

# Related Party Transactions: Implications for Investor Protection

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## Executive Summary

- In recent years, Related Party Transactions (RPTs) have received considerable attention from regulators in India.
- The SEBI Listing Obligations and Disclosure Requirements Regulations (LODR) have emphasized the role of promoter as a related party. SEBI LODR 2018 introduced stricter disclosure requirements and expanded the ambit of enforcement, which has led to increased reporting.
- The SEBI LODR 2021 has further tightened the disclosure requirements by bringing the timeline of disclosure closer to the announcement of the financial results and has also prescribed a list of documents to be submitted by the listed entity seeking approval from its audit committee.
- Among the BSE200 firms, chemicals and pharmaceuticals in the manufacturing sector and banking in the services sector account for most of the RPTs reported, while engineering and construction account for the largest share of transactions in terms of value.
- The incidence of RPT is higher in firms with higher promoter holding and lower market capitalization.
- Indian regulations have over the years converged with the standards of the United States and the European Union.

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## I. Introduction

The Governor of the Reserve Bank of India (RBI) recently flagged Related Party Transactions (RPTs) as an issue of concern. In his address at the National Academy of Audit and Accounts (NAAA), Shimla, the RBI Governor drew attention to ‘instances of diversion of funds and / or transfer of profits to connected parties through various means – intra-group loans on favourable terms, over or under invoicing of transactions, asset transfers without fair valuation, etc’ (Das 2021). He urged auditors ‘to identify and thoroughly scrutinise related or connected party transactions to ensure that there is no undue transfer of income or assets’ (ibid).

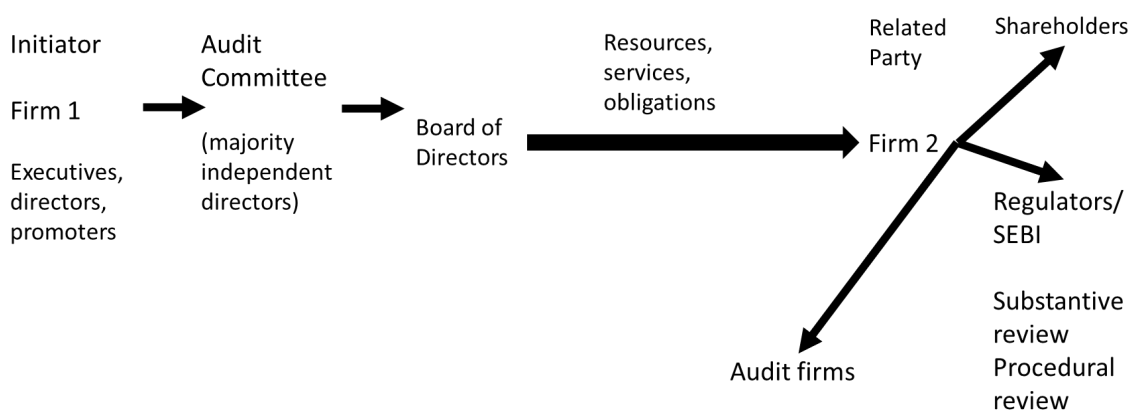
RPTs are one of the means through which controlling owners can expropriate wealth from minority shareholders. In the Indian context, firms are particularly vulnerable to RPTs owing to the concentrated ownership structure in the hands of the promoters (Rasheed et al 2019). Many countries have adopted regulations to check expropriation through RPTs and protect minority shareholders. However, RPTs can also be beneficial if they can substitute internal markets resulting in cost savings, increased efficiency and optimal utilisation of resources. Consequently, RPTs need to be regulated but should not be banned.

This *Quarterly Briefing* examines the evolution of RPT regulation in India and is divided into four parts. The first examines the regulatory framework of RPTs with an emphasis on the amendments in the Listing Obligations and Disclosure Requirements Regulations, 2021 (LODR) adopted by the SEBI on November 9<sup>th</sup>, 2021. The second discusses RPTs involving BSE200 firms during 2014-2020. The third compares the regulation of RPTs in India with the United States and the European Union. We conclude with a brief discussion on the road ahead.

