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RPT Framework for Listed Companies – Analysis of Recent Changes

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Background

Given the concentrated nature of shareholding and the overall influence wielded by promoters and promoter group members in Indian listed companies, related party transactions (***RPTs***) have been a key area of regulatory focus in corporate governance. While abusive and one-sided RPTs could adversely impact minority shareholders' interests, genuine intra-group transactions can result in significant value creation for listed companies. According to an OECD report published in 2022, the total consolidated income originating from RPTs of the top 500 listed companies in India has nearly doubled from 5.5% in 2006 to 11% in 2019.

There are two primary legislations governing RPTs in India -- the Companies Act, 2013 (***Companies Act***) which applies to both listed and unlisted companies, and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (***Listing Regulations***) which apply only to listed companies. Following the recommendations of a working group to review the RPT regime for listed companies, SEBI amended the Listing Regulations in late 2021, with most of the amendments coming into force in April 2022 and the remaining amendments due to take effect from April 2023. Following various representations received from market participants, SEBI has also issued two separate clarifications on the amendments, one in March 2022 and the other in April 2022.

This article analyses the recent amendments to the RPT regime as well as the related clarificatory circulars issued by SEBI in this regard.

Scope of Related Parties and RPTs

Scope of related parties

Prior to the amendment, a related party was defined under the Listing Regulations to include any promoter or promoter group member holding 20% or more shareholding in the listed company. The Listing Regulations have now expanded this definition to include all promoter and promoter group members, irrespective of their shareholding in the listed company as well as any person holding 20% or more during the previous financial year, whether directly or by way of beneficial holdings. Further, although not part of the recommendations of the working group, with effect from April 2023, the 20% shareholding threshold will stand reduced to 10%. While the 10% threshold is consistent with the fall-away threshold for promoter reclassification under the Listing Regulations, it is at variance with the threshold for categorisation as an 'associate' company under the Companies Act, which continues to be pegged at 20%. Also, the inclusion

of all promoter and promoter group members within the definition of related parties seems to suggest that SEBI's earlier proposal to overhaul the concept of promoters is still a while away from fruition.

Scope of RPTs

The recent amendments have also widened the definition of RPTs. Previously, the definition of RPT included only transactions between a listed entity (or its subsidiaries) and its related parties. With effect from 1 April 2023, RPTs will also include any transactions with third parties *"the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries"*. While this concept has been borrowed from the UK premium listing rules, there is no guidance provided by SEBI on the 'purpose and effect' test.

The amendments also clarify that certain corporate actions such as preferential allotment as well as any actions uniformly applicable to all shareholders (such as payment of dividend, buyback, rights and bonus issue of securities) shall be excluded from the definition. While such exclusions were long overdue and are much welcome, there is still no clarity on the position with respect to other matters such as payment of managerial remuneration and appointment of nominee directors, which are also regulated separately but would nonetheless technically qualify as RPTs.

Approval Requirements – Further divergence between Companies Act and Listing Regulations

Approval of audit committee / board of directors

Both the Companies Act as well as the Listing Regulations require approval of the audit committee for all RPTs. While the Companies Act mandates fresh approval for any subsequent modifications to the RPTs, only *"material modifications"* require a fresh approval under the Listing Regulations. Both regimes also provide for 'omnibus' approval of the audit committee for recurring RPTs (see details of the omnibus approval requirement in the next section below). As an additional requirement, the Companies Act requires any RPT which is either not in the ordinary course of business or on non-arm's length terms to be approved by the board of directors as well.

In the context of listed Indian subsidiaries of overseas companies, given transfer pricing requirements, RPTs involving group companies are invariably on arm's length terms. Also, transactions such as employee secondment / recharge arrangements and intra-group procurement arrangements would also be in the ordinary course of business. Having said that, in practice, even RPTs which are in the ordinary course of business and on arm's length terms are invariably approved by both the audit committee as well as the board of directors of such listed entities.

