Related Party Transactions

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India is characterised by concentrated ownership and by the widespread use of company groups, often in the form of pyramids and with several layers. One study of the 1470 companies listed on the NSE indicated that as of March 2010 promoters held 57 per cent of all shares and institutional shareholders about 20 per cent (Bhardwaj, 2011). Some studies suggest that related party transactions (RPTs) have been detriment to the interest of minority shareholders and to valuations of those companies. Using a sample of 600 of the 1000 largest (by revenues) listed companies in 2004, one study found that firm performance is negatively associated with the extent of RPTs for group firms (Chakraborty et al., 2008).

In India, complex structures have evolved overtime to optimise on tax or labour cost, create silos to protect against unlimited liability, operate in different jurisdictions or with different partners. Additionally, family structures and promoter shareholding in Indian companies also remains very elevated relative to global companies. Whilst there are multiple reasons for group structures and transactions between them, some of which are necessary for various reasons there is no denying that group structures have also been used to create inequitable treatment of minority shareholders by the controlling shareholders and to carry out questionable or illegitimate activities, that are egregious to minority and other stakeholders.

RPTs that treat shareholders inequitably or oppress minority tend to damage capital market integrity. Therefore, RPT's covering both equity and non-equity transactions, is an important corporate governance and regulatory issue, dogging the mind of the regulators. There is a clear concern globally that such transactions can be abused by insiders such as executives and controlling shareholders and hence need to be regulated or monitored. Searching for the right balance in developing an anti-abuse legislation is a difficult but ongoing process.

Under Companies Act 2013, shareholder's approval is required only if RPT is not at arms-length or not in the ordinary course of business and the transactions exceeds a particular turnover or net worth threshold of the Company. Besides the requirement of Companies Act did not cover transactions between subsidiaries. As per pre-revised LODR regulation, all material related party transaction (exceeding ten percent of the annual consolidated turnover of the listed entity) required approval of the shareholder, but those requirements did not apply to unlisted subsidiaries or transactions between subsidiaries. Either the materiality thresholds were very high, or RPTs were being routed through unlisted subsidiaries. Therefore, many RPT's were not required to be approved by the shareholders of the listed parent either as per SEBI LODR regulation or Companies Act, even if those were egregious. Amendment to SEBI LODR, Regulation 23, was the need of the hour. Accordingly, the definition of Related Parties, RPT's and approval mechanism were strengthened to include transactions which may be undertaken with the intention of benefitting related parties.

It is with this background that SEBI amended the related party legislation comprehensively, and in doing so, ensured that a fine balance is achieved between compliance burden and addressing the concerns relating to egregious transactions carried out against minority shareholders. Corporate and institutional investors were provided with sufficient opportunity to make representations and provide suggestions. Most of the requirements of the revised RPT legislation apply with effect from 1 April, 2022, though some provisions would kick in with effect from 1 April, 2023.

First and foremost, the definition of related parties and RPT's, needed some change. The share price of a listed entity is not based on performance of the listed entity alone, but of the entire group, including the subsidiaries. It was also observed that unlisted subsidiaries of listed entities to which shareholders of listed parent had no access, were often used as a conduit to carry out egregious transactions. Therefore, it was important that good governance trickled down to the entire structure.

To give effect to this, the RPT was defined to be between "the listed entity or any of its subsidiaries on the one hand, and a related party of the listed entity or any of its subsidiaries on the other hand". Listed subsidiaries were exempted from complying with the requirement of audit committee or shareholder's approval of listed parent, because the listed subsidiary would in any case be subjected to those requirements. To soften the compliance burden, prior approval of the listed parent's audit committee with respect to RPT's by the unlisted subsidiary, is required only if the value of the transaction exceeded 10% of the total annual standalone turnover of the subsidiary.

Sometimes to conceal RPT's a conduit is used between two related parties. As an anti-abuse measure, the regulations were amended to include transactions within the ambit of RPT's, "the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries." Many entities wanted this term to be defined by SEBI. In the authors view, no purpose would have been served by any guidance on this term, because, entities know best, whey they have used a conduit. On the other hand, entities that do not use a conduit, have nothing to fear. As such, retaining the concept, using a principle-based approach rather than a rule-based approach was felt to be more desirable.

The definition of related parties was expanded to include any person or entity belonging to the promoter or promoter group of the listed entity. In the previous regulations, the requirements applied only if the holding of the promoter or the promoter group exceeded 20% or more of the shareholding. Additionally, the requirements

were also extended to shareholders holding 20% shares or more, but which was reduced to 10% with effect from April 1, 2023. Experience suggests that 10% shareholding is sufficiently large in the Indian context to influence a RPT in a way that is egregious to minority shareholders. Many constituents felt that this would substantially expand the list of related parties as large financial institutions in India are permitted to have a holding of greater than 10% in the shareholding of the listed entity. However, a list of such shareholding is not expected to be very large, besides, transactions with these related parties are unlikely to breach the materiality threshold required for shareholder's approval.

A transaction with a related party shall be considered material, and therefore requiring shareholder's approval, if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds rupees one thousand crore or ten per cent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity, whichever is lower. Many entities did not want a monetary materiality threshold; however, a one thousand crore monetary limit was felt to be quite significant for shareholders to be involved in approving such transactions. Whether or not, such a monetary threshold should be further increased by SEBI, can be judged only if the number of resolutions coming for shareholders for approval is disproportionately large. At this stage, the monetary threshold of one thousand crores appears reasonable, because it is applied to all transactions in a particular annual period, with respect to a related party.

Under the new regulations only independent directors can vote and approve a RPT. The SEBI, vide a circular dated Nov 22, 2021 has prescribed the information to be placed before the audit committee for approval of a proposed RPT. The circular requires detailed information to be provided to the audit committee. One of the details requires tenure of the proposed transaction to be specified. Therefore, every related party contract subjected to audit committee approval will need to have a fixed tenure. This was necessary to plug the loophole, where entities did not have a fixed tenure to a related party contract, thereby, giving them a free hand to milk the company eternally.

SEBI has exempted certain corporate actions by the listed entity, which are uniformly applicable to all shareholders, from the RPT definition. This covers rights issue or bonus issue, buyback, dividend, etc. However, the use of the words "*by the listed entity*" has resulted in confusion as to whether corporate actions by the subsidiaries of the listed entity are also carved out. SEBI may provide appropriate clarifications in this regard.

SEBI in amending the RPT legislation, has taken a bold but balanced initiative, which is commendable. SEBI has been reasonable in, protecting minority interest on the one hand, and ensuring that entities are not over-burdened with compliance requirements. SEBI as a pro-active and reasonable regulator will certainly look into these regulations, on an ongoing basis, and tweak them if necessary. Certainly, a sweet spot has been found in the amended RPT legislation.