## II. Regulatory Framework

The Companies Act, 2013, the Indian Accounting Standard 18 (Ind AS 18), and the LODR 2021 govern RPTs in India (Figure 1). The Income Tax Act, 1961 also contains relevant provisions on transfer pricing. The recent history of the regulatory framework can be divided into four phases outlined in Figure 2.

**Figure 1: Regulation of Related Party Transactions**

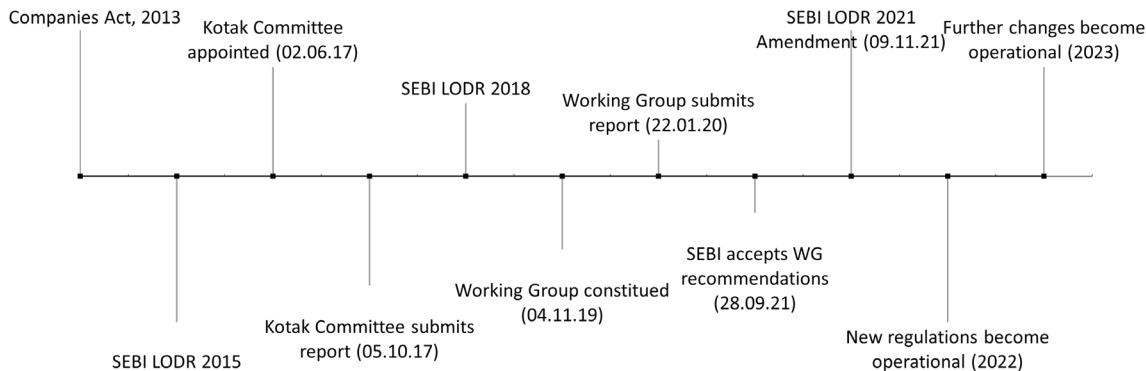


Source: Authors

The pre-2013 regulations mandated disclosure but did not call for its approval by an independent organ of the corporation, say, independent board members or disinterested shareholders. The Companies Act 2013 moved closer to global standards by requiring approval of disclosure by an independent organ of the company. In 2015, the SEBI amended Clause 49 to align it with the Companies Act, 2013. The Uday Kotak Committee that expanded the definition of related parties to include promoters marks the beginning of the third phase, while the fourth and current phase began in 2021 when the recommendations of a Working Group on RPTs were adopted by the SEBI (Figure 2). The Working Group called for the harmonisation of provisions governing RPTs in various regulations and recommended further strengthening of monitoring and enforcement mechanisms. Its recommendations include changes in the

definitions of related party, RPTs and threshold classification of RPTs and a tightening of disclosure mechanisms with a greater onus on audit committee of the listed entity.

**Figure 2: Evolution of RPT regulations**



Source: Authors

Following the Working Group’s recommendation, the definition of related party has been expanded to cover promoters and promoter groups with any level of shareholding and it now includes any person or their relatives having at least 20% shareholding. This threshold will drop to 10% in 2023. The lowering of the threshold was not suggested by the Working Group. The definition of ‘relative’ follows the Companies Act 2013.

The Working Group noted that RPTs increasingly involve complex transactions, through relatives not covered in the regulation and loans being given to an unrelated party that in turn offers loan to a related party. Accordingly, it recommended that RPTs should include transactions which are undertaken, whether directly or indirectly, with the intention of benefitting related parties. These changes have been accepted by the SEBI. At the same time, the Working Group recommended that corporate actions such as payment of dividend, sub-division or consolidation of securities, buy-back, rights and bonus issue of securities should be excluded from the list of RPTs as they treated all shareholders equally. Similarly, it also recommended that preferential allotment of securities that are separately regulated by the SEBI should be excluded. The SEBI, however, did not accept these exclusions.

