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# **A CRITIQUE OF THE SIXTH AMENDMENT RULES ON RELATED PARTY TRANSACTIONS IN INDIA: CHALLENGES AND SUGGESTIONS"**

AUTHORED BY - SHASHWAT SEHGAL & SUYASH SWARUP

## **INTRODUCTION**

The legal scheme of the Related Party Transactions (hereinafter referred to as RPTs), has long been viewed with reservations not only in India but also United Kingdom, Italy, Korea et cetera. This is predominantly due to the type of transactions that RPTs entail. Though listed companies ideally work on behalf of and in the best interests of shareholders, the possibility of transactions where the Board of Directors (BOD) (alias the 'representers of shareholders') are intrinsically motivated to enter due to agency conflict of personal interests and that of shareholders can neither be ruled out nor overlooked. Legal jurisdictions around the globe have been inundated with matters where the BOD failed to act in accordance with its statutory duties more pertinently, the duty to act in the best of shareholders of the company. Thus, wary of the raised issue, the Indian market regulator, brought out several amendments in order to amplify the scope of RPTs Regulation for Listed Entities in India and further fortify the interests of shareholders. Nonetheless, as this paper shall argue, the Indian Regulations despite the recent 2021 amendment require serious reconsideration as to certain aspects which despite having been brought in good faith may further a negative impact not only for companies as a whole but in advancing the best interests of shareholders.

## **COMPARISON BETWEEN PRE AND POST AMENDMENT RPTs REGULATIONS IN INDIA**

It behoves to be aired out at the outset that RPTs in themselves do not constitute an illegal act. However, what would make a certain category of RPTs (as shall be explained hereinafter) illegal would be non-compliance of the listed entity to meet with prior approvals from both the Audit Committee and the Shareholders. The first RPTs regulation in India came in 2015 namely, the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (hereinafter referred to as the 'LODR Regulations'). In spite of being thoroughly well-worded, it contained certain a plethora of loopholes in respect of RPTs and thus

became distinctly pronounced over a period of time. Acknowledging the loopholes, SEBI introduced the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2021 (hereinafter referred to as the 'Sixth Amendment') based on the groundwork of the Working Committee that was created specifically the alteration of the definition of 'related party' under Regulation 2 (1) (zb) of the LODR Regulations.

The alteration brought the inclusion of 'any person forming part of the promoter or promoter group of the listed entity' regardless of the percentage of shareholding they hold in the listed entity. This was a step away from the pre-amended LODR Regulations that required that person or entity belonging to the promoter group only when it held 20 percent shareholding in the listed company. The reason reflected was to cover for the cases where promoter/promoter group entities could slip through the cracks by not getting termed as a related party for holding less than 20 percent shareholding.<sup>1</sup> Additionally, it added any person or entity holding 20 percent or 10 percent (with effect from April 1, 2023) shareholding in the listed entity either directly or through force of Section 89, Companies Act, 2013. The *raison d'être* for including people of substantial holding was to bring definition of related parties in line with that of other jurisdictions such as the United Kingdom<sup>2</sup> and to account for the Indian scenario where notable number of businesses were run with the promoters exercising significant control or influence. Drawing parallels to the term 'substantial shareholder used in the definition of 'related party' in the UK regulation<sup>3</sup>, the Sixth Amendment brought the Indian RPTs regime on similar terms as that of the UK.

The second major change brought by the Sixth amendment is the broadening of the definition of 'related party transactions' under Regulation 2(zc) of the RPT Regulations. The Sixth Amendment widened the scope of RPTs in the aspect that it included transactions between a listed entity or subsidiary with a related party. Additionally, it brought in force the 'purpose and effect test' within the definition of the RPTs that further covered transactions between the listed entity or subsidiary with any other person or entity where the 'purpose and effect' of the transaction is to benefit that. The 'purpose and effect test' served two purposes, it aligned the RPT Regulation with the standard of the UK RPTs Regulation<sup>4</sup> and it introduced an element of *mens rea* to the concept of RPTs as

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<sup>1</sup> Sebi Report of the Working Group on Related Party Transactions, ch. 2, at 10, [https://www.sebi.gov.in/reports-and-statistics/reports/jan-2020/report-of-the-working-group-on-related-party-transactions\\_45805.html](https://www.sebi.gov.in/reports-and-statistics/reports/jan-2020/report-of-the-working-group-on-related-party-transactions_45805.html).

<sup>2</sup> Disclosure Guidance and Transparency Rules, Chapter 7, 7.3.2 and IAS 24, IFRS Standards.

<sup>3</sup> LR 11.1.4, Related party transactions, <https://www.handbook.fca.org.uk/handbook/LR/11/1.html>.

