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Analysis of the impact of suggestions of SEBI's Working Group on RPTs

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In November 2019, SEBI had constituted a Working Group to review the policy space pertaining to related party transactions ('RPTs') under the Chairmanship of Mr. Ramesh Srinivasan (Managing Director & CEO, Kotak Mahindra Capital Company Ltd.). The terms of reference of the Working Group were to make recommendations to SEBI on following issues:

(*i*) Reviewing the policy relating to RPTs, which includes the definition of 'related party' and RPT, thresholds for classification of RPTs as 'material'; and process followed by Audit Committee for approval of RPTs,

(*ii*) Reviewing the provisions relating to RPTs in the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ('SEBI LODR Regulations') vis-à-vis the Indian Accounting Standards and the Companies Act, 2013,

(*iii*) Specifying a format for periodic disclosure of RPTs by listed entities,

(*iv*) Recommendations for strengthening the monitoring and enforcement of regulatory norms related to RPTs,

(*v*) Any other matter, as the Working Group deems fit pertaining to RPTs.

This article is an analysis of the key recommendations and its impact on governance and compliance by the listed entities.

Scope of 'Related Party': As per extant provisions of the SEBI LODR Regulations, 'related party' means 'related party' under the Companies Act, 2013 or under the applicable Accounting Standards. Any person or entity belonging to the 'promoter' or 'promoter group' of the listed entity shall be a 'related party'. The Working Group has proposed amendment to another class of 'related party' and has suggested that – any person or any entity, directly or indirectly (including with their relatives), holding 20% or more of the equity shareholding in the listed entity – shall deemed to be a 'related party'. The proposed amendment clarifies the existing clause w.r.t. manner of holding shares in the company (directly or indirectly) and type of shareholding in the company i.e. equity shares. The proposed amendment is to the clause which was amended by SEBI (LODR) (Amendment) Regulations, 2018 w.e.f. April 1, 2019 recommended by Kotak Committee in its Report dated October 5, 2017. Also, it is interesting to note that such party is neither 'promoter' nor from the 'promoter group', therefore, any shareholder (generally, a strategic investor) holding 20% equity shares in listed entity shall deemed to be 'related party'.

Scope of 'Related Party Transactions': The Working Group observed that recently, certain innovative structures have been used to avoid classification of transactions as RPTs and thus avoid the associated regulatory compliance and disclosure requirements. Such instances include: (i) Use of complex structures, (ii) Transactions undertaken by a listed entity with seemingly unrelated parties, however intended to benefit related parties; and (iii) Instances of loans being given to an unrelated party which in turn gives such loan to a related party.

According to the extant provisions, 'RPT' means a transaction involving a transfer of resources, services or obligations between listed entity and a related party. Now, the Working Group has suggested inclusion of following parties, which are:

(*i*) *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* – The scope of related party transaction is significantly enhanced as following transactions may fall under RPT provisions of SEBI LODR Regulations:

- (*a*) Transaction between listed entity's subsidiary company and related party of listed entity,
- (*b*) Transaction between listed entity's subsidiary company and related party of listed entity's subsidiary company,
- (*c*) Transaction between listed entity and related party of listed entity (this is RPT, undoubtedly),
- (*d*) Transaction between listed entity and subsidiary company of listed entity (this is RPT, undoubtedly).

For a transaction between listed entity's subsidiary company and related party of listed entity, listed entity is not even a party to the transactions but may be a beneficiary in the transaction. Also, subsidiary company can be a private company, unlisted public company or a listed public company. Based on the above background, it is necessary to check whether a transaction between listed entity's step-down overseas subsidiary company and related party of listed entity would be an RPT under the proposed RPT provisions?

(*ii*) *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* – In this case also, the scope of RPT is significantly enhanced under the provisions of SEBI LODR Regulations, as determining 'benefit to a related party of the listed entity or any of its subsidiaries' is a very subjective exercise. The transaction becomes complex where listed entity or any of its subsidiary company enters into a transaction with an unrelated party (person or entity) and the beneficiary of the transaction is a related party. There could have been certain transaction in the past of such nature, but ensuring compliance of such kind of RPT would be very difficult for the listed entity.

Certain transactions are not 'Related Party Transactions': The Working Group has excluded certain transactions from the purview of RPTs under the SEBI LODR Regulations. Such transactions include issue of securities on preferential basis, corporate actions i.e. dividend payment, sub-division or consolidation of shares, issue of securities by rights issue or bonus issue, buy-back of securities.

