Law regulating Related Party Transactions

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Objectives

- To elevate levels of Board transparency and governance.

- To deter transactions/contracts giving rise to conflict of interest.

- Regulations to be examined separately for:
  - Listed companies with reference to LODR Regulations.
  - Unlisted companies (both private and public)

Salient Features in the present Regulations

(i) Focus in present law on self regulation subject to conditions
(ii) Process of two tier authorization under the Act.
(iii) Section 177 and 188 operate under separate unrelated domains.
(iv) In LODR focus on Audit committee authorisations.
(v) Streaks of commonality run through both regulations with certain divergences.
(vi) Unlike in old Act no requirement of central Govt. intervention.
Definition of Related party – Section 2(76)

- Unlike in old Act where thrust was on transactions with directors’ interest thereon, emphasis on qualitative aspects of transactions in present Act. Extends interest to cover KMPs, their relatives.
- Definition in Section 2(76) to apply only for unlisted companies.
- **Means** definition covering:
  - Director or his relative. Relative to cover meaning u/s 2(77) and Rules.
Related party – Definition

- KMP or his relative. KMP as per Section 2(51).
- Firm in which director, Manager or his relative is partner.
- Private Co in which director, manager or his relative is a member or director.
- A public company in which director, or manager is a director and holds along with his relatives more than 2% of its paid up share capital.
- Any body corporate whose board is accustomed to act as per directions or instructions of director or manager.
Any person on whose direction, advice or instructions a director or manager is accustomed to act.

Preceding two clauses do not apply in case advice, instructions are provided in professional capacity.

Any body corporate which is—

- Holding, subsidiary or associate of such company
- Subsidiary of holding company to which it is also subsidiary or
- Investing company or venturer of the company.
Related party  – Definition

- Investing company or venturer company means body corporate whose investment in company results in company becoming associate company of body corporate.
- Any other person as prescribed.
- Rule 3 of Specification of definitions rules– Related party includes director other than independent director or KMP of holding company or his relative with reference to company.
Extension of definition through IndAS–24

- Ind AS 24 extends contours of RP much wider.
- IndAS 24 only reporting standard for companies which embrace Ind.AS Rules.
- For listed Entities definition of Related party wider as it covers Section 2(76) or the applicable AS.(Reg.2(zb)).
- Listed Co–Need for authoriztation for RPTs under Act as also per AS.
Some significant aspects of law

- Paradox in the Act–No definition for RPT.
- Section 188 culls out certain contracts or arrangements only.
- RPTs could be of many other types – Say – provision of a financial obligation, declaration of dividend by subsidiary to Hold Co.
- Further Section 188 has no application in case of:
  - A) Transactions in ordinary course of business and
  - B) which are at arm’s length.
RPT – Per listing regulations

- RPT under Re.2(zc) of LODR:
  - Transfer of resources, services or obligations between listed company and RP
  - Immaterial whether a charged for the same.
  - Transaction includes a single transaction or a group of transactions under a single contract.
  - Definition is exhaustive but has a wider bandwidth than Section 188.
Manner of regulating RPTs—Under the Act

Where company constitutes Audit Committee per Rule 6—

Listed company and any other public company with thresholds (capital 10 crore or turnover 100 crore or borrowing fifty crore or more)

Approval of every transaction or any modifications thereto.

Rule of ordinary course and Arm’s length not to apply.
Committee to consider–
Repetitiveness of transaction (past and future)
Justification for omnibus route.
Information to be provided:
A) Name of RPs.
B) Nature and duration of transaction
C) Maximum amount per transaction
D) Indicative/contracted price and formula for variation in price.
E) Any other information relevant for grant of approval.
Omnibus approval–some aspects

- Where transaction cannot be foreseen and relevant information not available omnibus approval capped to one Crore per transaction.
- Omnibus approval to be taken every year with provision for renewal.
- Should all transactions be subject to dual approval by AC and by Board? – Point to Ponder.
- Committee can recommend to Board if it does not approve any transaction not within Section 188.
Omnibus approval rules

- Provision for omnibus approval—Rule 6A
- Criteria for approval to be set with Board approval considering –
  - Maximum value in aggregate to be allowed each year.
  - Max.value per transaction.
  - Extent and manner of disclosure for seeking approval.
  - Review periodically RPTs approved on omnibus route.
Transactions without approval

- Transaction not exceeding one Cr.if made by director or officer without approval of committee and not ratified within three months, transaction voidable at option of Committee. Director concerned to indemnify against loss.