<sup>4</sup> LR 11.1.5, Related party transactions, <https://www.handbook.fca.org.uk/handbook/LR/11/1.html>.

the concept of 'purpose and effect test' seeks to unravel the RPTs and look behind it ascertain the purpose of having indulged in that transaction. The only exception to the aforesaid in the scenarios whereby defaults the transactions involve parity between shareholders such as payment of dividends, issuance of rights issue, buyback of securities, and consolidation of shares.<sup>5</sup>

The third amendment and potentially the most robust amendment is that brought in respect of Regulation 23 of the RPTs Regulations. The amendments are with respect to two sub-regulations namely (2) and (4) of Regulation 23. Apropos of sub-regulation (2), the audit committee is tasked to mandatorily define what would constitute 'material modification' in its RPTs policy, and the listed entity, on the other hand, is obligated to take the 'prior' approval of the audit committee if the RPTs entails the subsidiary of the listed entity but not the listed entity and where the transaction exceeds 10 percent of the annual standalone turnover as per the last financial statement of the subsidiary. Supplementary to aforementioned, the Sixth Amendment in order to further bolster the interests of shareholders, requires the 'prior' approval for all RPTs through resolution<sup>6</sup> which when read along with sub-regulation with (1) made material any transaction either independently or series of transactions exceeds 10 percent or 1000 Cr. (whichever is lower) of the annual consolidated turnover of the listed entity per the last audited financial statements.<sup>7</sup> The rationale for making the addition of 1000 Cr. in addition to 10 percent to sub-regulation was derived from *ex-post* evaluation of the top 500 listed entities<sup>8</sup>.

## **DRAWBACKS OF THE NEW REGIME**

As can be drawn from above, companies frequently use RPTs as a way to handle contractual delays, easy access to capital, and cost cutting. However, RPTs are still a major worry for regulators as they are frequently misused to commit corporate fraud upon the shareholders of the respective companies. While there is no doubt that this revamped system of RPT enacted by SEBI would provide the capital market regulator additional authority to monitor and govern such transactions, it is important that SEBI must address some of the challenges and drawbacks surrounding the interpretation and practical implementation of the law.

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<sup>5</sup> Part, I (b), Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2021.

<sup>6</sup> Part II (e), Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2021.

<sup>7</sup> Part II (a), Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Sixth Amendment) Regulations, 2021.

<sup>8</sup> Para 3.3.3-3.3.5, SEBI Review of Regulatory Provisions on Related Party Transactions, [https://www.sebi.gov.in/sebi\\_data/meetingfiles/nov-2021/1635849275396\\_1.pdf](https://www.sebi.gov.in/sebi_data/meetingfiles/nov-2021/1635849275396_1.pdf).

The first drawback of the new system of regulation of RPTs is the inclusion of promoter or promoter group as a related party, irrespective of their shareholding in the listed entity. The rationale behind this recommendation put forward by the Working Group was that a significant percentage of Indian businesses were structured as group entities intrinsically linked with one another such that they operate as a single economic unit, with the promoters exercising influence over the entire group.<sup>9</sup> Thus, a promoter or promoter group may exercise control over a company irrespective of the extent of shareholding.<sup>10</sup> Additionally, there were concerns that a shareholder not classified as a promoter may exercise influence over the decisions of the listed entity by virtue of his or her shareholding in the company.<sup>11</sup> That was the reason behind imposing the limit of 20% (10% from 1<sup>st</sup> April 2023) or more of the equity shareholding by a person to be considered a related party. However, in most companies, such a large stake is generally owned by large financial investors apart from the promoters.<sup>12</sup> Since the second proviso to Section 188 of Companies Act, 2013 created restrictions on voting by excluding any related party to vote on ordinary resolutions approving an RPT,<sup>13</sup> such expansion of the definition of related parties pursuant to the Sixth Amendment creates massive practical issues in terms of obtaining approval from shareholders for genuine related party transactions. Since both promoters, as well as large financial investors, are now unable to vote on such transactions due to them being a related party, the onus to analyse, approve and vote on RPTs would fall on small financial investors, who may look at RPTs from a short-term profitability perspective rather than from the needs of business, and on retail investors, who either don't vote or lack the skills, know-how or even access to necessary and relevant information to make a judicious decision.<sup>14</sup>

The second drawback is related to the widening of the definition of RPTs to include transactions between the listed entity or any of its subsidiaries and a related party of the listed entity or any of its subsidiaries. The Working Group was of the opinion that the current regulations on RPT may be insufficient to cover transactions where the listed entity could transfer its assets to a subsidiary, whether in India or overseas, and such entity could then transact with the related parties of the listed entity to move the assets out of the consolidated entity.<sup>15</sup> The problem arising here is that

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<sup>9</sup> SEBI Review of Regulatory Provisions on Related Party Transactions, [https://www.sebi.gov.in/sebi\\_data/meetingfiles/nov-2021/1635849275396\\_1.pdf](https://www.sebi.gov.in/sebi_data/meetingfiles/nov-2021/1635849275396_1.pdf).

