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SEBI TIGHTENS GOVERNANCE AND DISCLOSURE REQUIREMENTS FOR RELATED PARTY TRANSACTIONS

Introduction

Related Parties (**RP(s)**) and Related Party Transactions (**RPTs**) form the cornerstone of most discussions involving corporate governance. Both the Ministry of Corporate Affairs (**MCA**) and the Securities Exchange Board of India (**SEBI**) have periodically discussed facets and parameters relating to RPs and RPTs, evident from the formation of committees such as the 2017 Kotak Committee on Corporate Governance and the 'Report of the Working Group on Related Party Transactions' dated 22 January 2020 (**WG**).

The key legislations applicable to a listed entity in terms of governance and regulation of RPs and RPTs are the Companies Act, 2013 (**Companies Act**) for general compliance and the SEBI Listing Obligations and Disclosure Requirements, 2015 (**LODR**) for additional and more specific compliance requirements. The Indian Accounting Standards (**Ind AS**) also become relevant from an audit perspective.

Recently, the SEBI amended the LODR by way of the SEBI (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2021 (**Amendment**) to, *inter alia,* widen the ambit of RPs and RPTs. While the definitions of the terms under the LODR were inclusive and covered the requisite parameters prescribed under the Companies Act and Ind AS 24, the changes, as discussed below, have been introduced with a view to limit transgressions by those persons who exercise control over a company or have influence in the decision making of a company.

While the Amendment becomes effective from 1 April 2022 (excluding certain provisions which become applicable from 1 April 2023), it becomes critical for listed and to be listed entities to get their house in order to ensure compliance with the revised stringent norms, for a smooth foray towards the new legal regime.

In addition to the Amendment, SEBI has also issued a circular dated 22 November 2021 titled 'Disclosure obligations of listed entities in relation to Related Party Transactions' (**Circular**) enhancing disclosure norms by prescribing the information to be placed before the audit committee and the shareholders for consideration of RPTs.

In this piece, we discuss and analyse the Amendment and the Circular from a practical standpoint.

Key changes:

1. Widening the Related Party network

Prior to the Amendment, members of the promoter group (including promoters) of a listed entity holding 20% or more of the shareholding of the listed entity were deemed to be its related parties.

Pursuant to the Amendment:

- Any person or entity (*irrespective of shareholding*) forming part of the promoter group of the listed entity shall be deemed RPs. Further, the term has been expanded to include any person / entity holding equity shares of 20% or more of the listed entity, directly or on a beneficial basis, at any time in the immediately

preceding financial year. The 20% threshold shall stand reduced to 10% or more, with effect from 1 April 2023.

Analysis:

The widening of the deeming provision is above and beyond the threshold contemplated and suggested by the WG, which had proposed a threshold of 20% indirect or direct equity shareholding.

While the regulatory intent of introducing greater levels of transparency and stricter governance norms is apparent with this amendment, implementing the 10% threshold may pose practical challenges to the governance and conducting day to day business of a listed entity, since transactions with an entity in which a minority stake is held will now require audit committee approval. Further, the requirement to keep track of entities having held shareholding above the applicable thresholds, at any time during the past financial year, could be a daunting task and will require greater levels of interfacing with the registrars and depositories.

Inclusion of any shareholder with a 10% direct and indirect shareholding in a listed entity will pose some practical issues. It is pertinent to note that a shareholder holding 10% shareholding in the current financial year is not defined to mean a related party. The rationale of defining RP with reference to the previous financial year is not clear since such a shareholder may have ceased to continue a 10% shareholder or even continue to hold any shares in the listed entity when the transaction is being undertaken.

2. Definition of Related Party Transactions

The scope of the term has been made significantly wider, principally with a view to bring transactions with subsidiaries (listed or unlisted, Indian or foreign) within its ambit.

Previously, the definition covered transfer of resources, services or obligations between a listed entity and a RP, regardless of whether a price is charged, whether singular, or a group of transactions (excluding units issued by mutual funds listed on stock exchange(s) (**SEs**)).

Pursuant to the Amendment:

- RPTs include transactions involving a transfer of resources, services or obligations between listed entities ***or any of its subsidiaries*** on one hand and a related party of the listed entity, ***or any of its subsidiaries*** on the other hand.

- With effect from 1 April 2023, it shall also include transactions between a listed entity or any of its subsidiaries on 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***.

- Certain corporate actions such as issue of securities on preferential basis, rights issues, buy-backs, payment of dividend, sub-division or consolidation, etc. have been excluded from the ambit of the definition. Further, the acceptance of fixed deposits by banks or NBFCs and units issued by mutual funds listed on SEs have also been excluded from the definition, but the former has been made subject to disclosure norms, along with disclosure of related party transactions every six months to the SEs.

