beneficial Ownership Rules – Transactional Implications

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Introduction

Following through on India's commitment to align its regulatory framework with the recommendations of the Financial Action Task Force, to check the misuse of multi-layered corporate entities for money laundering and other illegal activities, the Ministry of Corporate Affairs (MCA), vide the Companies (Amendment) Act, 2017 (Amendment Act), amended the Companies Act, 2013 (Act) with an intent to strengthen beneficial ownership disclosures.

Pursuant to the Amendment Act, for the first time, a definition of 'beneficial interest' was introduced and also new disclosure and filing requirements were specified for 'significant beneficial owners'. To give effect to the filing requirements, the MCA notified the Companies (Significant Beneficial Owners) Rules, 2018 (SBO Rules) that brought about a paradigm shift under corporate law by prescribing detailed requirements to identify the ultimate individual owners of a company in order to disregard opaque and intermediate corporate structures. The SBO Rules were subsequently amended through the Companies (Significant Beneficial Owners) Amendment Rules, 2019 (New SBO Rules) to bring in clarity wherever it was lacking. The first SBO filings under the New SBO Rules were due on 8 May 2019.

While the trigger of these changes is to bring in greater transparency and control, as a practical matter, there are now more compliances and issues for parties to consider as part of deal making.

The concept of 'beneficial interest' and 'significant beneficial owners'

The concept that a share could have a registered owner different from the actual beneficial owner of such share is not a new phenomenon under Indian corporate law. Section 187C of the erstwhile Companies Act, 1956 permitted a shareholder to assign the beneficial interest in a share to another person (including corporate entities).

However, there was no definition for 'beneficial interest' or 'beneficial ownership' provided under company law. Under the erstwhile Section 187C of the Companies Act, 1956, the generally accepted trigger for disclosure was when shares were held by persons for the benefit of other persons as nominees of the latter. Indirect beneficial interests such as voting agreements, etc., were generally never reported. This understanding, however, was completely overhauled when the Amendment Act notified the definition of 'beneficial interest' in Section 89(10) of the Act. This definition is very widely worded and includes interests held 'directly or indirectly', whether 'through a contract, arrangement or otherwise', as a 'right or entitlement' of a person acting 'alone or together with any other person' in relation to a share.

Separately, Section 90 of the Act requires every individual who is identified as a significant beneficial owner (**SBO**) of a company to make a declaration to the company specifying, *inter alia*, the nature of the beneficial interest held by the SBO. Note that the SBO should ultimately be an *individual*, who acting alone, or in conjunction with other persons, meets any of the following conditions: (i) holds not less than 10% shares, voting rights or dividends; or (ii) exercises or has the right to exercise 'control' or 'significant influence', over a company. A caveat here is that only direct shareholding is excluded from the purview of the above items.

The key distinction between Sections 89 and 90 is that while Section 89 is concerned with declaration of 'beneficial interest' in a share, Section 90 deals with identification of SBO. Under Section 89: (a) a registered owner who does not hold beneficial interest; and (b) a holder of beneficial interest (both juristic and natural persons), both need to make filings. Moreover, the person disclosed as holder of beneficial interest has rights created in respect of the shares for which the declaration is made. Under Section 90, the SBO alone is required to make a declaration, and the Company is also under an obligation to issue notices demanding information and disclosures from individuals that it reasonably believes to be SBOs – i.e., to virtually look through all legal structures to identify the ultimate natural person behind the layers of artificial legal entities who meet the tests prescribed for an SBO. There is no additional right or interest created in favour of the SBO over the shares for which an SBO declaration is made.

Transactional Implications

Post notification of the 'beneficial interest' definition, every share now needs to be looked at as a bundle of rights (right to vote, right to receive to dividends, etc.) and each right attached to a share is capable of being assigned to another person. Therefore, one share can have multiple beneficial owners. This may require investors to revisit all their existing shareholder agreements, voting agreements, etc. to evaluate whether the rights created under those agreements have triggered filing requirements under Section 89 of the Act. Additionally, compliances for SBO filings will also need to be factored in.

Some key points to consider, include:

Structuring Parties use opaque structures as part of better structuring options. The SBO filings which will contain information of the ultimate beneficial owners may provide ammunition to tax authorities to look through some of the structures. Although the law doesn't contemplate sharing of filings with tax authorities, the public access to the SBO forms may lead to practical issues – the possibility of tax authorities to use this to deny benefits/question the *bona fides* of a group structure cannot be ruled out.

Due Diligence Due diligence exercise on determination of ownership will broaden in scope. The possibility of multiple holders of beneficial interest may pose new challenges for diligence – for instance, as part of diligence, one will have to examine whether declarations for all beneficial interests held with respect to a share have been duly filed. Also, whether the SBO determination is accurate and relevant filings have been made. From a purely compliance perspective, diligence checklists will also feature requests for review of SBO register, beneficial interest filings and SBO filings etc.

Documentation From an investor perspective, representations on ownership have to be robust to ensure all aspects of definition of 'beneficial interest' are adequately covered. Further, for full title to shares, investors will have to complete acquisition of beneficial interests held with respect to shares from all such holders of beneficial interest. Moreover, in this multiple beneficial interest holders' scenario, there are likely to be practical issues in completion of the transfer – for instance, how to deal with payment of consideration and filings under exchange control regulations when the non-resident/resident holds only a part of the beneficial interest. In a share subscription scenario, the company may want the investor to complete the SBO filings in connection with the transaction. It is pertinent to note that, pursuant to the Amendment Act, there is an obligation on the Company to investigate and identify the SBO. Given this, the pragmatic approach for all parties involved would be to agree upon the basis and extent of the information proposed to be declared in the SBO filings as a part of the transaction documents. Interestingly, this will also be relevant in case of secondary transfers. Accordingly, these filings have to be appropriately documented in the transaction documents as post-closing filings.

Voting arrangements As the definition of beneficial interest is wide and broad enough to include various rights, the presence of voting arrangements could trigger creation of beneficial interest. The principle to be mindful of is whether the right in respect of which the interest is created is a right attached to the share or a mere contractual commitment – for a right attached to a share, a beneficial interest is created; however, a mere contractual commitment will most likely not result in the creation of a beneficial interest. While in theory this is well understood, the assessment gets more complex depending on how such voting arrangements are recorded. For instance, if a shareholder A has the right to direct/exercise the voting rights attached to shares held by shareholder B – in such a case, A will have beneficial interest in the shares held by B. Taking an example of a typical further assurances clause – a mere enabling clause that parties will vote with each other to give effect to matters agreed under the shareholders' agreement is not likely to be construed as creation of beneficial interest as this is a mere contractual commitment as opposed to the creation of a right or entitlement in favour of one shareholder to direct or cause the other party to exercise its voting rights in a certain manner. Similarly, veto rights are also not likely to result in the creation of a beneficial interest as the holder of the veto right does not have the right or entitlement to cause the other shareholders to vote in a particular manner. The veto right only bestows the holder with the power to block the target company from approving a specific item / resolution.

Way forward

Although the intention behind introduction of the new significant beneficial ownership regime by the Government probably was to curb the use of multi layered corporate structures for money laundering and tax evasion purposes by individuals, they have also increased complexities and compliances in regular and *bona fide* deal making. Investors in addition to diligence, will have to ensure that requisite filings and disclosures have been made by all the concerned parties to avoid any future claims questioning the capacity and/or authority of the seller to transfer the shares.

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