

# Companies Act Series

November 22, 2023

## UNVEILING THE VEIL OF LLPS - SBO RULES

### [GOVERNMENT STRENGTHENS BENEFICIAL INTEREST DISCLOSURE REGIME - PART II]

#### BACKGROUND:

On November 9, 2023, the Ministry of Corporate Affairs ("MCA") notified the Limited Liability Partnership (Significant Beneficial Owners) Rules, 2023<sup>1</sup> ("SBO Rules"). These SBO Rules are issued pursuant to Section 90 of the Companies Act, 2013 ("CA 2013"), which was applied to all the Limited Liability Partnerships ("LLPs") through the MCA's Notification dated February 11, 2022<sup>2</sup>, with certain amendments wherein the words 'shares', 'company', 'member' and 'officer' used under said provision were substituted with 'contribution', 'LLP', 'partner' and 'designated partner', respectively in the context of LLPs.

Until now, only the companies were subjected to identify their Significant Beneficial Owners ("SBOs") and the related compliances under Sections 89(10) and 90 of CA 2013 read with Companies (Significant Beneficial Owners) Rules, 2018<sup>3</sup>, read with the Companies (Significant Beneficial Owners) Amendment Rules, 2019<sup>4</sup> ("Companies SBO Rules"), which have now been extended to the LLPs through these SBO Rules. As a result, all the existing LLPs and the SBOs identified pursuant to SBO Rules would be required to take necessary steps and make requisite disclosure of such significant beneficial ownership.

#### KEY HIGHLIGHTS OF SBO RULES

a) **SBO in relation to reporting LLP:** SBO Rules define SBOs in relation to reporting LLP as an individual, who acting alone or together or through one or more persons or trust, hold one or more of following rights or entitlements – (i) holds indirectly (or together with any direct holdings), at least 10% of contribution; (ii) holds indirectly (or together with any direct holdings), at least 10% of voting rights in respect of the management or policy decisions; (iii) has right to/participate in at least 10% of total distributable profits/any other distribution through indirect holdings alone (or together with direct holdings); and (iv) has right to exercise/actually exercises significant influence or control, in any manner other than through direct-holdings alone (together, referred to as 'Four Parameters'). While the first three parameters are objective and quantitative in nature, the fourth parameter is a subjective and qualitative test.

b) **Direct and Indirect holding in reporting LLP:** Explanations to SBO's definition clarifies as to what amounts to direct and indirect holding of right or entitlement in reporting LLP under different circumstances. As clarified, only an individual who holds any right or entitlement indirectly should be treated as an SBO and direct holding is only optional and in addition to indirect holding. In this context, the scenarios - (i) where the contribution representing such right or entitlement is held directly in the name of individual; or (ii) such individual has declared himself as beneficial partner under Rule 22B(2) of the Limited Liability Partnership Rules, 2009 ("Amended LLP Rules")<sup>5</sup> are to be considered as direct holding. In addition, the explanations also guide as to how to determine indirect holding in the context of different types of partners such as body corporate, partnership firm, trust, Hindu-undivided family (HUF) or pooled investment vehicles (PIV), in reporting LLP.

The term 'majority stake' has been defined (which is essential for determining indirect holding in case of body corporate or partnership firm being a partner), which broadly mean holding more than one-half of equity share capital in the body corporate; or contribution in a partnership entity; or voting rights in the body corporate; or right to more than one half of distributable profits or any other distribution. The terms 'control' and 'significant influence' have also been defined specifically in the context of LLPs.

c) **Reporting duties on LLP and SBO:** All the existing LLPs are required to identify any individual who is an SBO and cause him to declare his significant beneficial ownership (in Form No LLP BEN-1). The LLPs are also obligated to send notice (in Form No. LLP BEN-4) to all the existing non-individual partners holding at least 10% of contribution / voting rights / profit rights, seeking information of SBO and wherever applicable, require them to declare it. In respect of individuals who have already become SBO pursuant to SBO Rules, they are required to declare it within 90 days of commencement of SBO Rules and in respect of any future acquisition of (including any change in) such significant beneficial ownership, they have to declare it within 30 days of such acquisition or change. After receiving declarations from SBO as stated above, reporting LLP will need to file them (in Form No LLP BEN-2) with the Indian registrar.

d) **Register of SBOs and NCLT:** SBO Rules provide for maintenance of register of SBOs (in Form No LLP BEN-3) based on the declarations received from SBO(s). It is also provided that when a person fails to give information of significant beneficial ownership as required under law or has provided unsatisfactory information, reporting LLP should approach the National Company Law Tribunal which can then, at its discretion, restrict the transfer of or suspension of voting rights or profit distribution rights associated with the contribution in question.

