

Chapter 2

SEBI reviews norms relating to related party transactions



This article aims to:

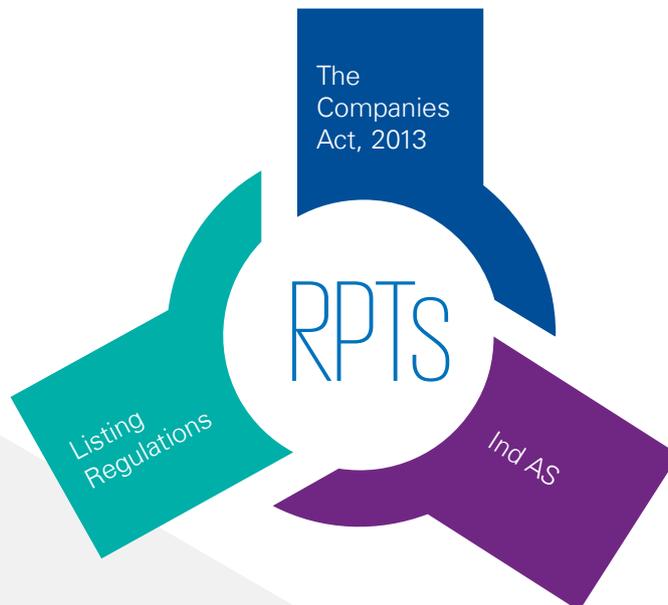
Summarise key recommendations of the SEBI working group on related party transactions.

Background

Related party relationships are a normal feature of commerce and business. For example, entities frequently carry on parts of their activities through subsidiaries, joint ventures and associates. In those circumstances, the entity has the ability to affect the financial and operating policies of the investee through the presence of control, joint control or significant influence.

A related party relationship could have an effect on the profit or loss and financial position of an entity. Related parties may enter into transactions that unrelated parties would not. For example, an entity that sells goods to its parent at cost might not sell on those terms to another customer. Also, transactions between related parties may not be made at the same amounts as between unrelated parties.

Applicable frameworks



For Related Party Transactions (RPTs), the corporates in India comply with Ind AS and the Companies Act, 2013 (2013 Act). Additionally, the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) provides regulatory framework for the listed entities to comply in case of RPTs.

In May 2018, SEBI amended the Listing Regulations on various topics including RPTs based on the recommendations of the Committee on Corporate Governance constituted by SEBI under the chairmanship of Uday Kotak (the Kotak Committee).

New development

In order to strengthen regulatory norms in relation to RPTs undertaken by listed entities in India, SEBI constituted a working group in November 2019 to review the provisions pertaining to RPTs under the Chairmanship of Mr. Ramesh Srinivasan.

The working group consisted of officials from Primary Market Advisory Committee (PMAC), industry, professional bodies, stock exchanges, intermediaries, proxy advisors, lawyers, etc. The working group reviewed the approval mechanisms for RPTs and revisited disclosure requirements relating to information relevant for the persons (including shareholders, where required) involved in the approval mechanism.