The SEBI has added ₹1,000 crore to the threshold of 10% of the consolidated annual turnover of a listed entity for determining the materiality of a transaction for shareholder approval. This makes the requirement of shareholder approval more stringent. Similarly, the scope of the audit committee for scrutinising RPTs has been enhanced. For instance, the timeline of disclosure of a RPT to the stock exchange and shareholders has been compressed from 30 days to 15 days (every six months) for a listed entity after the publication of the consolidated and standalone financial results. Effective from April 1<sup>st</sup>, 2023, this disclosure needs to be on the date of publication of the financial results. Notably, the SEBI has introduced the regulatory changes in a phased manner over a period of two years (i.e., (financial years 2022 and 2023)).

**Table 1: Comparison of different regulations in India**

	Companies Act (amended 2017)	SEBI (LODR) 2018	SEBI (LODR) November 9, 2021	Differences
<b>Related Party</b>	Related party includes director, relatives of a director, key managerial personnel	In addition to the requirements of the Companies Act and accounting standards, the LODR deems any person or entity belonging to the promoter or promoter group of the listed entity and holding 20% or more of the shareholding of the listed entity, to be a related party.	Includes any person or entity (a) belonging to the 'promoter' or 'promoter group', irrespective of their shareholding in the listed entity and (b) any person/entity holding 20% or more equity shares in the listed entity, either directly or on a beneficial interest basis at any time during the preceding financial year. From April 2023, this threshold will be 10% or more.	Promoter included as a related party in the LODR. The shareholding threshold reduced in the LODR 2021.
<b>RPT</b>	a. Sale, purchase or supply of any goods or materials; b. selling or otherwise disposing of, or buying, property of any kind; c. leasing of property of any kind; d. availing or rendering of any services; e. appointment of any agent for purchase or sale of goods, materials, services or property; f. such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and g. underwriting the subscription of any securities or derivatives thereof, of the company.	A transfer of resources, services or obligations between a listed entity and a related party (excluding units issued by mutual funds which are listed on a recognised stock exchanges), regardless of whether a price is charged.	Transactions between: a. the listed entity or any of its subsidiaries on one hand and a related party of the listed entity or any of its subsidiaries on the other; b. the listed entity or any of its subsidiaries on one hand, and any other person or entity on the other, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries w.e.f. April 1, 2023.	Definition of RPT is broader in the Companies Act

	Companies Act (amended 2017)	SEBI (LODR) 2018	SEBI (LODR) November 9, 2021	Differences
<b>Threshold Classification</b>	10% of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity in case of sale or purchase of material through agent, property, leasing of property and engagement of service. In case of related party appointment, threshold for shareholder approval is a remuneration exceeding Rs. 2,50,000/- per month. The threshold is 1% of the net worth of the Company in case of underwriting of securities etc. All these RPTs would require board approval, irrespective of the threshold.	A transaction with a related party shall be considered material if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds -		
		10% of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity.	A threshold of lower of ₹1,000 crore or 10% of the consolidated annual turnover of the listed entity for shareholder approval.	Threshold classification similar in the Companies Act and the LODR. The LODR 2021 adds a lower threshold of ₹1,000 crore
<b>Oversight</b>	Board Approval of all RPTs. Shareholder approval required over a certain threshold, mentioned above. Approval of audit committee after board approval in companies where audit committee exists as per Section 177(1) of the Companies Act.	Part C of Schedule II of the LODR  The audit committee shall mandatorily review the following information:  a. disclosure of any RPTs  b. approval or any subsequent modification of transactions of the listed entity with related parties. The audit committee shall mandatorily review	Enhanced disclosure of information related to RPTs, including between subsidiaries, to be:  a. placed before the audit committee,  b. provided in the notice to shareholders for material RPTs, and  c. provided to the stock exchanges every six months in the format  specified by the Board with the following timelines:	Audit committee approval is required by both the Companies Act and the LODR, but the thresholds vary.  The LODR 2021 also requires the approval of

	Companies Act (amended 2017)	SEBI (LODR) 2018	SEBI (LODR) November 9, 2021	Differences
		the information statement of significant RPTs (as defined by the audit committee), submitted by management.  The disclosure timeline: within 30 days from the date of publication of the financial results of the listed entity.	i. within 15 days from the date of publication of financials.  ii. simultaneously with the financials w.e.f. April 1, 2023.  The amendments shall be effective from April 1, 2022 unless otherwise specified above.	transactions between subsidiaries by the audit committee.