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e) **Non-applicability:** SBO Rules exempt from its requirements in case of contribution of an LLP – (i) held by Central or State government or any local authority (including such holding by a reporting LLP / body corporate / entity controlled between Central or State government); or (ii) held by investment vehicles registered with and regulated by the Securities and Exchange Board of India (SEBI) or those regulated by the Reserve Bank of India (RBI), or the Insurance Regulatory and Development Authority of India (IRDA), or the Pension Fund Regulatory and Development Authority (PFRDA),

Broadly, except a few suitable modifications from an LLP perspective, the overall framework of SBO Rules is quite similar to that of Companies SBO Rules applied for the companies.

#### OUR ANALYSIS, AMBIGUITIES & CHALLENGES:

a) **Direct holding & Indirect holding:** Requirement of declaring beneficial interest in LLP's contribution got notified through Rule 22B(2) of the Amended LLP Rules recently which provided LLPs with a similar framework as provided by Section 89 of CA 2013 for the companies. For our detailed analysis of Amended LLP Rules, please visit this [Link](#). Any such beneficial interest declared under Rule 22B(2) and holding of such interest directly in the name of registered partner himself, both would qualify as direct holding of right or entitlement from SBO Rules standpoint. On the other hand, the interest of Section 90 of CA 2013 and SBO Rules goes a step further and is aimed at piercing the corporate veil for identifying any natural person(s) who indirectly holds right or entitlement in an LLP. Hence, existence of indirect holding is essential for SBO Rules to operate and they will not apply if there is no indirect holding of any right or entitlement by any natural person.

Pertinent to note that, Rule 22B which requires to declare beneficial interest, has not explicitly clarified what 'beneficial interest in contribution of an LLP' would mean. The meaning of 'beneficial interest in shares' has been however clarified under Section 89(10) of CA 2013 (which corresponds to Rule 22B) for the purpose of both Section 89 and Section 90 of CA 2013. Also, while Section 90 is applied to LLPs, Section 89(10) which defines as what the beneficial interest mean has not been applied to LLPs. However, as per the LLP Act, the partner's contribution in an LLP can be in any form and the obligation to contribute, voting rights and profit distribution rights in relation to such contribution are governed by LLP agreement, which essentially mean that, pursuant to LLP agreement, the beneficial partner may have acquired voting or profit distribution rights which may not exactly correlate with the contribution standing in the name of registered partner. Hence, the expression 'beneficial interest in contribution' could have been defined in the context of LLPs as it could have helped what nature of interest needs to be declared as per Rule 22B. Notably, while Rule 22B refers to only beneficial interest in contribution of an LLP, SBO Rules require to declare indirect holding of right or entitlements in an LLP as per aforesaid Four Parameters (one of which includes right or entitlement by virtue of contribution in an LLP).

b) **Partners of reporting LLP:** Section 5 of the LLP Act provides that only an individual or body corporate can become a partner of an LLP. Hence, the circumstances of a trust, HUF, PIV (not being a body corporate) or partnership firm being a partner of an LLP as contemplated in the explanations to SBO's definition needs to be evaluated in the context of Section 5. Going by this, only when a body corporate is acting as partner of LLP on behalf of entities restricted under Section 5 (like, as a partner of partnership firm or a trustee of trust etc.), the requirement of applying SBO test (and requisite declarations as per Rule 22(B)) may trigger. Also, an HUF or its Karta cannot become a partner or designated partner of LLP, as clarified under MCA's General Circular No. 13/2013 dated July 29, 2013<sup>6</sup> read with General Circular No. 2/16 dated January 15, 2016<sup>7</sup> and this directly contradicts with explanation (ii) to SBO's definition.

c) **SBO Identification and Indirect holding computation:** There are also certain anomalies while computing indirect holding of 10% and identifying SBO, by relying upon the SBO's definition and explanations thereunder, as discussed below:

