excellence enablers CORPORATE GOVERNANCE SPECIALISTS
(AN M. DAMODARAN INITIATIVE)

RELATED PARTY TRANSACTIONS – WHAT NEXT?
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SUMMARY OF DISCUSSIONS

Background

Related Party Transactions (RPTs) have been the subject of continuing attention over the last few years. The regulations have been tweaked, or significantly changed, with a frequency that is unsettling. It is reasonable to presume that many of these changes have been occasioned by instances of irresponsible conduct in the regulated universe. Some of these measures, though unquestionably well intentioned, assume the character of kneejerk reactions to individual cases of misconduct. It is unarguable that conflict of interest needs to be rooted out of the corporate arena. At the same time, if regulations which are intended to facilitate the legitimate conduct of business, become unduly prescriptive, the outcome could be negative, especially for well-intentioned corporates. The recent changes in the regulations relating to RPTs have attracted some criticism on the grounds of being excessive. In the ultimate analysis, it is necessary to put in place a regulatory regime that ensures good corporate conduct, while facilitating the conduct of business. What are the next steps for regulated entities as well as for Regulators?

DISCUSSIONS

- **RPTs should be regulated, but not over-regulated:** RPTs are legal and are allowed. They cannot be prohibited. However, they continue to get a lot of attention because of some companies having abused them. There are a number of regulations relating to RPTs. However, in response to any adverse event in the corporate world, SEBI seems to further tighten these regulations. While corporate India agrees that RPTs have to be regulated, since they could represent a conflict of interest, the regulations must be practical to implement, and should focus on abusive RPTs, and not RPTs in general. If a company misconducts itself, the Board should be held accountable, and writing a new regulation should not be the first response. Further, cost of compliance should be considered, for all types and sizes of companies, and one solution fitting all companies cannot be the approach to be followed.

- **Better implementation, and not more regulation:** Over time, regulations relating to RPTs have become excessively prescriptive. Companies are finding it very cumbersome to comply with these guidelines. What is needed is better implementation of existing regulations, and not more regulations. The purpose of any regulation should be ease in compliance. Present regulations relating to RPTs do not promote this.

- **Second-guessing Board and Audit Committee (AC):** A number of responsibilities, and the resultant accountability, are cast on members of the Board and/or AC. However, they have limited powers. With a number of RPTs going to shareholders for their approval, it seems that shareholders have to second-guess the decisions taken by the Board and/or AC. If a Board and an AC have not been able to decide that a transaction is dubious, it is unlikely that shareholders would be able to do so. It is important to see the spirit behind an RPT. Whether a related party has benefited or not, or whether there was an intent to abuse or not, are the important points to be considered. These can be best judged by the Board/ AC, and not by retail investors or proxy advisory firms.

- **Distrust needs to be addressed:** From relying on self-declaration in matters relating to conflict of interest, to moving to over-prescriptive regulations, which are difficult to comply with, the move is in the wrong direction. The burden of proof that each transaction is genuine, seems to be shifting to the companies. Such distrust needs to be addressed.

- **Power of the shareholders:** Regulations give a lot of powers to the shareholders, by empowering them to approve several types of RPTs. This is not a solution. Conceptually, seeking approval from minority shareholders is a good idea. But, in most cases, shareholders, especially institutional shareholders, end up following the recommendations of proxy advisory firms. These firms sometimes may have their own yardstick, which could be higher than what is prescribed in law and regulations. Penalising companies for these higher yardsticks is not correct. Further, most of the time, these firms do not take cognisance of what the company might have to say in response to their recommendations. They could have biases, which may be inconsistent with facts.

- **Informed decision or not:** The voting patterns in India would seem to indicate that most shareholders are indifferent to most resolutions brought to them. They may not understand the importance of some of the RPTs, and may not vote taking into account facts put out by the company. Putting such resolutions to vote only adds to the burden of the corporates, in terms of both cost incurred and lead time involved.