- Furthermore, thresholds for material RPTs as provided under Regulation 23 of the LODR have been revised to include all transactions entered into:

    - either individually or taken together with previous transactions during a financial year,

    - exceeding either ₹1,000 crore or 10% of the annual consolidated turnover as per the last audited financials, whichever is lower.

Analysis:

The Amendment is in line with the WG Report. It is interesting to note that the ambit of RPTs has been amplified to include transactions that not only have a direct nexus with an RP, but eventually also those which would indirectly

benefit the RP. This increased regulatory fetter may demand a scrutiny of every transaction with a third party, on a consolidated basis, and may further result in requiring listed entities to expressly demonstrate that the RP is not benefitted from a third party transaction.

While this is aimed at containing the menace of indirect benefits of transactions not carried out on an arms-length basis, and roundtripping; conforming to these increased requirements may be cumbersome for listed entities, as the ancillary secretarial processes and compliances will consequently increase. It would be prudent for listed entities to forecast RP benefit in order to accurately classify a transaction as an RPT, seek omnibus approval, where possible, and proceed accordingly.

In our view, the review and approval of such third-party transactions may militate against the independence of the boards of directors of subsidiaries, as the internal and external stakeholders of the subsidiary and those of the listed entity may be different. The directors of the listed entity may find it difficult to discharge their obligations to act in the best interest of the listed entity and its stakeholders, all at the same time. This may also unwarrantedly make the directors of the listed entity liable for a transaction of a subsidiary. The proposed amendment will also involve a mandatory disclosure of transactions between subsidiaries of a listed entity and the related parties of listed entity. The list of related parties of a listed entity is not a static one. There will have to be a real time exchange of information about RPs and RPTs between the listed entity and its subsidiaries to ensure appropriate compliance of the new requirements.

3. Prior approval requirements from audit committee and shareholders

Previously, all RPTs required the approval of the audit committee, provided that only independent directors of the audit committee could approve such transactions.

Pursuant to the Amendment:

- *Audit committee approval:* All RPTs as well as any ***subsequent material modifications*** by the listed entity shall require prior approval from the audit committee of the listed entity.
    - Furthermore, the definition of the term 'material modifications' will be required to be defined and disclosed as a part of the policy on materiality, as mandated under Regulation 23 of the LODR.
    - An RPT to which a subsidiary of a listed entity is a party (even if the listed entity by itself is not a party) shall require prior approval from the audit committee of the listed entity, if the value of such transaction (individually or together with previous transactions during the FY) exceeds 10% of the annual consolidated turnover, as per the last audited financials of the listed entity. With effect from 1 April 2023, the threshold shall stand revised to 10% of the annual consolidated turnover, as per the last audited financials of the subsidiary.
    - However, prior approval of the audit committee of the listed entity shall not be required for RPTs to which the listed subsidiary is a party, but the listed entity is not a party if Regulation 23 and Regulation 15(2) of LODR (*Corporate Governance*) are applicable to such listed subsidiary.
- *Shareholders Approval:* Further, per the amendment, all material RPTs including subsequent material modifications shall require the prior approval of shareholders. While such additional shareholder approval has been mandated, the same shall not be required for RPTs of unlisted subsidiaries of a listed subsidiary, and the prior approval of the shareholders of the listed subsidiary shall suffice. The exception provided to resolution plans approved under Section 31 of the Insolvency and Bankruptcy Code, 2016 remains unchanged.

Analysis

As a whole, this tweak in law takes a leaf from the WG Report and the Kotak Committee's 'Report of Committee on Corporate Governance' dated 5 October 2017 (**Kotak Committee Report**), to strengthen the regulation of RPTs and increase the lines of defence. It is also a welcome endeavour to align the LODR with the Companies Act and iron out the variation in compliances under the two laws.

In terms of the audit committee action points for listed entities, the need to revise and update the policy to materiality to provide for 'material modifications', has been considered paramount. With this in place, the requirement for an audit committee to review the statement of significant related party transactions has been done away with. Accordingly, the audit committee now has limited discretion as the materiality becomes codified in policy.

Additionally, the WG had reasoned that the aforementioned prior approval of shareholders should be sought "in order to maintain consistency", since the LODR specifically requires prior approval of the audit committee. Both the RPT as well as the 'material modification' thereof would require prior shareholder approval. If one delves into the fine print of the law, one can imply that vis-à-vis shareholder approval, all transactions between two wholly owned subsidiaries of the listed entity, or transaction between step-down subsidiaries of listed entities shall be exempt from shareholder approval for material RPTs.