- **Body corporate being a partner:** Though the definition of SBOs seems to suggest that 'indirect holding of 10%' needs to be calculated on a look-through basis (i.e., effective holding test), the explanations provided thereunder requires an individual to hold 'majority stake' either in the body corporate partner or in its ultimate holding company as a pre-requisite to calculate such indirect holding. This 'majority stake' requirement directly contradicts with look-through test suggested under SBO's definition. For instance, in a layered structure, if an individual holds 70% of ultimate holding entity, which in turn, holds 60% of the body corporate partner entity which holds 20% of reporting LLP, then, on a look through basis, the indirect holding of that individual in reporting LLP comes to 8.4% (i.e., less than 10% threshold) and therefore, SBO Rules should not trigger. However, going by majority stake criteria, since such individual hold more than half (i.e., 70%) of equity capital/voting rights in an ultimate parent entity and the body corporate partner entity holds more than 10% (i.e., 20%) in reporting LLP, he becomes an SBO for reporting LLP, although his indirect holding on a look through basis is well within 10% threshold.
- **Partnership firm being a partner:** Since only a body corporate or natural person can become a partner, a firm can become a partner of an LLP only through its partner who is an individual or body corporate, subject to necessary declarations under Rule 22B. Also, where an individual is acting as a partner on behalf of firm, there may not be any indirect holding so, practically, SBO Rules should apply only when a body corporate is a partner acting on behalf of a firm. Further, where a partnership firm (through its partner) holds at least 10% in reporting LLP and pursuant to the definition of 'majority stake', only if an individual hold more than one-half of the contribution, such partnership entity should be treated as an SBO. However, the explanation to SBO's definition considers all individual partner(s) of that partnership firm as SBO even if such individual partner(s) do not hold majority stake thus making the majority stake criteria prescribed for a firm infructuous.
- **Pooled Investment Vehicle (PIV):** SBO Rules do not explicitly define what would constitute a PIV. Globally, the investors often use non-fund structures (such as corporate vehicles, LLPs, and trusts) to operate a PIV and hence, adequate guidance is needed as to what SBO Rules construe to be within the ambit of PIV in such different structures. Also, it is unambiguously clarified that, in case of an offshore PIV (or an entity controlled by such PIV) being a partner of a reporting LLP and based in a member state of the FATF where the securities market regulator is a member of the International Organization of Securities Commission (IOSCO), an individual who is the general partner or investment manager of that PIV shall be an SBO. Where the investment manager is a body corporate or

partnership entity, the CEO of that manager entity needs to be considered as an SBO. Thus, in a scenario where general partner of PIV is not an individual, no SBO should be identified further. Notably, the limited partners of PIV are clearly excluded from being treating as SBO.

■ **Acting together:** SBO Rules have defined this expression in a much broader sense in order to bring into books an individual who may be acting together with any person or trust to exercise any right or entitlement. However, from reporting LLP's perspective, it may be practically difficult to track such arrangements and impose SBO compliances on such individual(s). For instance, where the individual is acting in concert with any other non-individual partner without the knowledge of LLP and no disclosure of such arrangement has been made, no practical guidance or steps have been provided for an LLP to bring those arrangement into books. Also, where the individuals are relatives, they are not deemed as 'acting together' by virtue of relationship itself and hence, unless they fulfil the criteria of 'acting together' as per SBO Rules, their individual holdings are not to be clubbed. These aspects become relevant while ascertaining the majority stake at the immediate partner entity or at an ultimate parent entity level.

d) **Voting and Profit Distribution Rights:** Under the LLP Act, the voting rights in respect of the management or policy decisions and profit distribution rights are governed by the terms of LLP agreement and they need not always correlate with the extent of contribution by the partners. So, if LLP agreement do not explicitly mention as to how such rights are distributed among the partners, then the provisions of Schedule I of the LLP Act<sup>8</sup> would prevail and as per which, generally, equal voting and profit distribution rights are conferred to all the existing partners irrespective of the contribution made by each of them. Resultantly, in such cases, all the body corporate partners of an LLP, by virtue of being the holders of equal rights as per Schedule I, may have to undergo SBO test by default, although the actual contribution of some of them may be less than 10% threshold.

e) **Control and Significant Influence:** These are subjective cum qualitative tests and are explicitly defined from an LLP's standpoint. As per SBO Rules, only an individual exercising control or significant influence over an LLP through indirect means (and not directly by virtue of contribution made in an LLP) needs to be treated as an SBO. However, what exactly amounts to 'control' and 'significant influence' needs a careful evaluation in view of fundamental structure of an LLP.