- **Definition of relatives**: The definition of relatives is very wide. In fact, it is one of the widest in the world. It is nearly impossible for all persons/ corporates to keep track of all such relationships. There is a need to sync the definitions given in the Companies Act, 2013 (the Act) and SEBI LODR Regulations, 2015 (LODR), so that the focus is on the concept of dependent and/or financially dependent persons, and not on relatives.

- **Concept of arms' length pricing:** The process of getting 2-3 quotes for determining arms' length pricing is needless in most cases. There could be situations where proprietary information is involved, and so one vendor is preferred over the others. For RPTs, price alone cannot be a determining factor.

- **Process issues:** It is not practically possible to take prior approvals for RPTs each time. Ratification of some kinds of RPTs should be allowed.

- **CFO's role:** It is not possible for a CFO to list each and every transaction, especially those at the subsidiary level.

PROBLEMS AHEAD

- **Absolute value or percentage**: At present, transactions which exceed a fixed percentage, or are material, go to shareholders for approval. Going forward, any transaction which exceeds 10% of the annual consolidated turnover of the listed entity, or exceeds Rs 1000 crores, would need shareholder approval. Unlike in the past, where the value of a transaction was measured as a percentage of the turnover, the presently prescribed absolute amount will be have to be considered by all companies, irrespective of their size. For some of the bigger companies in India, this amount is very low.

- **RPTs of subsidiaries would have to be considered by the parent company:**
  There is an umbrella definition of RPTs. It includes RPTs of subsidiaries, which would be within the ambit of RPTs of the parent company. This would present a huge challenge.

- **Purpose and effect:** RPTs will, from April 1, 2023, 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". The words "the purpose and effect of which is to benefit a related party…." are significant. How will the ACs determine whether the purpose and effect is to benefit someone. Are its members soothsayers or clairvoyants? What if subsequent events prove them wrong?

- **Information overload:** For each resolution on an RPT, a number of details would have to be given. Some of this could be misused by competition. Also, it is not necessary that so much information will help shareholders make better decisions, given that they are likely to rely on the opinion of proxy advisory firms. The need for disclosures relating to RPTs on the website of the company is also unclear, since, owing to the volume of disclosure, most persons would not be able to make sense of it.

- **Equity holding of 10% or more:** Related parties, in the future, would include persons or entities holding 10% or more of the equity of the company. Unlike in the Accounting Standards, there is no exemption currently being given to the Government holding equity in a company, and so it would become a related party. Also, there are a number of investors/ private equity firms who hold more than 10%, and they would also become related parties.

- **Subsidiary network:** RPTs of/with subsidiaries fall, or will fall, under regulations relating to RPTs. It is incorrect to assume that a company would have total control over the decisions of a subsidiary, which would be managed by different persons. To prescribe that ACs of parent companies have to approve the RPTs of subsidiaries is not practical. These subsidiaries being based overseas, or if it they are Joint Ventures (JVs), would only add to the problem.

- **Taxation issues:** Taxation laws consider the place of decision as the primary place of business. In case ACs of parent companies were to take decisions on RPTs involving subsidiaries, the place of taxation could change, and have wider ramifications.

- **Workload of ACs:** With changes in regulations, volume of approvals will increase. Focus on truly exceptional items may suffer. Duration of AC meetings cannot expand proportionately, and so quality of governance may suffer. Further, the regulations do not look at information deliberately not presented to AC, and the AC members have no way of finding such gaps.

WHAT NEXT

COMPANIES

- **Improved SOPs and control systems:** Bigger companies may have SOPs and control systems for tracking RPTs. Smaller companies too would have to create templates. Existing control systems would have to be improved. Accounting systems would have to create a long list, covering all related parties. Also, these would have to be updated periodically. Consequently, the manpower needs would increase.

- **Accounting and business functions:** Until now, the accounting and business functions did not interact much in regard to such matters. Now, the business function would have to be made aware of these regulations, so that they can give prior intimation/ seek prior approval, wherever required.

- **Accountability:** There is a need to define "key persons" better. Further the Code of Conduct needs to be revamped so that key persons are aware of the punishments associated with non-adherence to the Code.