Source: Authors

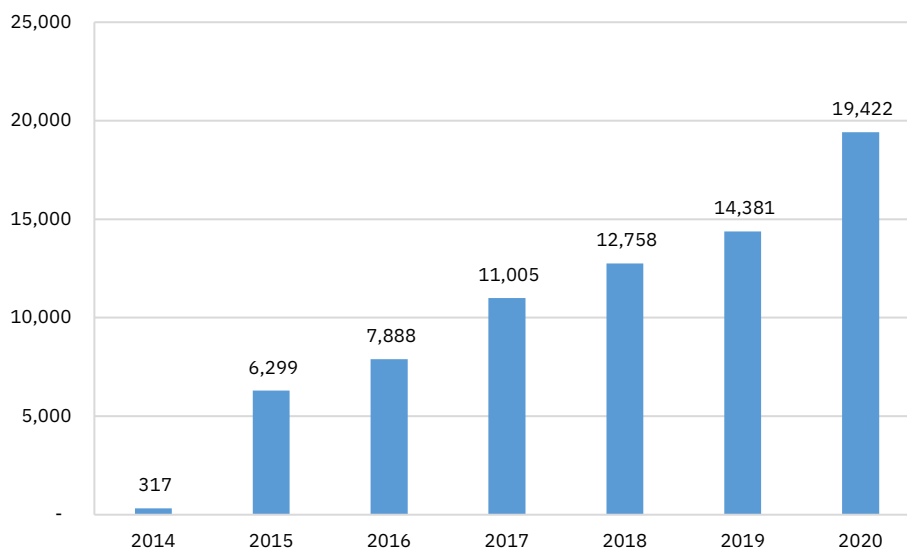
### III. Impact of Regulation

We use data from CMIE Prowess for the period from 2014 to 2020 for BSE200 Companies (2020) to analyze the incidence and volume of RPTs by industry group, market capitalisation, ownership and promoter holding. The key findings on incidence and volume of RPTs are discussed in this section.

#### Incidence

During 2014-20, 192 firms reported 72,070 RPTs (Figure 3), while eight (8) firms did not report any such transaction in a few years. Figure 3 shows that there has been a dramatic increase in the reporting of RPTs after 2017-18, i.e., the implementation of the recommendations of the Uday Kotak Committee. Over the years, three major industries, namely, Chemicals, Pharmaceuticals and Financial services account for a large share of RPTs (Figure 4). The lowest incidence of reporting is observed in apparel manufacture, leather manufacture and air transport.

**Figure 3: Incidence of RPTs Reported by BSE200 Companies during 2014-2020**

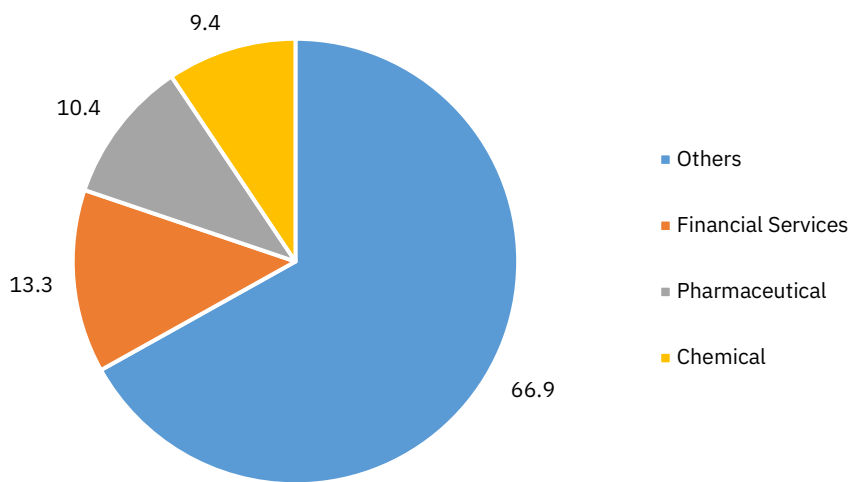


Source: CMIE Prowess

So far as the industry classification of 551 promoter-led RPTs is concerned, we find that the banking sector (Axis Bank and HDFC Bank) accounts for 219 RPTs in the period from 2017–20. This is followed by warehousing services industry. For the entire period of analysis and the entire sample, the manufacturing industry dominates RPTs, while the services industry dominates in case of promoter-led RPTs.