Approval of Audit Committee: W.r.t. approval process, the Working Group has recommended that RPT to which subsidiary company of listed entity is party but the listed entity is not a party, such transaction shall require prior approval of Audit Committee of the listed entity only if the value of such transaction (individually or taken together) exceeds 10% of the annual total revenues, total assets or net worth of the subsidiary company (on standalone basis), for immediately preceding financial year, whichever is lower. The criterion relating to net worth shall not be applicable if the net worth of the subsidiary company is negative. This clause, if included in the amendments, would be quite difficult to comply as several thresholds are required to be calculated of the subsidiary company for ensuring compliance of SEBI LODR Regulations.

Further listed entity's Audit Committee's prior approval shall not be required for RPT to which the listed subsidiary is a party but the listed entity is not a party, if such listed subsidiary is not exempt from Reg. 23 (relating to 'RPT') and the other corporate governance provisions of these regulations specified in Reg. 15(2) of SEBI LODR Regulations. This clause, if included in the amendments, also would be quite difficult to comply as there is a reference of 'listed subsidiary' and 'listed entity'.

Approval of shareholders for 'material' RPT: The Woking Group has suggested that all material RPTs and subsequent material modifications, shall require 'prior' approval of the shareholders through resolution i.e. ordinary resolution. The amendment aligns with the provisions of the Companies Act, 2013 and Rules made thereunder. In addition to the existing exemptions from obtaining approval of shareholder, the Working Group has suggested another transaction i.e. RPT to which the listed subsidiary is a party but the listed entity is not a party, if such listed subsidiary is not exempt from Reg. 23 (relating to 'RPT') and the other corporate governance provisions of these regulations specified in Reg. 15(2) of SEBI LODR Regulations.

Materiality Thresholds w.r.t. prior approvals for RPTs: Taking into consideration the statistical data, Working Group observed that present threshold of 10% of consolidated turnover appears to be high. Further, particularly in case of listed entities with a high turnover, several RPTs may not be placed before shareholders for approval. The Working Group suggested an amendment to materiality thresholds w.r.t. approval of RPTs. According to the recommendations, RPT shall be considered 'material' if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds Rs.1,000 crore or 5% of annual total revenues, total assets or net worth of the listed entity (on a consolidated basis as per the last audited financial statements of the listed entity), whichever is lower. However, criterion relating to net worth shall not be applicable if the net worth of the listed entity is negative. This clause, if included in the amendments, would be quite difficult to comply as several thresholds are required to be calculated for the listed entity for ensuring compliance of SEBI LODR Regulations. However, the approach towards the suggestion seems to be rational.

Disclosures & other riders for RPTs: The Working Group has suggested amendments to the information for Audit Committee's mandatory review. It has also been suggested that RPTs should not be for an open-ended or indefinite term, upper limit shall be prescribed for continuous transaction. These suggestions, if implemented, would bring in more transparency and accountability towards the Audit Committee and shareholders. At the same-time, the role of Independent Directors / Audit Committee will increase as adequate (or enormous) disclosures are being made of the RPT. The Working Group has suggested some disclosures to the shareholders for seeking approval for any proposed RPT. Such disclosures are in addition to the requirements under the Companies Act, 2013.

Strengthening the monitoring & enforcement of regulatory norms relating to RPTs: Taking into consideration the penal provisions under the Companies Act, SEBI Act, SEBI Regulations, the Working Group considered improvements in monitoring and enforcements in 3 main areas: (i) Use of structured data (iXBRL) to augment enforcement, (ii) Use of standardised identifiers to identify RPTs; and (iii) Capacity building, both human and technological, at SEBI and the stock exchanges.

Conclusion: The amendments suggested by the Working Group would bring a significant change in the compliance system and mechanism of listed entities. This would be due to changes suggested to the definition of 'related party' and 'related party transaction'. Identification of a related party transaction, its disclosures, compliance and approval process would bring significant change in perception towards RPTs and overall Governance. The transaction where the intention of the parties would not even be 'RPT' even such transaction may fall under the scope of 'RPT' (i.e. due to the expanded definition of 'related party transaction'). Also, the Working Group ought to have deliberated and discussed whether giving of loan, guarantee or security by a listed entity to its related party amounts to 'RPT'. Such transactions fall within the purview of section 185-186 of the Companies Act, 2013 and may not fall under the provisions of 'transfer of resources' under the SEBI LODR Regulations. Also, the Working Group ought to have deliberated and discussed whether appointment and payment remuneration to executive and non-executive directors amounts to 'RPT' and whether approval of Audit Committee is required. In my view, the RPT provisions would require much closer look from the perspective of compliance of routine transactions and not just 'complex' transactions, as some RPTs could be genuine and in the in the interest of company/group of company.

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