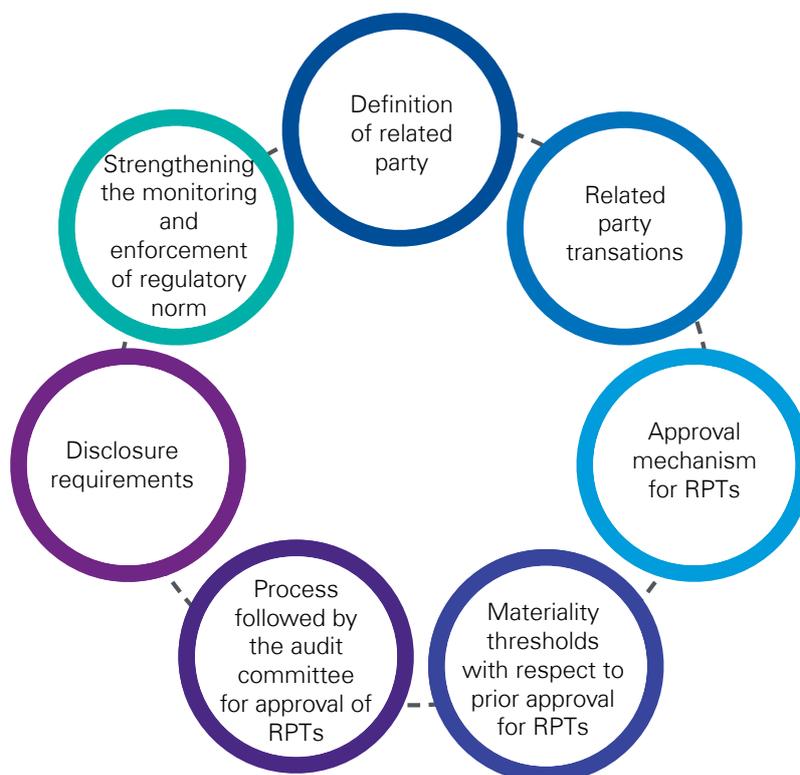
The working group submitted its report to SEBI on 22 January 2020, which includes recommendations of the working group along with the rationale for such recommendations. The SEBI has, subsequently issued the report for public comments with the timeline of 26 February 2020.

This article aims to summarise key recommendations of the working group report.

Recommendations

The recommendations in the report suggest changes to current regulatory framework by amending certain provisions of the Listing Regulations.

The recommendations of the working group have been consolidated into seven themes as described in the diagram below.



1. Definition of related party

Background

Listing Regulations define related party as defined under both the 2013 Act and the applicable accounting standards (or Ind AS). Additionally, any person or entity belonging to the promoter or promoter group of the listed entity and holding 20 per cent or more of shareholding in the listed entity would be deemed to be a related party.

Recommendation

The working group proposes that all persons or entities belonging to the 'promoter' or 'promoter group', irrespective of their shareholding in the listed entity, should be deemed to be related parties. Additionally, it is proposed to include significant shareholders within the purview of 'related parties even if they do not form part of the 'promoter' or 'promoter group'. Therefore, similar to the provisions of the 2013 Act and Ind AS 28, *Investments in Associates and Joint Ventures*, a shareholder or any entity would be considered as a related party when directly or indirectly (including their relatives) hold 20 per cent or more of the equity shareholding in the listed entity.

2. Related party transactions

Background

As per Listing Regulations, related party transaction means transfer of resources, services or obligations between a listed entity and a related party regardless of whether a price is charged or not and a 'transaction' with a related party would be construed to include a single transaction or a group of transactions.

Recommendation

The working group recommended broadening the definition of RPTs to include transactions which are undertaken, whether directly or indirectly, with the intention of benefitting related parties. The definition of related party transactions should be amended and the proposed definition includes transactions carried out between:

- i. 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 or



- ii. The listed entity or any of its subsidiaries on the one hand and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries.

The above transactions would be considered as RPTs regardless of whether a price is charged.

Additionally, it is proposed to exclude certain transactions which have similar effect for all shareholders such as payment of dividend, sub-division or consolidation of securities, buy-back, rights and bonus issue of securities. The transactions which are specifically provided under other regulations, such as preferential allotment, would also be excluded from the purview of RPTs.

3. Approval mechanism for RPTs

Background

Currently, Listing Regulations and the 2013 Act provide approval mechanism for RPTs. Listing Regulations require approval of the audit committee for all RPTs, whereas Section 188(1) of the 2013 Act, requires approval of the board of directors of the company for specific RPTs, with an exemption for transactions in the ordinary course of business and on an arm's length basis.

Additionally, Listing Regulations require approval of shareholders for all material RPTs and for transactions listed in Section 188(1) of the 2013 Act exceeding specified threshold, with an exemption for transactions in the ordinary course of business and on an arm's length basis.

Recommendation

Considering the current regulatory framework governing transactions of subsidiaries of a listed entity, the working group recommended to strengthen the laws for regulation and oversight of RPTs undertaken by a subsidiary with the related parties of the listed entity or its subsidiaries. It is recommended that prior approval of the audit committee of the listed entity should be made mandatory for all RPTs and subsequent material modifications.