While both the Companies Act and the Listing Regulations require independent directors to constitute a majority of the audit committee, with the recent amendments to the Listing Regulations, only independent directors who are members of the audit committee of a listed entity are entitled to vote on RPTs.

Separately, following the recent amendments to the Listing Regulations, the audit committee of a listed company will now need to approve RPTs to which only a subsidiary is a party, provided that the value of such transaction exceeds 10% of the latest annual consolidated turnover of the listed entity (and effective April 2023, 10% of the latest annual standalone turnover of the subsidiary). This amendment effectively challenges the independence of the boards of the subsidiaries, especially in the context of joint ventures with third parties, since all such transactions will now be subject to the approval of the parent listed company.

Approval of shareholders

While the Companies Act provides a blanket exemption from seeking shareholders' approval for RPTs which are in the ordinary course of business and on arm's length terms, the Listing Regulations do not have any such exemption and require all 'material' RPTs to be approved by the shareholders (see materiality thresholds in the next section below). In the context of a company pursuing an IPO, any surviving material RPTs will need to be approved by the public shareholders

following the company's listing. Further, while the Companies Act excludes only those related parties who are specifically interested in the context of the relevant RPT from voting on the resolution, the Listing Regulations exclude all related parties of a listed entity from voting on a resolution for approval of material RPTs, regardless of their interest in the context of the specific RPT for which the approval is sought.

Both the Companies Act and the Listing Regulations include an exemption from seeking shareholder approval for RPTs between a listed company and its wholly owned subsidiary, whose accounts have been consolidated and placed before the members for approval. It is relevant to note that if a new wholly owned subsidiary is created by a listed entity (e.g., as part of a spin-off of a division), the exemption would only apply once the accounts of the wholly owned subsidiary are actually consolidated and placed before the shareholders of the listed entity for approval. Additionally, a new exclusion has now been added in respect of transactions entered into between two wholly owned subsidiaries of a listed company, again subject to the accounts of such subsidiaries being consolidated with the listed company.

Materiality Thresholds for Shareholder Approval

Percentage based and absolute numerical thresholds

RPTs which exceed the specified thresholds under the Listing Regulations are termed as 'material' and require shareholder approval in addition to audit committee approval. Prior to the recent amendments, the materiality thresholds were: (i) 10% of the annual consolidated turnover of the listed entity in case of RPTs other than those involving brand usage or royalty; and (ii) 5% of the annual consolidated turnovers for RPTs involving payments for brand usage or royalty. Although the materiality threshold for brand usage and royalty payments remains unchanged, the threshold for other RPTs is now set at INR 1,000 crores (~US$130m) or 10% of the annual consolidated turnover, whichever is lower. While the amendment is consistent with the recommendations of the working group, as a part of the public comments received, most market participants were opposed to including an absolute numerical threshold on the basis that it was arbitrary and also inconsistent with a prior amendment under the Companies Act in November 2019 (i.e., which had removed an absolute threshold of INR 100 crores in case of certain RPTs). The inclusion of an absolute threshold is also contrary to the benchmarks for material RPTs in other jurisdictions such as the UK, Singapore and Malaysia, which rely on only a percentage-based threshold. However, SEBI still went ahead with the amendment based on the view that several high value transactions were not getting covered under the percentage-based threshold.

It is also worth noting that since the introduction of the shareholder approval in the RPT regime in 2014 under the erstwhile listing agreement, listed companies have followed varying practices in seeking shareholder approval for RPTs. Given that the RPT requirements are broadly worded and apply to any *"transaction involving a transfer of resources, services or obligations,"* shareholder approval is usually sought either for a specific transaction / series of transactions with a related party or alternatively in respect of a specific contract with a related party (and therefore, by extension, to all transactions under such contract). Since the RPT thresholds are based on the annual consolidated turnover numbers, the thresholds would need to be tested on a yearly basis. However, there are differing practices on the frequency and nature of approvals which are sought by listed companies. In several cases, companies have obtained RPT approval from their shareholders on an annual basis, specifying the general nature of transactions to be entered into with the related party during the year (e.g., purchase / sale of goods, availing / rendering of services). Certain other companies have preferred to seek approval for a fixed number of financial years, including a cap on the aggregate value of RPTs during each year. In some others, particularly in cases where the RPTs in the upcoming year are expected to breach the previously approved cap, companies have chosen to go back to the shareholders for a fresh approval. There are also cases where companies have sought shareholder approval upfront on a one-time basis for all transactions under a contract with a related party. In this context, the working group had