In terms of ownership, business groups account for more RPTs. This is consistent with the fact that most of the RPTs reported occur in subsidiary companies. Moreover, the corporate governance literature also documents tunneling within business groups in India (Bertrand, Mehta and Muralidharan 2002).

**Figure 4: Incidence of RPTs Across Industries, 2014-20**



Source: CMIE Prowess

The incidence of RPTs seem to be independent of the level of profit of companies. However, a higher incidence of RPTs is observed among companies with higher promoter holding and lower market capitalization. This suggests that regulators should adopt a targeted approach towards RPTs, focusing more on business groups, specific industries and those firms with concentration of promoter holding and lower market capitalization.

Following the recommendation of the Uday Kotak Committee, promoters were included as a related party by the SEBI in 2018. The number of RPTs reported by promoters account for 0.11% of the total RPTs reported during 2018-2020. Interestingly, the median promoter holding in firms where promoters were involved in RPT is around 60%, with 51% RPTs occurring in firms with more than the median promoter holding.

## Volume

The mean transaction value, i.e., total revenue receipts associated with the transaction as a fraction of income, is highest in the services industry, particularly, engineering services and construction activities. The mean value of transactions is highest in business groups, followed by government enterprises.

Further, the volume of RPTs is higher for firms with higher promoter holding and lower market capitalization. This provides a justification for the focus on promoter holding in RPT regulation. However, contrary to our observation which suggests there should be greater focus on higher promoter holding, the SEBI has lowered the threshold for promoter holding from 20% in LODR 2018<sup>1</sup> to zero by 2021. This might overburden the regulatory mechanism.

<sup>1</sup> The 20% threshold was based on the definition of ‘significant influence’ in the Companies Act under the definition of ‘associate company’ to mean “control of at least 20% of the total voting power, or control or participation in business decisions under an agreement”. Further, Indian Accounting Standards 28 also states: “If an entity holds, directly or indirectly (e.g., through subsidiaries),

In terms of transaction volume as captured by revenue receipts as a percentage of income, we find the mean transaction size peaked in the year 2015. Thereafter, there has been a steady decline in 2016 and 2017 and a smaller peak in 2018. On the other hand, there has been a significant increase in the number of reported RPTs after 2016-17.

There is a dip in the number of reported RPTs in the financial year ending on March 31<sup>st</sup>, 2021, which overlaps with the Covid-19 pandemic that suppressed economic activity. During this period, the Working Group committee also submitted its reports to the SEBI in January 2021. Following the Working Group, the SEBI increased the scope of reporting further by lowering the threshold of promoter holding and expanding the disclosure criteria, as discussed above. The full impact of the changes adopted by the SEBI will become clear only after these provisions are implemented.

### **Oversight**

The Companies Act 2013 and the SEBI LODR both require an approval of the audit committee for RPTs. In the LODR 2015, additional requirement involves submission of the minutes of the audit committee report to the board of directors, while the board in turn needs to determine the independence of the independent directors and disclose the same in its corporate governance report. The Working Group's review of the listing requirements for approval by audit committee emphasized the need for independence of the committee members and a list of minimum requirements on which information should be provided to the audit committee. The list includes type, material terms and particulars of the RPT, tenure, value of the proposed RPT in terms of the revenue, asset and net worth of the listed entity, details pertaining to the financials of the RPT, justification of the RPT and its relevance to the listed entity and an external valuation report.

