

Understanding The Need for Clear Rules on Layering Restrictions and Clarity of The Applicability of The WOS Restriction.

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Abstract—In India, the advent of the concept of corporate layering has revolutionized the environment of corporate structuring, corporate governance and cross-border transactions. These rules, which were introduced to prevent financial irregularities, financial fraud and to promote transparency, are now giving rise to a lot of interpretation hassles, particularly under the Companies Act, 2013 and the framework of the Foreign Exchange Management Act (FEMA). This paper reviews the corporate layering framework in India and looks into the ambiguity created by the Companies (Restriction on Number of Layers) Rules, 2017 and Foreign Exchange Management (Overseas Investment) Rules, 2022. It breaks down the conceptual distinction between horizontal layering and vertical layering, looks at the regulatory conflict and uncertainty of the Wholly Owned Subsidiary (WOS) exemption, and considers the regulatory conflict between various definitions of an "investment company". Moreover, this article compares the regulatory framework in India, which, if anything, is even more structural than the one in the United States and Japan, in their current stages, ex post, to the national ex-ante prohibitions. Further, the current ex post, disclosure and tax-driven regulatory regimes of the United States and Japan are compared to the ex-ante structural prohibitions in India. From this synthesis, we are proposing a harmonized and risk calibrated regulatory roadmap that gives a balance between transparency for the companies and the flexibility they need in their structures to operate in the modern global business structure.

I. INTRODUCTION: GENESIS AND EVOLUTION OF STRUCTURAL INTERVENTION.

The move towards limiting multi layered corporate structures in India is for regulatory reason, after all some historical instances of systemic manipulation of the stock market occur, in India in 2001 during the stock market crisis (Ketan Parekh's scam). In its wake,

the Joint Parliamentary Committee (JPC) and the Department of Company Affairs (DCA) realized that public money was routinely misappropriated by promoters through the "subsidiary route", circular transactions and the concealment of the actual beneficial owner of the money the "ultimate beneficial owner" (UBO). Structural screens were used in complex corporate setups to allow companies to evade investment thresholds and back to market through market intermediaries or associates.

The Indian lawmakers adopted a more proactive approach to the structural issues by moving from ex-post disclosure to ex-ante structural interventions to plug the structural loopholes. The inter-corporate loans and investments were governed by the Companies Act, 1956, through transaction-based scrutiny under Section 372A of the Companies Act. On the other hand, the Companies Act, 2013, brought about physical structural constraints. Section 186(1) of the Act prohibits a company from investing using two or more layers of investment companies and the proviso to Section 2(87) allows the CG to limit vertical layers of investment companies in the holding companies it wishes to allow.

These statutory provisions finally led to notification of the Companies (Restriction on Number of Layers) Rules, 2017 (the "Layering Rules"). The Layering Rules set up a blanket cap of 2 vertical layers of subsidiaries. But there are some carve-outs in the rules that are unclear, notably the carve-out for wholly owned subsidiaries ("WOS Exemption"). These ambiguities have come into conflict with subsequent international investment guidelines, such as the Foreign Exchange Management (Overseas Investment) Rules, 2022 (the "OI Rules"), leading to a challenging compliance environment for both cross-border and domestic corporate groups.

II. RELEVANT THEORIES AND ECONOMIC BASIS FOR CORPORATE PYRAMIDS

To assess the effectiveness of layering constraints, the economic motivations that underlie corporate groups' use of multi-layered, pyramidal structures must be explored. A multi-layered structure from a corporate finance point of view has a number of valid economic uses. One of the primary uses of holding companies is to separate risks of certain projects, assets, and jurisdictions by using step down subsidiaries.

The liability partitioning shields the parent company's balance sheet from a single-point failure in their operation. Second, pyramidal structures smoothen the flow of capital within the corporate group by enabling the pooling of resources, smooth reallocation of capital between entities and lower the external borrowing rate. Last but not least, separate corporate layers allow local partners or VC investors to participate at certain project levels, while keeping the parent holding level in control. These advantages come with huge agency costs, however. Pyramidal structures separate cash flow rights from voting rights, allowing the controlling shareholders to have a large amount of control over lower tier subsidiaries, and few economic stakes. This structural imbalance can result in the transfer of assets, profits and/or business opportunity from the lower tier subsidiary (where majority is concentrated with minority shareholders) to the upper tier company, which is entirely controlled by the promoters.