recommended that RPTs should not be indefinite or open-ended and that each transaction should have an upper time limit (and that in case of recurring transactions, the aggregate value and time period within which the limit gets exhausted should be specified). However, except for the clarification relating to 'omnibus' approvals (see below), SEBI has not approved any changes in this regard as part of the recent amendments to the Listing Regulations. The amendments simply clarify that 'prior' approval of the shareholders will be required for all material RPTs and subsequent material modifications.

'Omnibus' approval conundrum

In the context of recurring transactions, the audit committee is allowed to grant an 'omnibus' approval, with such approval being valid for a period not exceeding one financial year. While companies are not expected to identify all the details of the RPT upfront, the omnibus approvals will still need to specify the name of the related party, nature, period and indicative base price for the transactions. Following the recent amendments to the Listing Regulations, SEBI issued a circular in March 2022 to clarify that RPTs that have been approved by the audit committee and shareholders of a listed company prior to 1 April 2022 do not need to be approved afresh by the shareholders. A subsequent circular issued in April went on to add that the shareholders' approval of omnibus RPTs approved in an AGM shall be valid up to the date of the next AGM for a period not exceeding fifteen months, and in case of omnibus approvals for material RPTs obtained from shareholders in general meetings other than AGMs, the validity of such omnibus approvals shall not exceed one year.

While both the Companies Act and the Listing Regulations provide for 'omnibus' approval of transactions by the audit committee, there is no such concept in the context of seeking approval of the shareholders. The recent circulars seek to clarify that RPTs which have been granted omnibus approval by the audit committee will also need the approval of the shareholders if such transactions are expected to breach the specified materiality thresholds. However, while the previous regime did not specify the validity of the shareholders' approval, the recent circulars require the shareholders' approval for such RPTs to also be renewed on an annual basis. This seems to create separate categories of shareholders' approval in respect of material RPTs. In the case of recurring transactions where the detailed terms are not available upfront, listed companies would be required to test the limits on an annual basis and seek shareholders' approval for any year in which such transactions are expected to breach the materiality threshold. However, in cases where the RPTs are in the nature of firm contracts documenting all the material terms, listed companies would likely continue to have the flexibility to seek a one-time approval for all the transactions under such contract, potentially for the entire term of the contract. Companies could also potentially face hybrid situations involving both firm / long-term contracts with related parties on certain matters as well as routine / recurring RPTs with the same related party on other matters. It remains to be seen what approach companies will choose to adopt in such situations.

Enhanced disclosure requirements

SEBI has also mandated every listed entity to make RPT disclosures in a pre-specified format every six months, within 15 days of the date of publication of the standalone and consolidated financial results. Further, a listed entity is required to provide the audit committee with the particular tenure of the proposed transaction and justification of how the RPT being considered is in the interests of the listed entity. It is worth noting that these disclosure requirements are in addition to the disclosure requirements under the Companies Act, which require various RPT details to be included in the annual reports.

Concluding Thoughts

While the amendments can be considered as a step forward in protecting minority interests and promoting good corporate governance, the additional requirements are sure to increase compliance requirements for listed companies, especially for audit committees. More substantively, the introduction of an absolute numerical materiality threshold, 'purpose and effect' test as well a one-year validity period for

omnibus shareholder approvals are likely to significantly increase the number of RPTs which will need to be tabled for the approval of shareholders. One hopes that in due course, the absolute materiality is dropped altogether and the 'purpose and effect' test as well as the omnibus shareholder approval requirements are appropriately clarified by SEBI.

This material is for general information only and is not intended to provide legal advice. For further information, please contact:

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