<sup>10</sup> *See id.* at para. 3.1.4 (d).

<sup>11</sup> *See id.* at para. 3.1.3 (c).

<sup>12</sup> Harish Kumar, *Key challenges ahead for new related party regime*, Indian Business Law Journal, Aug. 1, 2022.

<sup>13</sup> The Companies Act, 2013, § 188.

<sup>14</sup> Kumar, *supra* note 13.

<sup>15</sup> SEBI, *supra* note 9.

all subsidiary companies of the holding company, including unlisted subsidiaries and foreign subsidiaries, have been included in this definition. As the LODR Regulations do not apply to it, an unlisted subsidiary company would, however, prepare its list of related parties in accordance with section 2(76) of the Companies Act, 2013, which means that two different laws would govern the rules on RPTs in the case of a holding company and its unlisted subsidiary company. Additionally, questions arise as to whether a foreign subsidiary would be governed by the LODR Regulations or as per the law of the country in which the subsidiary is incorporated. The law is not yet clear in this regard, leading to ambiguity in the interpretation and implementation of this rule.

The third drawback is related to the introduction of the 'purpose and effect' test within the RPT regime. This test was introduced to curb certain innovative structures which could be used to avoid the classification of transactions as RPTs to avoid regulatory compliance and disclosure requirements.<sup>16</sup> However, this subject of this test is very wide and ambiguous. What constitutes as a transaction, the purpose of which is to provide benefit to a related party has not been defined. Similar concerns were placed in front of the SEBI Primary Market Advisory Committee; however, no explanation was provided for the same. However, practically it may be difficult to ascertain such RPTs, leaving scope for different interpretations of this test and thereby a lot of uncertainty in its implementation.

The fourth problem of the new regime is the revamping of the materiality threshold. The introduction of the limit of 1000 crores to determine whether a transaction with a related party is material or not is arbitrary. Additionally, since the threshold is calculated on a consolidated basis, even an RPT entered into by an unlisted subsidiary of the listed company may come under the scrutiny of this threshold, despite the LODR Regulations not being applicable to the unlisted subsidiary. Also, the regulations provide for clubbing of transactions to check whether it breaches the materiality threshold. However, there is no clarity on the approach to be followed to club such transactions, thereby allowing different companies to use different approaches which are in their interest.<sup>17</sup> Further, there are certain high value transactions which may not be covered under the new materiality threshold.<sup>18</sup> For example, in FY21, 47 Nifty50 companies had annual consolidated

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<sup>16</sup> See *supra* note 9.

<sup>17</sup> Kumar, *supra* note 13.

<sup>18</sup> SEBI, *supra* note 9.

turnover ranging from Rs 11,000 crore to Rs 5,40,000 crore.<sup>19</sup> Therefore, for some large companies, the Rs 1,000 crore threshold does not constitute even 1% of the turnover while, for some smaller companies, this threshold may never be breached.<sup>20</sup> At the same time, since shareholders' approval is required to approve such transactions, it may lead to delay in execution of contracts and a lot of the times the counterparties are not willing to wait for these approvals which may take significant amount of time.<sup>21</sup> This is just another addition to the already expansive list of regulatory and compliance requirements that are required to be ticked off by a company to engage in related party transactions. Not only does this hurt the productivity of the firms and impact efficiency, but it is also a massive roadblock in the government's mission to enhance the country's 'Ease of Doing Business'.

Lastly, another drawback of the regime is with the requirement of obtaining approval from the audit committee. While this is in line with the provisions of the Companies Act 2013, the first proviso to the Regulation 23(2) of the LODR Regulations provides that only independent directors who are part of the audit committee are allowed to vote on such transactions. This is a massive issue because independent directors, due to their very role and nature, are not involved in the day-to-day affairs of the company. As a result, they would not be aware of all the regular happenings and daily needs of the company and would have to rely merely on the information put forward and shared during the meetings which they are a part of. Therefore, the independent directors may face tough challenges in reviewing the metrics of a related party transaction, particularly at the subsidiary level where most of the transactions are to manage the day-to-day affairs of the company since they are not involved in the decision-making at this level and do not have a board seat.<sup>22</sup>

## SUGGESTIONS

The latest amendments to the LODR Regulations run the risk of becoming overly restrictive in terms of policy and regulatory compliance, which may be detrimental to the business environment in India. To ensure that such a situation does not arise, SEBI must revise or, at the very least, provide clarity or explanation on its inclusion of certain provisions in the new regulations. Some ways in which this can be achieved by SEBI are provided below.

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<sup>19</sup> Dutta & Sanyal, *Assuming summary toxicity: SEBI's new norms on related party transactions norms risk being a policy overkill*, Financial Express, Feb. 10, 2022.