Additionally, there is informational asymmetry due to multiple levels of the corporations. Adding layers to the forensic audit or tracing the fund flows adds to the administrative burden in an exponential manner. The complex corporate structures may confuse the tax obligations and UBO information for regulators, which can lead to hidden tax obligations and UFTs. This tension is therefore addressed by the concept of restrictions on layering restrictions to reduce agency costs of pyramids, while maintaining the flexibility of corporate groups.

III. THE INDIAN LAYERING RULES ARE DECONSTRUCTED TO UNCOVER AMBIGUITIES.

Although the language and structure of the Layering Rules are complex, they are also unclear in some respects, which creates compliance issues.

A. Horizontal vs. Vertical Layering

According to Rule 2(1) of the Layering Rules, "no company shall have more than two layers of subsidiaries. One of the main arguments is against vertical versus horizontal structures (step-down subsidiaries versus multiple direct subsidiaries under one parent). Under Explanation (d) to section 2(87) of the Act, "layer" means "its subsidiary or subsidiaries" for a holding company, but the view of the corporate practitioners is that the restriction only applies to vertical layers. An unlimited number of direct, horizontal subsidiaries are allowed under a holding company. The rules, however, do not specifically cover the issue of asymmetric vertical structures (e.g., the subsidiary on one level is a horizontal subsidiary, while the other subsidiary is not), and therefore may provide for different interpretations.

B. The dilemma of the 'Wholly Owned Subsidiary' (WOS) exemption.

The second proviso to Rule 2(1) states:

Further, under this rule, one layer comprising one or more wholly owned subsidiary or subsidiaries shall not be taken into account when computing the number of layers under this rule.

This language does not say what layer (WOS) this exempted WOS layer must be located at in the vertical hierarchy. There have been two main interpretations:

Contiguous/Direct Layer Interpretation: It is claimed that the WOS exemption applies only to a first-tier subsidiary of the parent company. Consequently, where all of the assets of the first layer are wholly owned subsidiaries, that layer is considered transparent and the second is considered to be the first operational layer. If the parent owns a WOS, which in turn owns an 80% subsidiary, and a subsidiary with a 51% subsidiary, the first layer of WOS is ignored and exactly two layers of subsidiaries are counted.

The Flexible Layer Interpretation: This view is that any layer of the vertical chain of WOSs can be dropped, no matter where it is located. For example, if the first layer consists of 80% subsidiaries and the second layer consists of WOSs, then this second WOS layer would not be included in the computation and a third layer of subsidiaries could be placed underneath. The uncertainty on this issue makes it difficult for companies to plan joint ventures and acquisitions,

since there is the possibility of non-compliance if the interpretation of the WOS exemption is different from the Registrar of Companies (RoC).

C. The Offshore Acquisition Exemption

The first proviso to Rule 2(1) allows a company to not be subject to layering limit when it is a "company incorporated outside India with subsidiaries more than two layers as per the laws of the country.

This clause leaves an unanswered question regarding the distinction between "acquisition" of a foreign entity already in existence and "incorporation" of a new offshore holding company. A literal interpretation would indicate that one Indian company may take over an existing foreign group and its three-tiered structure; however, that same Indian company would not be able to form an entirely new foreign group and its three-tiered structure, even if the latter type of structure were necessary for the Indian company's regional operations. This differentiation treats greenfield overseas investments less favourably than brownfield investments, which does not necessarily follow the principle of a policy aimed at achieving economic objectives.