- No applicability of 177 to transactions between Hold co. and WOS.
Applicability of Section 188

Consent at Meeting. No circular approval.

Approval subject to conditions imposed by Board.

Range of contracts covered

A) sale/purchase /supply of goods/services.
B) sale/purchase of property of any kind.
C) lease of property
D) availing or rendering of services.
E) Appointment of any agent for sale/purchase of goods/property/services
Section 188 and relevant rules

- F) RP’s appointment – any office or place of profit in company, subsidiary or Associate
- G) Underwriting of any securities or derivatives.
- Thresholds for shareholder approval of above provided by Rule 15. Approval ordinary resolution.
- Threshold
  - Sale/purchase of goods/services – value over 10% of turnover or 100 Cr. whichever lower
Rule 15

- Sale/purchase of property – 10% of net worth or 100 crore whichever lower.
- Lease of property – 10% of networth or turnover or 100 crore whichever lower.
- Availing of services – 10% of turnover or 50 crore whichever lower.
- Threshold to be seen based on transactions value for each year.
- Appointment place/office of profit – remuneration monthly 2.5 lacs.
- Remuneration for underwriting – one percent of net worth.
Other Compliances under Section 188

Agenda for meeting of Board to provide all details of RPT to be approved.

Interested director not to be present at meeting when RPT discussed by board. (Rule 15(2))

184(2) provides for disclosure by director of his interest and non-participation at meeting.

Related party not to vote on resolution for RPT.

Exception to above for company where 90% or more of members in number are relatives of promoters or are related parties.
Litmus test under Section 188

- Application of litmus test—applicability of Section 188
- What is “Ordinary course of business”.
- Rules of interpretation.—Reference to Jurisprudence.
- “normal and activities incidental thereto”—Usual transactions, customs and practices.
- Whether activity authorized by objects clause.
- Activity factually established to be in normal course.
Arm’s length basis

- Nexus between activity and nature of business carried on.
- Activity with profit motive.
- Frequency with which carried on.
- Systematic process by which activity carried on.
- **Arm’s length basis**
- Transaction between related parties conducted as if they are unrelated—purely commercial terms.
LODR Compliances

Reg.23

Formulation of policy on materiality of RPTs—periodic review and update once three years.

Material transaction—Individually or in aggregate value exceeds 10% of consolidated turnover of listed company.

Transactions—usage of brand /royalty—material if payment exceeds 5% of consolidated turnover.
LODR Compliances

- All RPTs prior approval of Audit committee.
- Provision for omnibus approval of RPTs—In sync with Act.
- Review of all transactions every quarter based on omnibus approval.
- Approval of material RPTs shareholder approval. No RP to vote whether party thereto or not. Modified to entitlement to vote negatively.
- Requirements for prospective transactions.
No applicability to
A)Transactions between two Govt. companies.
B)transaction between holding company and WOS where accounts consolidated and presented to shareholders.
Provision of RPTs within one month of submission of financial results on consolidated basis to Exchanges.
Recommendations of SEBI

- Working group set up Nov 19 for review of regulations by SEBI
- Report submitted in January 2020
- Public views sought
- Major proposals
  - Widening concept of RPTs—to cover transactions between RPs of subsidiaries with subsidiaries.
  - Extending term RP
Recommendations of SEBI

- Exemption from approval in respect of transactions between holding co and subsidiary in respect of:
  - Dividend
  - Rights/bonus /buy backs etc.
  - Additional disclosures relating to RPTs in annual Report.
- No action yet on above.
THANK YOU