<sup>20</sup> *See id.*

<sup>21</sup> Bhende & Bahuva, *SEBI's related party transaction rules may hurt 'ease of doing business'*, Feb. 18, 2022.

<sup>22</sup> *See id.*

Firstly, it must devise an alternate mechanism that allows more people to vote on RPTs than just small financial investors and retail investors for the reasons which have already been mentioned. While the inclusion of the promoters in the threshold cannot be disputed, SEBI must allow some of the other large financial investors to vote on such transactions, since apart from the promoters, it is they who have the most stakes involved in the company. One way to achieve this would be to increase the limit of 10% of equity shareholding used to determine a related party. This would not limit the voting to just a select number of people with a small holding in the company who may not have the best interests of the company at heart and instead look for personal gains while voting for RPTs.

Secondly, it must properly define the ambit of the purpose and effect test used to determine a related party transaction. SEBI more clarity as to what tests/guiding principles could be used by adjudicating authorities/courts to reach conclusive answers so as determine whether the purpose and effect of the impugned transaction were to benefit a related party. However, this should be done in such a way that it does not act as a hindrance to the efficient working of a company, while at the same time fulfilling the object of SEBI behind the introduction of this rule. One way is to look at certain other tests used by the Courts while examining this issue. A case pertinent to the aforementioned matter is *Nabha Investment P Ltd. v. Assistant Commissioner of Income Tax*<sup>23</sup> where the court applied the ‘test of commercial expediency’ as laid down in *CIT vs. M/s Panipat Woollen & General Mills Co. Ltd.*<sup>24</sup>, and further enunciated its mode of usage. The Delhi High Court used the ‘test of commercial expediency’ in order to ascertain whether the transactions entered by the appellant company were genuine transactions or mere subterfuge. In this regard, the aforesaid test requires the court to place itself in the boots of the business and determine whether it would have been reasonable for it to indulge in that transaction. The test of commercial expediency may well be read with the settled doctrine of ‘lifting the corporate veil’<sup>25</sup> in order to answer the evolving jurisprudence on the purpose and effect test. Ergo, despite the ambiguity related to its jurisprudence, it could certainly be argued that the ‘purpose and effect test’ reinforces and further provides a statutory backing for the ‘doctrine of lifting the corporate veil’ and the ‘test of commercial expediency’ by viewing transactions entered for the benefit of related party(ies) within the ambit of commercial scrutiny by courts.

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<sup>23</sup> *Nabha Investment P Ltd. v. Assistant Commissioner of Income Tax*, 1995 (33) DRJ 496, para 14.

<sup>24</sup> *CIT vs. M/s Panipat Woollen & General Mills Co. Ltd.*, 1976 AIR SC 640, para 10-14.

<sup>25</sup> *Jai Narain Parasrampurua (Dead) And Others v. Pushpa Devi Saraf and Others*, 2006 SCC 7 756, para 48-51.

Thirdly, there is a need to rejig the materiality threshold set forth by the Sixth Amendment Rules. The limit of 1000 crores must be amended if not removed as it only adds to a lot of the existing complexities and compliance issues, since not only does it lead to a large number of genuine RPTs falling under the radar of regulatory bodies, but also leads to delay in execution of such transactions. Additionally, the threshold must be calculated on a standalone basis, taking into account only the financials of the listed entity and not those of its subsidiaries. Further, SEBI must provide guidance on the rules and accounting principles to be followed while clubbing transactions of the same financial year, such that a uniform method is established and followed by all companies, rather than each company using a different approach that suits their interests.

Lastly, the proviso to Regulation 23(2) of the LODR Regulations, which allows only independent directors who are part of the audit committee to vote on RPTs, must be done away with. The provisions of Section 177 provide that the audit committee must consist of at least three directors, the majority of which are independent. It is well established that the directors of a company have a fiduciary duty to act in the best interests of the company, and not towards any individual or group of shareholders.<sup>26</sup> Therefore, there is no reason to exclude those directors who are not independent directors but are a part of the audit committee from voting on RPTs. Since they would be more informed on the working of the company, it will only help them make a judicious decision on whether a given RPT is in the best interests of the company. At the same time, there would be more people approving the RPT, meaning that the decision-making would not be solely in the hands of a few people, leading to a more informed decision.

## CONCLUSION

The intention of SEBI in bringing about the Sixth Purpose based on the recommendations of the Working Group however seemingly prudent is yet fragmented with limitations and requires amendments or at least serious deliberation. As explained in the paragraphs above, without it, it could potentially end up causing unintended harm and prove inhibitive to the growth of the corporate sector in the era of increased globalization.

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<sup>26</sup> *Peskin v Anderson*, [2001] 1 BCLC 372.