AUDIT COMMITTEE

- **RPT guidelines:** All ACs should insist on creating RPT guidelines. These should be got approved from the Board. For most RPTs, only the approval of ACs is required. But since AC members are members of the Board, it could be a good idea to have the RPT guidelines approved by the Board, so that the AC members know that they are representing the Board when they take such decisions. Further, with frequent changes in regulations, these guidelines would have to be updated periodically.

- **Approval of RPTs:** The process for approval of RPTs has to be strengthened. In addition to having RPT guidelines, the process should focus on proper identification of each RPT, and then following the process. These guidelines have to be binding on management. At each meeting, the management has to confirm adherence to the guidelines. AC can check some transactions at random. CFOs can give certificates regarding the information that is being placed with the ACs.

- **Certification from outside experts:** Given the complexity and the volume of RPT transactions involved, some ACs have resorted to the practice of getting outside experts, especially CAs, to study the transactions, and to make recommendations on whether the AC should clear the transactions. While getting expert assistance from the outside has its positives, it does not take away from the fact that the outside expert may not have as much of a feel for the transaction as AC members have. Further, outsourcing the process almost mechanically on a continuing basis, could lead to the charge that the AC is shying away from application of mind. Outside experts also do not have fiduciary responsibilities, and therefore, the legal liabilities, if any, that AC members might face, will not be decreased because the Committee has availed of outside expertise. There is also the important perception issue that with the CA being appointed by the management, there could be a tendency to support the management proposals in most cases. External advice would be useful when the AC of the parent company is required to approve RPTs of subsidiary companies, where the AC has much less visibility.

BOARDS

- **Encourage openness:** Board members should encourage openness so that key persons can speak to Directors, and not rely only on information relating to RPT coming to them.

- **Interaction with JVs and subsidiaries:** There should be a formal process for companies to interact with JVs and subsidiaries. What comes to the Board at present, is only a business update.

REGULATOR

- **Implementation of existing regulations:** Better implementation of existing regulations is the need of the hour. Making an example of some erring companies, would help.

- **Regulatory impact assessment**: There is a need for regulatory impact assessment, including considering the impact of these regulations on the ease of doing business. This assessment should also look at the cost of compliance.

- **End statement:** Before a regulation is sought to be amended, the Regulator should define the end statement, and make it known to the stakeholders. This does not seem to be done at present. Further, there should also be a decision taken on whether the concerned regulations should be general or prescriptive.

- **Materiality:** Materiality, determined by factors such as the size of company, should be considered while making regulations. Concept of materiality is very important, and cannot be ignored.

- **Consultation process:** The process for framing regulations needs to be improved. While SEBI publishes consultation papers, the consultative period should be longer. The suggestions received should be put out in public domain, and for the ones which are not accepted, reasons should be provided. Further, the process should have 2 stages. Once the initial comments are received, SEBI should mention what would be accepted, and can be done, and then publish the revised document for comments. Taking suggestions, and implementing them, should not be viewed unfavourably by the Regulator. Industry bodies should be more involved in such a process.

- **Alignment of law and regulations:** Efforts should be made for aligning the Act and LODR. Terms such as material, and material modifications, and the process to be followed need to be aligned.

- **Materiality of transactions:** Instead of absolute amounts, there should be materiality thresholds that should be reached for transactions to require approval from shareholders. Absolute amounts promote inequity, since they do not consider the size of the company.

- **Listing of companies:** Regulators should bear in mind that listing of companies on the stock exchanges should be encouraged. By making regulations, which seem adverse to promoter interest, listing cannot be encouraged.

- **Onerous responsibilities:** With so many regulations, and such onerous responsibilities being cast on Independent Directors (IDs), it would be difficult to get good IDs to serve on ACs.

- **Persons from outside:** The Regulator should have persons, who come from the outside to work with the Regulator for a limited period of time, so that Regulators and the regulatory environment are both enriched.

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(AN M. DAMODARAN INITIATIVE)

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