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## Decoding Impact of Corporate Governance Committee's recommendations on "Related Party Transactions"

October 17, 2017 7:30 pm | By : Gaurav N. Pingle



A critical test of good Corporate Governance for a company (whether listed or not) is how it deals with Related Party Transactions (RPTs). The Companies Act, 2013 and the Rules made there under provides for exhaustive provisions relating to RPTs. The SEBI's Listing Regulations also covers provisions and compliances for RPTs. The Kotak Committee has made certain recommendations relating to RPTs. One of the terms of

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reference of the Committee was to improve safeguards and disclosures pertaining to RPTs. Chapter V of the Report relates to “Promoters/Controlling Shareholders and Related Party Transactions”. This article is an analysis of the recommendations on the provisions relating to RPTs.

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- **Disclosure of RPTs & strict penalties for such non-disclosures:** With an objective to strengthen transparency on RPTs, Kotak Committee recommended half yearly disclosure of RPTs on a consolidated basis, in the disclosure format required for RPTs in the annual accounts (as per Accounting Standards). The Committee proposed that the disclosure should be on company’s website and submission with the Stock Exchanges. The Committee also suggested strict penalties may be imposed by SEBI for failing to make requisite disclosures of RPTs. In my view, the half yearly reporting on RPTs will not make in any significant change in the compliance or internal approval mechanism, however, it will ensure only better disclosure practice. The Committee has recommended strict penalties for only for failing to make requisite disclosures of RPTs. In my view, strict penalties should be imposed for overall non-compliance of RPT provisions, inadequate disclosure being one of it.

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- **Change in “Related Party”:** Considering the definition of ‘Related Parties’ under SEBI’s Listing Regulations, Kotak Panel observed that certain promoters / promoter group entities are not being categorized as ‘related parties’. The Panel observed that transactions with such parties are not getting categorised as RPTs under SEBI’s Listing Regulations. Considering the same, Kotak Panel recommended the following:

- All promoters/promoter group entities that hold 20% or above in a listed Co. to be considered “related parties” for the purposes of Listing Regulations;
- Disclosures of transactions with promoters/promoter group entities holding 10% or more shareholding be made annually and on half yearly basis (even if not classified as ‘related parties’).

The proposed expansion in the definition of ‘related party’ may affect the investors / promoters of the listed entity that hold 20% or more. Another recommendation relates only to the disclosures i.e. Disclosures of transactions with promoters/promoter group entities holding 10% or more shareholding, and not compliance. However, in my view, merely holding

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20% in a company should not amount to a party being a 'related party'. There ought to be some amount of influence in the company.

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- **Approval of RPTs:** Kotak Panel deliberated upon the gap in the legal framework wherein Companies Act allowed related parties to vote on (albeit not in favour of) a RPT while SEBI's Listing Regulations require such parties to abstain from voting. Kotak Panel observed that similar to the Companies Act, SEBI's Listing Regulations may be amended to allow related parties to cast a negative vote, as such voting cannot be considered to be in conflict of interest. In my view, the recommendation is not very significant and at the same time, it will not make any dynamic change in the approval mechanism of RPTs.
- **Royalty and Brand Payments to Related Parties:** Presently, there are no specific provisions in SEBI's Listing Regulations for the payments made pertaining to brand and royalty to related parties. Kotak Committee recommended that payments made by listed entities with respect to brands usage/royalty amounting to more than 5% of consolidated turnover of the listed entity may require prior approval from the shareholders on a "majority of minority" basis. This sub-limit of 5% will be considered within the overall 10% limit to determine 'Material RPTs'. The proposed provisions relating to 'Royalty and Brand Payments to Related Parties' is going to have a significant impact on the listed Indian companies which are joint venture / associate / subsidiaries of foreign holding company. Pursuant to the Kotak Committee's recommendation, the shareholders' approval is required for payments relating to brands usage/royalty in excess of 5% of consolidated turnover of listed entity. Such approval will be required even if the transaction is in the ordinary course of business and on arm's length basis (important conditions under Cos. Act, 2013). One of the interesting recommendations is w.r.t. the voting which will be on "majority of minority" basis. Therefore, Kotak Panel recommends that the related parties or the recipient parties are abstained from voting such resolution. In my view, this provision will also have an impact on the foreign exchange inflows and outflows. At the same time, approval under the Companies Act, 2013 will be required when the prescribed thresholds (under the Rules) are breached.
- **Materiality Policy:** Pursuant to the extant provisions of SEBI's Listing Regulations, the listed entities are under obligation to formulate a Policy on materiality of RPTs and on dealing with RPTs. W.r.t. the Materiality Policy, the Kotak Panel has suggested following recommendations:

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- Policy shall include clear monetary threshold limits duly approved by Board of Directors,
- Materiality Policy should be reviewed and updated at least once every 3 years.

Based on my research and analysis, some listed companies have prepared Materiality Policy on RPTs as one-page document. In the Policy, the companies have given necessary references to SEBI's Listing Regulations, Companies Act, 2013 and Accounting Standard, as applicable. Probably, based on this practice, Kotak Panel might have recommended monetary threshold limits for approval. Also taking into consideration the constant changes in the business and economic environment along with significant changes in the applicable law, Kotak Committee has rightly recommended reviewing and updating Materiality Policy at least once in 3 years.

**Conclusion:** In my view, the focus of Kotak Committee is more on the disclosures of RPTs and not on the compliance / approval aspect of it. Even after the Committee recommendations, there is no harmony in the provisions relating to RPTs under the Companies Act, 2013 and SEBI's Listing Regulations. Presently, there is harmony in only two provisions of RPTs under the two laws: (i) Type of shareholders' resolution (i.e. ordinary resolution) and (ii) Audit Committee's Omnibus approval. In my view, there ought to be some unanimity on the provisions relating to RPTs w.r.t. the pricing, related parties, restriction on voting of related parties, ordinary course of business / arm's length basis, board approval process, etc.

***Gaurav N. Pingle** is a Practising Company Secretary from Pune. He handles various assignments of Secretarial Audits, Due Diligence, Quarterly compliance audit of listed companies, routine compliance (under Companies Act & FEMA) for private companies, wholly owned subsidiaries, joint venture companies. As an Author, he religiously writes articles and columns on the current case laws, latest happenings in Corporate Laws and articulates his views, which are published in leading business and professional journals. Many of his articles have bagged the "Best Article" award. He is visiting faculty for the Company Law & Securities Laws at ILS Law College, Pune, Pune Chapter of ICSI, Thane Chapter of ICSI and also at various colleges in Pune, Mangalore, Udipi. (E): [gp@csgauravpingle.com](mailto:gp@csgauravpingle.com) , (W): [www.csgauravpingle.com](http://www.csgauravpingle.com) .*

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