

SEBI amendments to related-party transactions

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By Hitesh D. Gajaria, Senior Partner, KPMG in India

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Key takeaways:

- *Amplified responsibility and accountability for the Directors (including Independent Directors) and Audit Committee to ensure that the related-company transactions are undertaken on an arm's length basis in the regular course of business*
- *Increased transparency, ensuring good corporate governance and protecting the interests of all stakeholders.*

An important element of corporate governance in any company is to demonstrate that related-party transactions (RPT) have been conducted on an arm's length basis.

RPTs have traditionally attracted attention of regulators, auditors and managements. Currently, these are facing increasing scrutiny from independent directors and shareholders. Astute independent directors, especially those constituting the audit committee recognise their enhanced responsibility and accountability to ensure that RPTs are undertaken on an arm's length basis, and they also are undertaken in the regular course of business when necessary.

Despite multiple regulations, there is still a fair bit of unease over RPTs. Regulators are struggling to find the right balance that satisfies two apparently contradictory objectives of any RPT regulation:

- Protection of stakeholders' interests from abusive RPTs; and
- Facilitating 'ease of doing business' by not disproportionately increasing the compliance burden on companies.

Recently, SEBI recommended several changes to the coverage, disclosure, and approval process for RPTs coupled with a heightened onus on independent directors, having far-reaching implications.¹

¹ (Alternative Investment Funds) Regulations, 2012 [Last amended on November 09, 2021], Securities and Exchange Board of India, 9 November 2021

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Noteworthy amendments are:

- Prior approval of shareholders to be obtained in respect of material RPT i.e. RPT exceeding INR1,000 Crore (INR10 Billion) or 10 per cent of the consolidated annual turnover of a listed entity.
- Promoter / promoter group entities to be included in the definition of related party, irrespective of shareholding (erstwhile 20 per cent shareholding threshold removed).
- Even a transaction that indirectly benefits any related party will be considered as RPT.
- Increased onus on independent directors - their approval is required for all RPTs.

These amendments will be applicable in a phased manner, with certain amendments coming into effect almost immediately - from 1 April 2022 and others will come into effect from 1 April 2023.

It is imperative that the board of directors especially members of their audit committee and all independent directors evaluate how prepared a listed entity is on the following parameters:

- Whether the entity has a Standard Operating Process (SOP) to ensure that RPTs are carried out on an arm's length basis?
- Whether the entity maintains full and complete documentation on RPT to demonstrate they have been carried out at arm's length on a real time basis?
- If the entity has carried out all compliances in a timely manner?
- Does the organisation's documentation demonstrate the process that was followed to do price benchmarking on an arm's length basis?

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- (a) prices at which similar transactions are undertaken with unrelated parties
- (b) comparative price quotes
- (c) comparable companies' profitability (extracted from external databases) from similar transactions in the absence of specific pricing related data, etc.

Conclusion

In India, businesses are often structured as intrinsically linked group entities that operate as a single economic unit. Regulators have observed that these business structures have been used to avoid classification of transactions as RPT. Accordingly, SEBI rightly continues to take measures to strengthen its regulations around RPT. Consequently, a company's management, its board of directors, especially those sitting on its audit committee and all independent directors, need to delve deeper into RPT, considering the end beneficiaries of such transactions.

Managements of companies will need to satisfy independent directors that all related parties and RPT have been identified, a due process to ensure their arm's length nature has been followed and sufficient and relevant documentation has been maintained to provide them with all material information and explanations. This will enable the independent directors to provide timely approvals to such RPT.

While these amendments are viewed as a positive step towards minority rights and good corporate governance, they have significantly increased compliance on listed companies, their subsidiaries, their audit committee members and independent directors.

Companies and Independent Directors need to invest time to understand these new requirements as they kick in from 1 April 2022 and accordingly, plan for their implementation.

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