A RPT to which a subsidiary of a listed entity is a party (but the listed entity is not a party) would require prior approval of the audit committee of the listed entity only if the value of such transaction (whether entered into individually or taken together with previous transactions during a financial year) exceeds 10 per cent of the annual total revenues, total assets or net worth of the subsidiary (on a standalone basis) for the immediately preceding financial year, whichever is lower.

An exception from taking approval of the audit committee and shareholders of the parent listed entity (subject to materiality thresholds) should be given for listed subsidiaries, since they are independently subject to the Listing Regulations framework on RPTs. Further, the working group suggested that an explanation be added to clarify that for RPTs of unlisted subsidiaries of a listed subsidiary, prior approval of the audit committee or shareholders, as applicable, of the listed subsidiary would suffice.

Additionally, in line with the exemption given to transactions between a holding company and its wholly-owned subsidiary from the requirements of audit committee and shareholders' approval, it is recommended that transactions between two wholly-owned subsidiaries of the listed holding company should be exempt from these requirements.

4. Materiality thresholds with respect to prior approval for RPTs

Background

Regulation 23 of the Listing Regulations requires approval of the shareholders for RPTs, which individually or taken together with the previous transactions during that financial year exceed 10 per cent of the annual consolidated turnover of such entity in accordance with the last audited financial statements.

Whereas, the 2013 Act exempts RPTs carried out in the ordinary course of business and which are on an arm's length from the requirements of shareholders' approval.

Recommendation

The working group deliberated on the current framework and suggested to reduce the percentage threshold for materiality and also introduce a numerical threshold for seeking shareholders' approval for RPTs.

It is recommended that the materiality threshold in Regulation 23(1) may be amended to 5 per cent of the annual total revenues, total assets or net worth of the listed entity on a consolidated basis or INR1,000 crore, whichever is lower. Further, the net worth criterion would not apply to companies with negative net worth. Companies would be permitted to specify a lower materiality threshold as per their RPT policies.

5. Process followed by the audit committee for approval of RPTs

Background

Regulation 18 of the Listing Regulations requires all listed entities to constitute an audit committee. Additionally, Listing Regulations cast responsibility on an audit committee for approving RPTs. However, there is no specific requirement on the minimum information that should be provided to the audit committee while seeking approval for a proposed RPT.

Recommendation

After deliberations, the working group suggested that the management of the listed entity should mandatorily

provide the prescribed information to the audit committee for approval of a proposed RPT such as:

1. Type, material terms and particulars of RPT
2. Name of the related party and its relationship with the listed entity or its subsidiary, including nature of its concern or interest (financial or otherwise)
3. Tenure of the transaction
4. Value of the transaction
5. The percentage of the listed entity's annual total revenues, total assets and net worth, on a consolidated basis, that is represented by the value of the proposed RPT (and for a related party transaction involving a subsidiary, such percentage calculated on the basis of the subsidiary's annual total revenues on a standalone basis)
6. Where the transaction relates to any loans, inter-corporate deposits, advances or investments made or given by the listed entity or its subsidiary:
 - a) Details of the source of funds in connection with the proposed RPT
 - b) Where any financial indebtedness is incurred to make or give loans, inter-corporate deposits — nature of indebtedness, cost of funds, and tenure
 - c) Applicable terms, including covenants, tenure, interest rate and repayment schedule, whether secured or unsecured and if secured, the nature of security
 - d) The purpose for which the funds will be utilised by the ultimate beneficiary of such funds pursuant to the RPT
7. Justification as to why the RPT is in the interest of the listed entity
8. A copy of the valuation or other external party report, if any such report has been relied upon and
9. Any other information that may be relevant.

6. Disclosure requirements – Information to be provided to shareholders for consideration of RPTs

Background

The 2013 Act requires that the notice for general meeting should be annexed with an explanatory statement containing prescribed information in respect of proposed RPT. Further, Listing Regulations provide that the recommendation of the board of directors of the listed

entity on each item of special business is required to be disclosed in the statement to be annexed to the notice to the shareholders.