IV. THE INTERFACE BETWEEN THE FEMA OVERSEAS INVESTMENT (OI) REGIME (2022) AND THE COMPANIES ACT

With the Foreign Exchange Management (Overseas Investment) Rules, 2022 ("OI Rules"), the regulatory framework for corporate layering became more complex. The previous foreign exchange regime was very restrictive with regards to "round tripping" as the Reserve Bank of India (RBI) felt that tax avoidance and money laundering were issues. This framework has been relaxed in the 2022 OI Rules which allow for structures where an Indian resident makes an Overseas Direct Investment (ODI) which subsequently leads to a Foreign Direct Investment (FDI) into India. However, Rule 19(3) of the OI Rules contains a very restrictive structure condition:

No person resident in India shall make financial commitment in a foreign entity that makes or makes a financial commitment in India at the time of the financial commitment or at any time thereafter, directly or indirectly, in a manner which creates a two or more layers of subsidiaries.

This rule generates a substantial conflict of interests with the domestic Layering Rules:

The non-existence of a WOS Exemption in FEMA

The Companies Layering Rules provide for the exclusion of one layer of WOSs but Rule 19(3) of the OI Rules do not include such carve-out. Therefore, for cross-border circular structures (ODI-FDI), all individual layers of a subsidiary must be taken into account, even wholly owned subsidiaries. For instance, it involves three layers under FEMA: an Indian Parent, an offshore WOS holding company, and an offshore operating subsidiary and an Indian operating joint venture. Even if this structure is incorporated into the Companies Act through the domestic WOS exemption, it would be a breach of foreign exchange regulations.

The definition of "Subsidiary" is different in other Jurisdictions.

The Companies Act, 2013, provides for a subsidiary relationship on the basis of control over the composition of the board of directors of the company or more than 50% of the voting rights. The OI Rules, however, apply to offshore entities, and their definition of "subsidiary" or "control" may differ from that given in the IFRS Standards, for example, using the economic interest approach or consolidation based on local accounting standards. A domestic, two-layer definition for foreign jurisdictions creates compliance issues for multinational groups.

Retroactive Non-Compliance Risks

The prohibition on round tripping of multi-tiered subsidiaries is found in Rule 19(3) and is in effect "at the time of such commitment or at any time thereafter. In the case of a foreign company with two layers of subsidiaries offshore, and the Indian company being the minority shareholder of the foreign company investing in the foreign company, the Indian investor may be considered to have fallen out of compliance under the FEMA rules in the case of incidental portfolio investment. This risk also makes outbound investments more complicated because Indian investors may not be able to stop the foreign partner from making downstream investments in India and that the risk of this may be borne by the Indian investors.

V. THE ISSUE OF REGULATORY OVERLAP AND THE "INVESTMENT COMPANY" MISMATCH.

The other hurdle in the Indian corporate regulatory regime is the differing definition of "investment companies" given by various regulators.

Under the definition of an "investment company" under Section 186 of the Companies Act 2013, an investment company is a company whose main business is the acquisition of shares, debentures or other securities. A company is considered to be principally engaged in this business if its investment assets account for 50% or more of the total assets, or if its investment income accounts for 50% or more of its gross income, under the explanation to Section 186. According to the Layering Rules, Rule 2(2), the systemically important Non-Banking Financial Companies (NBFCs) registered with the RBI would be exempt from the two-layer cap. But numerous holding companies and Core Investment Companies (CICs) fall below the asset size criteria laid down for registration as "systemically important" with the RBI, or may be even not be required to be registered.

Therefore, if a large, systemically important investment company has full structural flexibility, smaller and mid-sized holding companies will have to keep to the strict two-layer cap. This regulatory mismatch is a barrier for smaller enterprise groups to leverage special holding company structures to fund and control the operating subsidiaries and hence to scale up.

VI. THE COMPARATIVE ANALYSIS OF THE DIFFERENT APPROACHES IN JURISDICTIONS IS EX-ANTE PROHIBITION VERSUS EX-POST SCRUTINY.