The LODR 2021 lays down certain conditions for approval by the audit committee. In particular, the amendment requires all RPTs to be approved by the audit committee in case material change takes place due to RPT as defined by the audit committee. It also requires approval by the audit committee where a subsidiary of a listed entity is a related party, though the listed entity itself is not subject to a threshold of 10% of the turnover of the consolidated entity (10% of the standalone turnover of the subsidiary w.e.f. April 1<sup>st</sup>, 2023). Moreover, the audit committee of a listed entity must approve transactions undertaken across subsidiaries of that entity. The SEBI has also amended the LODR to stipulate minimal documentary requirements for approval by the audit committee.

## **IV. International Comparison**

In the United States, RPT regulations are covered under the Sarbanes Oxley Act 2002, the Securities Exchange Act 1934, US Generally Accepted Accounting Principles (GAAP) and NASDAQ. The Securities Exchange Commission (SEC), 2017 defines RPTs as "any transaction, arrangement or relationship, or any series of similar transactions, arrangements or relationships, in which (i) the Company or any of its subsidiaries is or will be a participant, and (ii) any Related Party has or will have a direct or indirect interest."

In 2017, the European Union (EU) introduced the Shareholder Rights Directive II that includes the RPT regulations. Table 2 compiles the salient features of the regulations on definition of related party and the RPT in the United States and the EU. A comparison of Tables 1 and 2 highlights the institutional context.

The definition of related party is based on accounting standards in both the United States and the EU. The Indian definition of related party takes the Ind AS18 as a benchmark and adds further related parties to the list based on the institutional context of the country and the nature of transactions. The threshold for determining a transaction to be material is 10% of the net worth of the firm in the EU while the United States does not provide any threshold limit. In India, too, the threshold to determine 'material transaction' is kept at lower of transaction value of ₹1,000 crore and 10% of the net worth. While the United States regulation provides for audit committee, as in India, the EU regulations do not call for approval by the audit committee. So far as these provisions are concerned, we find India converging to

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20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case" (Working Group Report 2020).



the international standards, except for the definition of related party, where the definition adopted by India is stricter as compared to the United States and the EU.

**Table 2: Comparison of RPT Regulations**

	United States	European Union
<b>Related Party</b>	"Related Party" means any person who is or was (since the beginning of the last fiscal year for which the Company has filed an Annual Report on Form 10-K and proxy statement, even if such person does not presently serve in that role) an executive officer, director or nominee for director of the Company, any shareholder owning more than 5% of any class of the company's voting securities, or an Immediate Family Member of any such person.	Shareholders Rights Directive (SRD) II refers to the International Accounting Standards (IAS). Companies that are members of the same group are always related parties, which means that each parent, subsidiary and fellow subsidiary is related to the others.
<b>RPT</b>	RPT means any transaction, arrangement or relationship, or any series of similar transactions, arrangements or relationships, in which (i) the Company or any of its subsidiaries is or will be a participant, and (ii) any Related Party has or will have a direct or indirect interest.	The provisions of SRD II apply only to material transactions (value exceeds 10% of the listed company's balance sheet sum) taking into account: "(a) the influence that the information about the transaction may have on the economic decisions of shareholders of the company and (b) the risk that the transaction creates for the company and its shareholders who are not a related party, including minority shareholders."
<b>Oversight and approval</b>	Oversight by the Audit Committee.	Shareholder approval by another corporate body, namely, the listed company's supervisory board.  Public announcement at the time of conclusion of transaction.

Source: Authors

## V. Way Forward

India is among the countries with a strong regulatory framework for governing RPTs. Since 2013, changes in Companies Act and the LODR regulation have driven the convergence of India's regulation of RPTs with global standards. It will be some time before the impact of the recent regulatory changes introduced by the SEBI become clear. In particular, we need to see how the revised timelines of the approval process and documentary requirement impact RPT disclosures. Further, our analysis suggests that regulators should focus resources to monitor RPTs in specific industries, firms with higher promoter holding and among business groups. The incidence of RPTs, both in terms of number and volume, is higher in companies with lower market capitalisation, thus requiring focus on relatively small-sized companies.

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