4. Exclusions

Prior to the Amendment, there were only two exclusions provided to the scheme of RP and RPT provisions, i.e., transactions between two government companies, and those between a holding company and wholly owned subsidiary, whose accounts were consolidated with such holding company and placed before the shareholders at the general meeting for approval.

Pursuant to the Amendment:

While the earlier two exclusions remain unchanged, a third exclusion has been added in respect of transactions entered into between two wholly-owned subsidiaries of the listed holding company, whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

Analysis:

The Amendment is aligned with the recommendation of the WG Report, consistent with the effort to govern RPTs in respect of subsidiaries and makes a necessary exclusion which would reduce the burden of compliance to a certain extent in case of excluded transactions between subsidiaries of the listed entity. While SEBI has given the benefit of familiarisation period for the new RPT regime, the exclusions could have been made effective immediately.

5. Significant changes to the disclosure regime

Prior to the Amendment and the Circular, the disclosure requirement was limited to that of RPTs on a consolidated basis within 30 days from date of publication of the financial results of half year.

Pursuant to the Amendment and the Circular:

- Listed entities shall submit disclosures of RPTs in the format specified by SEBI from time to time to the SEs and SEs shall publish the same on their website, and the listed entity shall make such disclosures every 6 months (within 15 days from the date of publication of its standalone and/or consolidated financial results).

- Entities which have listed non-convertible securities shall make disclosures in compliance with the Ind AS 24, provided that the same shall not be applicable to listed banks.

- The listed entity shall disclose the 'loans and advances (by listed entities and their subsidiaries) in the nature of loans to firms / companies in which directors are interested, which shall be by name and amount', provided that the same shall not be applicable to listed banks. With effect from 1 April 2023, the listed entity will be required to make such disclosures every 6 months on the date of publication of its standalone and consolidated financial results.

- Listed entities seeking approval for any proposed RPTs will also be required to provide certain additional information to the audit committees, and as a part of the explanatory statement in the notice being sent to the shareholders, including '*justification as to why the proposed transaction is in the interest of the listed company*'.

- The listed entities shall make RPT disclosures every 6 months to the SEs, in the format prescribed in the Circular.

Analysis:

While the WG, in its report had acknowledged the increased burden upon listed entities and their audit committees from the perspective of an in increase in disclosure requirements, the same has been implemented with a view to improve transparency and corporate governance.

It is worthwhile to note that the disclosure window in respect of RPTs has been reduced from the current requirement of 30 days from date of publication of financial statements to 15 days from date of publication of financial statements, which is further poised to be the date of publication of financial statements effective 1 April 2023. This will require secretarial readiness to ensure compliance.

The Circular is based on the recommendations of the WG and has increased the disclosure requirements manifold. As discussed above, the Amendment requires the approval of the audit committee for the transactions between a subsidiary of a listed entity on one hand and any other related party of the listed entity on the other hand, even when the listed entity is not a party to the transaction. Considering the information required to be placed before the audit committee, it would be difficult to comprehend the justification as to how such a third party transaction would be in the interest of the listed entity.

It is observed that the disclosure norms prescribed for contracts or arrangements with RPs under Rule 15 of the Companies (Meeting of Board and its Power) Rules, 2014 (**Meeting of Board Rules**) under Section 188 of the Companies Act significantly coincide and overlap with the disclosure obligations prescribed under the Circular. Both the Circular and the Meeting of Board Rules stipulate certain common disclosure requirements, including in relation to the name of the RPT, nature of the relationship, nature of the RPT, tenure, value, and any other information which may be deemed relevant. Further, both the Meeting of Board Rules and the Circular require that certain disclosure obligations prescribed under each of the Meeting of Board Rules and the Circular respectively, be annexed to the notice of a general meeting as a part of the explanatory statement.

Conclusion

The Amendment has implemented most recommendations of the WG Report. It will be interesting to see how companies will cope with the increased secretarial and disclosure requirements. If the past is to be used a reference point, increased secretarial compliances and corporate governance requirements have typically been met with resistance and or a blatant failure to comply, case in point being the requirement for appointing women independent directors which required regulatory whip to be enforced. April 2022 will be the litmus test for the practical enforceability of the suggestions of the WG and the mandates of the Amendment as the fetters on RP and RPTs would increase substantially. The secretarial and/or compliance teams will be required to work in tandem with the finance teams of listed entities to ensure the requirement bought about by the Amendment are met. Policies and processes will need to be relooked at to further achieve this objective.

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