Recommendation

The working group recommended that the notice that is being sent to shareholders seeking approval for any proposed RPT should include certain prescribed information as a part of the explanatory statement such as:

- Summary of the information provided by the management of the listed entity to the audit committee
- The recommendation of the audit committee in respect of the proposed transaction, specifying justification for why the transaction is in the interest of the listed entity
- Whether the approval of the related party transaction by the audit committee was unanimous
- Statement that the valuation or other external report, if any, relied upon by the listed entity in relation to the proposed transaction will be available for inspection at the registered office of the listed entity.

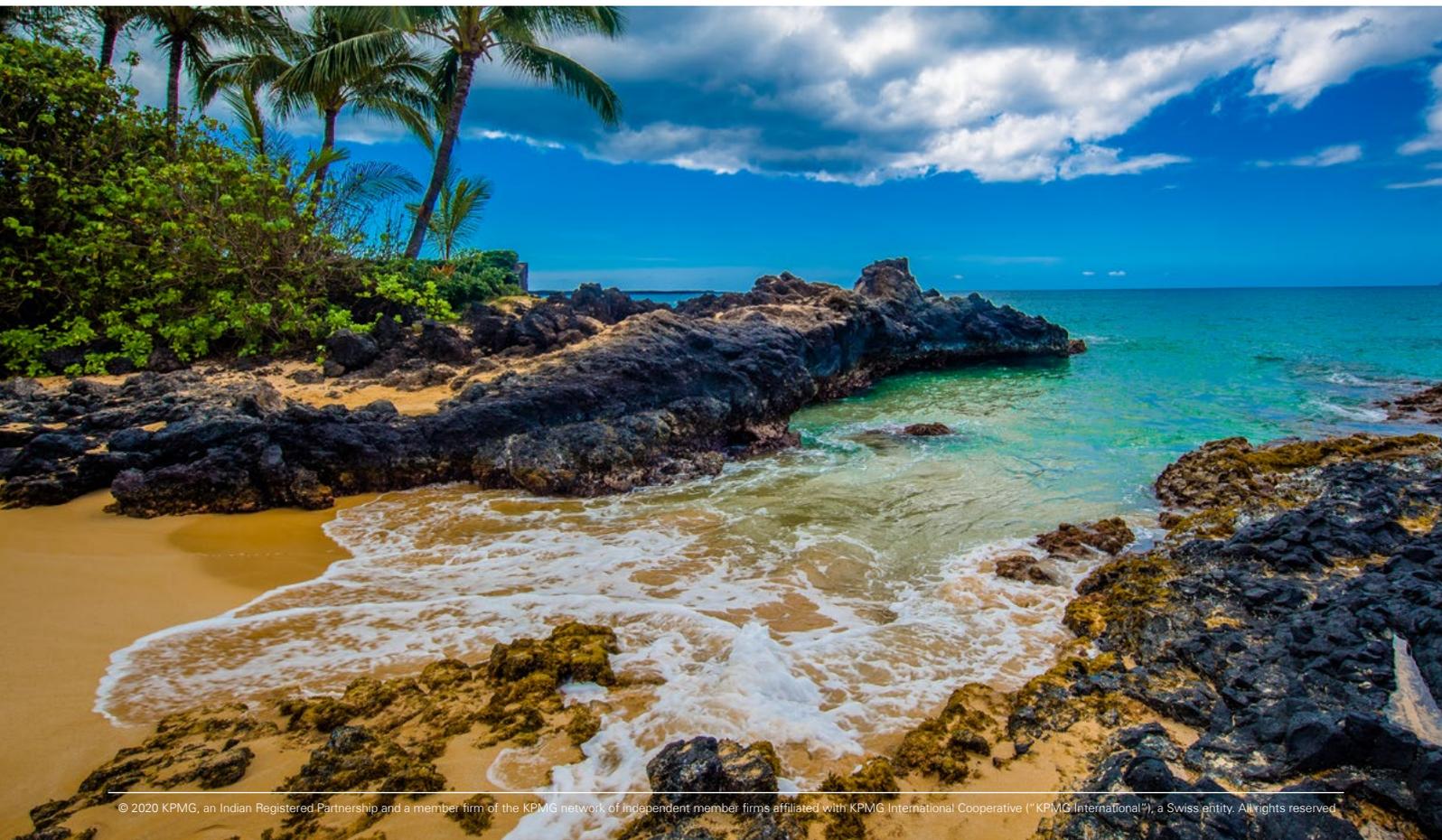
The working group also recommended the format and timeline of communication and suggested that a listed entity should make the RPT disclosure to the stock