The regulatory policies of India, US and Japan are unique strategies for the different regulatory environment and enforcement capacity in dealing with the complexity of companies. India's ex-ante structural prohibition is directly based on the rules, and is strictly applicable to the vertical subsidiary tiers. This reduces the administrative burden on regulators, but on the other hand creates a major structural burden on corporate groups, given the limited scope of legitimate strategies and global expansion plans. The U.S. has a soft-touch ex-post regulatory approach based on tax

compliance and market disclosure. The Internal Revenue Code (IRC) provisions, such as the Controlled Foreign Corporation (CFC) and Global Intangible Low-Taxed Income (GILTI) provisions, work against any artificial offshore layers and tax passive income repatriated to low tax jurisdictions. Also, interrelated entity transfer pricing rules on Section 482 provide for arm's length pricing. This is supplemented by the stringent disclosure demands imposed on public companies by the Securities and Exchange Commission (SEC), including e.g. Exhibit 21 of Form 10-K, to the effect that the companies are required to disclose all significant subsidiaries and their jurisdictions of incorporation.

In Japan, the main method of preventing company abuse is through corporate governance structures and standards, not through physical structural bans. The Tokyo Stock Exchange (TSE) Listing Codes and the Financial Instruments and Exchange Act (FIEA) provide for the listing of both parent companies and their subsidiaries (Oya-kojoso). These standards are directed towards protecting minority shareholders against being exploited, and include provisions to ensure the boards of subsidiaries are given operational independence and all transactions between the parent and subsidiary are on arm's length terms.

The primary difference is the "trade-off" between the UK and India, where the former allows for greater flexibility in corporate design, thus resulting in higher administrative costs for regulatory oversight and audit, while the latter has lower ex-ante costs that can lead to higher ex-post costs of enforcement and audit.

VII. POLICY RECOMMENDATIONS AND STRATEGIC REFORMS

We recommend a few specific policy changes in the Indian regulatory regime to address the ambiguities in the system, while ensuring transparency and flexibility in its functioning.

Make the Exemption in the WOS clearer.

The Ministry of Corporate Affairs (MCA) should, inter alia, clarify the vertical application of the WOS exemption in the Layering Rules. In particular, the exemption should be made clear and provide that the exempted WOS layer should be the first vertical tier immediately under the ultimate holding company. Clearly defining this location will remove any

ambiguity, ease compliance and offer clarity when restructuring.

This will involve harmonizing FEMA and Companies Act frameworks.

The OI Rules should be harmonized with Companies Act Layering Rules by the Ministry of Finance and the RBI. There should be a WOS exemption similar to that in the domestic Layering Rules in Rule 19(3) of the OI Rules. This will avoid instances where a corporate structure is allowed under the Companies Act, but may be a violation of FEMA and will complement the government's "ease of doing business" campaign.

We will need to reconcile the definitions of "Investment Company" with one another.

The exemptions in Rule 2(2) of the Layering Rules should be extended. The definition of exemptions should not be confined to 'systematically important' NBFCs, but should cover all the Core Investment Companies (CICs) and holding companies which hold equity stakes in group operating companies and do not accept public deposits. This will enable smaller and medium businesses to take advantage of holding company arrangements.

Risk-Calibrated Disclosure Model move to this model
On a longer-term basis, India needs to move from the rigid structural cap to a disclosure regime based on risk, like the US and the Japanese approaches. In non-sensitive industries, a more flexible two-layer limit may be replaced by the requirement for better reporting. According to this approach, businesses with more than two layers would be expected to have a comprehensive register of the Ultimate Beneficial Owners (UBO) up to the natural person level and provide this information in real time. This would mean transparency for regulators to stop any financial irregularities and not restrict corporate structures.

VIII. CONCLUSION

The corporate layering restrictions implemented in India were a direct consequence of previous events of financial misconduct and manipulative market practices. These rules have so far succeeded in slowing the growth of shell companies, but there are practical problems in corporate governance, joint ventures and international transactions that arise from the strict ex-ante structure of these rules.

It is notable that there is a conflict between the Companies Act, 2013, and the FEMA OI Rules, 2022, which highlights the importance of a synchronized regulatory framework. The exemption for WOS, the definition of cross-border and domestic investments, and the use of modern oversight mechanisms based on disclosure principles pave the way for a more sophisticated regulatory regime in India. Such changes would enable regulators to continue to have high expectations for corporate transparency and would give businesses the flexibility they need to be competitive in the global market.