Regulatory overreach on holding structures

The Companies (Restriction on number of layers) Rules, 2017 represent the government’s latest gambit in its continued assault against opaque fund-raising activities, black money, and shell companies. The government has already commenced a massive drive to voluntarily strike off dormant companies from the registry and crackdown on shell companies which have been traditionally perceived to be conduits for siphoning and diversion of funds. In tandem, the government has also begun an unprecedented exercise of naming and shaming directors on the boards of these so-called shell/ dormant companies which have been struck off the register as a strong dose of deterrence.

Briefly put, the Rules require both operating and investment companies to not have more than two layers of subsidiaries, with wholly owned subsidiaries being excluded from the count. With good sense having prevailed, this requirement will apply prospectively and all current structures get grandfathered. Companies have also been provided the liberty to reduce the number of layers—however, with a prohibition on reintroducing the folded layers. A filing in Form CRL-1 is required within a period of 150 days, disclosing details of the subsidiaries in the holding structure beyond two layers. The Rules do not apply to banking companies, systemically important non-banking financial companies, insurance companies and government companies.

Accordingly, it is not immediately clear whether an operating company that holds an exempted entity would need to comply with the restrictions under the Rules, which would not be applicable to its exempted subsidiary. Further, the Rules do not impose any restriction on Indian companies looking to acquire holding structures abroad beyond two layers, provided such structures are permissible under local law.

At the outset, the Rules interfere with the ability of entrepreneurs to structure their business activities in the manner they deem suitable. Pertinently, group-holding structures are commonplace worldwide as a legitimate means to ring-fence and delimit risk. This is socially desirable as it lowers the cost of capital and thereby incentivizes entrepreneurial risk-taking.

The aim of regulation should be to provide a conducive environment for risk-taking and also curtail strategic action. Clearly, where the government is not extending risk capital to entrepreneurs, the government should not be bothered with the manner in which the entrepreneur wishes to arrange his holding structure so long as the entrepreneur is otherwise compliant with the laws of the land, paying taxes and making disclosures. Critically, the Rules clamp down on operating subsidiaries and not pure investment entities which are already covered by the restriction under the Companies Act, 2013 that mandates that entities cannot have more than two layers of investment holding companies.

Interestingly, while the JJ Irani Committee acknowledged the possibility of abuse of multilayered structures, it noted that capping the number of subsidiaries and regulatory intervention in group organizations is a sub-optimal means of achieving the intended policy goal of checking abusive routing and diversion of funds. The committee instead borrowed from American judge Louis Brandeis who had remarked years ago that sunlight is the best disinfectant. It nudged the government towards choosing robust disclosure in relation to the raising and utilization of the funds or loans and advances given by entities within group structures. Plainly, it apprehended that regulations such as the current Rules could render Indian companies less competitive than their foreign counterparts.

Given the phalanx of anti-abuse provisions in the Income-Tax Act, 1961, the expansive deposit rules and limits of lending to interested directors, and minority protection devices and safeguards such as majority of minority voting rules, vetting by the audit committee under company law to check the menace of related-party transactions and illicit financing, the need for restricting the number of subsidiaries and layering by Indian companies appears to be a case of regulatory overreach. This sort of regulatory intervention imposes unnecessary costs that are a drag on business and entrepreneurship.

The government is already collecting vast amounts of information from regulatory filings and tax returns. The requirement under the Rules to file detailed data regarding holding structures from all companies along a holding chain is duplicative and will inundate the government with data, which requires time and effort to sift through and make sense of. While these new disclosures can be taken positively as injecting further transparency, one must be wary of the costs of information overload and the incremental benefits to the regulatory apparatus that is already overburdened and overworked.

The last few years have witnessed a slow yet steady export of our capital markets with start-ups and technology companies choosing foreign bourses to raise capital due to the ease of listing and compliance costs. These Rules could further hasten the flight of more entrepreneurs towards friendlier business jurisdictions like Singapore that offer a flexible business environment and permit entrepreneurs to focus on running the business rather than burdensome compliance.

The Rules and the restriction on the number of subsidiaries is not what India needs at a time when it is seeking an image makeover and move northwards in the global ease of doing business index.

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