exchange and publish on its website every six months on the date of publication of its standalone and consolidated financial results. Additionally, working group has suggested a detailed format for the RPTs disclosures as compared to existing format under Ind AS.

7. Strengthening the monitoring and enforcement of regulatory norm

The working group considered improvements in monitoring and enforcements in three main areas:

- Use of structured data (iXBRL) to augment enforcement:** Listing Regulations mandate that the disclosures provided by a listed entity to the stock exchanges should be in XBRL format. The working group recommended that there should be one filing format, which could be based on 'inline XBRL' (iXBRL), an open standard that enables a single document to provide both human-readable and structured, machine-readable data.
- Introduction of standardised identifiers to identify RPTs:** The working group suggested use of Permanent Account Number (PAN) of the parties involved in RPTs as a standardised identification of related parties.
- Capacity building:** The working group recommended for capacity building, both human and technological, at SEBI and the stock exchanges.



Our comments

The recommendations of the working group aim to strengthen the approval and disclosure processes to assist the audit committee and shareholders to make informed decision with respect to RPTs. The formation of working group and recommended changes represent SEBI's effort to make the regulations more investor friendly. Some of the key observations are:

- Definition of related party and RPTs broadened:** The working group has recommended changes to the related party definition and widened the scope of parties and transactions to fall within the purview of the RPTs. This change could entail many practical challenges, e.g. companies would need to establish processes to identify such transactions and understand if the purpose of any transaction is to benefit a related party, especially in complex structures where listed entities may have number of subsidiaries.
- Approval process:** Prior approval of an audit committee of a listed entity would be mandatory to transactions carried out between a listed entity, any of its subsidiary and a related party of the listed entity or its subsidiaries. An audit committee approval would also be required for any transaction between listed entity, its subsidiaries and any other person or entity if its purpose and effect is to benefit a related party of the listed entity or any of its subsidiaries. Additionally, all subsequent material modifications to RPTs have been proposed to require prior approval of an audit committee.
- Extensive information to be placed before audit committee:** It is proposed that with respect to the type, material terms and particulars of related party - each type of RPT with a single party should be disclosed separately and there should be no clubbing or netting of transactions of the same type.

However, RPTs with the same counter party and of the same type may be aggregated.

The audit committee should be aware of the value of a proposed RPT as a proportion of the annual total revenues, total assets and net worth of the consolidated entity. The working group also suggested that the audit committee should undertake an annual review of the status of long-term (more than one year) or recurring RPTs. Further, justification for each individual transaction must be provided, unless there are a series of transactions interdependent on each other, in which case the justification for the entire series need to be furnished.

- Revised materiality threshold:** The materiality threshold should be amended to 5 per cent of the annual total revenues, total assets or net worth of the listed entity on a consolidated basis or INR1,000 crore, whichever is lower. The working group felt that the threshold of 10 per cent of the consolidated turnover appears to be high, particularly in case of listed entities with a high turnover, as several RPTs may not be placed before the shareholders for approval. The intent of revising threshold is to cover such RPTs which otherwise would not get covered due to high threshold.
- Disclosure of RPTs:** It is proposed that a listed entity would be required to promptly make the disclosure to the stock exchange along with its financial results and publish the same on the website instead of submitting within 30 days from the date of publication of standalone/consolidated financial results. Additionally, a detailed format for disclosure has been proposed.

