

Feedback on Defining Shell Companies and Significant Beneficial Ownership Clause Companies (Amendment) Act, 2017

Policy Submission to Taskforce on Shell Companies

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Centre for Budget and Governance Accountability
(www.cbgaindia.org)

Subject: Feedback on identifying and defining ‘shell companies’ that facilitate illicit finance and clarity around significant beneficial ownership clause under the Companies (Amendment) Act, 2017

We are encouraged to see the efforts taken by the Ministry of Corporate Affairs (MCA) to crackdown on structures and activities that facilitate and generate illicit finance¹ with the institution of Taskforce on Shell Companies (hereafter, referred to as Taskforce) in 2017. We are writing to provide feedback on the recent steps taken to identify and define ‘shell companies’ and strengthen the ‘significant beneficial owner’ transparency clause under the Companies (Amendment) Act, 2017.

Irregularities noticed in the filing of annual financial returns since 2014 led to a deregistration exercise of 2,26,166 companies from the Register of Companies under Section 248 of Companies Act, 2013. Consequently, nearly 3,09,619 directors were disqualified for a period of five years until 2021. The disqualification of directors however, does not divulge the incriminating role played by ultimate beneficial owners.² Both shell companies and special purpose vehicles are used to infuse multiple layers to complicate and obscure the functioning of a business to not only hide true ownership (influence or control), launder money, avoid taxes but also to route dubious investments. Such structures make it easier to dispose of or transfer responsibility to another and evade existing laws and regulations. Commonly known as ‘paper, letterbox or front companies’, shell companies are intermediary instruments used to facilitate illicit finance and its cross-border flow. Dormant companies do not necessarily classify as shell companies.

The criteria³ proposed by the Taskforce for identifying shell companies is obscuring ownership, excessive leveraging, rotation or repetition in transaction with no apparent business purpose, inactive shareholders or directors, abnormal increase or decrease in debts, writing off more than 10 percent of debt at one go, increase in investment in partnership firms by 100 percent or more, majority of shares held by other companies, concentration of beneficial ownership, and disproportionate investment in shares of other companies. As further parameters are yet to be disclosed by the constituted body, we would urge the Ministry of Corporate Affairs and the Taskforce to consider the following indicators to identify shell companies or companies under scrutiny:

- Few or no nominal assets
- Low paid-up capital
- Majority of shares held by all legal entities (trusts, associations, foundations, co-operative societies, companies and limited liability partnerships)
- No real economic activity or operations
- Few or no employees
- High chances of assets comprised of cash and cash equivalents

Strengthening Corporate Governance through Transparency

¹ Illicit finance can be identified as funds generated through activities like tax abuse by multinational companies and elites, trade misinvoicing, abusive transfer pricing, laundering proceeds of crime and corruption facilitated by a network of enablers, gatekeepers and structures. The cross-border movement of such funds is called illicit financial flows.

² Beneficial owner is any natural person(s) who ultimately owns or controls the customer and/or the natural person(s) on whose behalf a transaction or activity is being conducted and includes the natural person(s) who ultimately owns or controls a legal entity through direct or indirect ownership of a sufficient percentage of the shares or voting rights or ownership interest in that entity, including through bearer shareholdings, or through control via other means.

³ Ministry of Corporate Affairs (2018). http://www.mca.gov.in/Ministry/pdf/Monthly_Newsletter_May_2018.pdf

As disqualifying directors alone may prove to be an insufficient and a cumbersome process, ascertaining persons with significant interest in an entity is a robust alternative to discourage the use of shell entities by putting the onus of any misuse upon the identified individual. We are deeply encouraged to see that MCA lowered the threshold of determining significant beneficial interest from 25 percent to 10 percent and laid out provisions⁴ to establish a significant beneficial owner (SBO). We would recommend that these provisions include the shareholding membership of limited liability partnerships, cooperative societies, associations (incorporated and unincorporated / body of persons) and foundations other than trusts. Moreover, the disclosure should be able to shed light on issuance conditions in addition to the information provided on corporate bonds, depository receipts, convertible bonds, preferred shared and such similar instruments. Legal clarity is still required over the calculation of threshold percentage for compulsory convertible debentures that classify for reporting.

In case overseas arrangements are used to conceal ownership, the SBO clause must apply to foreign and domestic beneficial owners alike. The acting authority should ensure appropriate probe of the ownership of offshore traded stock, securities, equity derivatives etc. especially in the case of listed companies.

Limiting the scope of the transparency reform, there is a need to reassess the Centre's right over abstaining any certain class or classes of persons from disclosing their true beneficial owners. Publicly accessible registries in an open data format, containing information on the ultimate beneficial ownership of all legal entities are therefore, essential to combat tax dodging and money laundering activities.

(For further information on these issues, kindly contact us at director@cbgindia.org or sakshi@cbgindia.org or at 011-49200400/401.)

⁴ Ministry of Corporate Affairs (2018). Notification dated 13 June 2018.
http://www.mca.gov.in/Ministry/pdf/CompaniesSignificantBeneficial1306_14062018.pdf