Unlike a company, there is no clear separation of management and ownership in an LLP structure. It is the partners who will assume both management and ownership rights (as per LLP agreement) considering only they can become the designated partners (apart from being the actual owners) and this basic feature of an LLP makes the ability of a partner to appoint majority designated partners practically infructuous. Also, as discussed above, unless LLP agreement specifically provide, by operation of law, every partner would get equal rights to vote and for profit sharing, leading to all the partners having equal and joint control over the affairs of an LLP. In such a case, the SBO test may have to be applied in respect of all existing body corporate partners (irrespective of percentage of their contribution). Notably, the 'control' has been defined to include holding it also by virtue of 'any other agreement or manner' thus, not limiting it only to the terms of LLP agreement. In case of any external investor or lender, who has been given affirmative voting rights on key operational matters either under LLP agreement or other investment or loan agreement, whether those rights amount to having actual voting rights or control or significant influence needs to be evaluated in the context of LLP. In case of a company, based on some case laws, there seems to be a clarity that such rights should not amount to 'control' as they only signify a 'negative' and 'reactive' power. Additionally, an individual SBO is obligated to provide the agreement copy, through which he has acquired significant influence and/or control over reporting LLP, while declaring his significant beneficial ownership to reporting LLP

Further, what would constitute participation in financial and operating policy decisions of an LLP is unclear. Every designated partner in case of an LLP and the key executives and/or board of directors of body corporate partners of an LLP (including such executives / directors of their ultimate parent entities) generally participates in financial and operating policy decisions. Should they be treated as an SBO for an LLP? Going by the intent of SBO Rules, it should not be the case since these persons exercise such powers under the law by virtue of the position they hold.

## CONCLUDING THOUGHTS:

An LLP as a structure has gradually become a popular business model for many reasons. Bringing LLPs within the regulatory framework of identifying and reporting of SBOs compliances, quite in similar lines with the obligations that are already applied for the companies, reflects that the Government's efforts are now directed towards enhancing transparency levels in terms of ultimate beneficial ownership of LLP structures also. The initiative of issuing SBO Rules has been applauded for its potential to improve overall transparency in ownership, strengthening corporate governance, and foster trust in the business ecosystem. However, the overall impact and effectiveness of these SBO Rules would be assessed over time as they are implemented, and their implications become clearer.

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You can direct your queries or comments to the authors.

<sup>1</sup> Available at <https://www.mca.gov.in/bin/dms/getdocument?mds=pJZasqhxL5W9F46Ukp5lw%253D%253D&type=open>.

<sup>2</sup> Available at <https://www.mca.gov.in/bin/ebook/dms/getdocument?doc=MTE3OTE3MTA=&docCategory=Notifications&type=open>

<sup>3</sup> Available at [https://www.mca.gov.in/Ministry/pdf/CompaniesSignificantBeneficial1306\\_14062018.pdf](https://www.mca.gov.in/Ministry/pdf/CompaniesSignificantBeneficial1306_14062018.pdf)

<sup>4</sup> Available at [https://www.mca.gov.in/Ministry/pdf/CompaniesOwnersAmendmentRules\\_08020219.pdf](https://www.mca.gov.in/Ministry/pdf/CompaniesOwnersAmendmentRules_08020219.pdf)

<sup>5</sup> Available at <https://www.mca.gov.in/bin/ebook/dms/getdocument?doc=Mzc2OTA4ODA4&docCategory=NotificationsAndCirculars&type=open>

<sup>6</sup> Available at [https://www.mca.gov.in/Ministry/pdf/General\\_Circular\\_13\\_2013\\_LLP.pdf](https://www.mca.gov.in/Ministry/pdf/General_Circular_13_2013_LLP.pdf)

<sup>7</sup> Available at [https://www.mca.gov.in/Ministry/pdf/General\\_Circular\\_2\\_2016.pdf](https://www.mca.gov.in/Ministry/pdf/General_Circular_2_2016.pdf)

<sup>8</sup> Available at [https://www.mca.gov.in/content/dam/mca/pdf/LLP\\_Act\\_2008\\_15jan2009.pdf](https://www.mca.gov.in/content/dam/mca/pdf/LLP_Act_2008_15jan2009.pdf)

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