Corporate Governance

Improving Corporate Governance in India

RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER PROTECTION



OECD

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Foreword

In 2011, India and the Organisation for Economic Co-operation and Development (OECD) launched a bilateral dialogue on policy options to improve corporate governance in India. The Securities and Exchange Board of India (SEBI) is a chief constituent of the programme, along with the Ministry of Corporate Affairs (MCA), stock exchanges and professional associations. The first phase of the programme focused on designing policies to improve the monitoring and prevention of abusive related party transactions (RPTs) in India. India also participated in the OECD Corporate Governance Committee's *Peer Review on Related Party Transactions and Minority Shareholder Rights* (2012), and contributed to the *Guide on Fighting Abusive Related-Party Transactions in Asia* (2009) through the Asian Roundtable on Corporate Governance.

In a meeting held on 14-15 December 2011 in Mumbai, a number of areas for improvement were identified, and initial recommendations to support the policy design of reforms were provided. Discussions focused on the means to combat abusive RPTs and to strengthen minority shareholder protection. The Committee's Peer Review served as the basis for discussion. The following methods were identified to prevent abusive RPTs: legal redress and more stringent enforcement, more active shareholder engagement, improved disclosure of company groups and improved effectiveness of independent directors.

On the basis of the discussions held in Mumbai, SEBI prepared a draft report with key proposals for the implementation of the Peer Review recommendations on related party transactions and minority shareholder protection. The aim was to build consensus around these objectives and suggest implementation steps. This final report is the result of extensive consultation with policymakers and practitioners from India and the OECD, and reflects inputs and suggestions received at the India-OECD Policy Dialogue held in New Delhi on 5-6 March 2013.

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Abbreviations and acronyms

AS 18	Accounting Standard 18 –'Related-Party Disclosures'
BSE	Bombay Stock Exchange
CARO	Companies Auditor's Report Order
FASB	Financial Accounting Standards Board
FCA	Financial Conduct Authority
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAI	Institute of Chartered Accountants of India
IFRS	International Financial Reporting Standards
IPO	Initial public offering
KMP	Key managerial personnel
MCA	Ministry of Corporate Affairs
NSE	National Stock Exchange
OECD	Organisation for Economic Co-operation and Development
PSU	Public-sector undertaking
RPT	Related party transaction
SEBI	Securities and Exchange Board of India

Introduction

A concern that many markets around the world share in relation to poor corporate governance is the abuse of related party transactions (RPTs). This is particularly true in markets where controlling ownership is predominant. Judging by the frequent reporting of RPTs, this calls for the relevant authorities and companies to be vigilant and have in place an effective oversight framework through which abusive RPTs can be identified, prevented or stopped. As many high profile cases have shown, abusive RPTs damage shareholders value, tarnish the company's reputation with investors, both domestic and foreign, and undermine investor confidence in the integrity of the financial market as a whole.

Concentrated ownership and widespread use of company groups is a common feature of listed companies in India; most companies are closely held by families or the state. This provides more scope for RPTs involving controlling shareholders, and increases the probability of abuse if not conducted at arms-length. Hence, there is a need to determine and assess the effectiveness of minority shareholder protection and the monitoring and prevention of abusive RPTs.

India has over the years pursued and introduced several measures to improve corporate governance standards including the introduction of a new Company Bill in 2013. However, further measures are needed to improve minority shareholder protection, support a higher degree of transparency and disclosure, and promote greater accountability of controlling shareholders.

This report is an outcome of the India-OECD Policy Dialogue since 2011 and extensive consultation with policymakers and practitioners from India and the OECD. It presents the current challenges and identifies suggestions to strengthen the legal and regulatory framework around the approval process of RPTs in India.

What are related party transactions and how to prevent abuse

According to the OECD Principles of Corporate Governance (2004), related parties can include entities that control or are under common control with the company, significant shareholders including members of their families and key management personnel. Transactions involving the major shareholders (or their close family, relations etc.), either directly or indirectly, are potentially the most difficult type of transactions to identify. In some jurisdictions, shareholders above a limit as low as 5 per cent shareholding are obliged to report transactions. Disclosure requirements include the nature of the relationship where control exists and the nature and amount of transactions with related parties, grouped as appropriate. Given the inherent opaqueness of many transactions, the obligation may need to be placed on the beneficiary to inform the board about the transaction, which in turn should disclose to the market. This should not absolve the company from maintaining its own monitoring, which is an important task for the board.

The International Accounting Standards Board (IASB) defines related party transactions as a transfer of resources, services, or obligations between related parties regardless for which a price is charged. The Financial Accounting Standards Board (FASB) in the United States defines them as a transaction between related parties even though it might not be given accounting recognition; for example, one entity may receive services from a second, related entity without charge and without recording a receipt of services.

A related party transaction can present a potential or actual conflict of interest and might not be aligned with the best interests of the company and its shareholders, especially minority shareholders. It can result in situations where such transactions are used as a conduit to channel funds out of the company into another entity which is a "related party." These transactions can also be considered as a business opportunity that is lost to a related party to the detriment of the interests of the company and its shareholders. Thus, these conflicts of interest are inherently linked to the governance structure of a company, which can either enhance or limit the board's effectiveness. The board carries the main responsibility for reviewing and guiding corporate

strategy and for effectively monitoring management, and is accountable to the company and its shareholders.

Not all RPTs are detrimental to the interest of the company or its shareholders. Some transactions can be legitimate and serve practical, commercial purposes. If companies are prohibited from entering into such transactions, their ability to maximise shareholder value can suffer. Take, for example, a large manufacturing company X and a software giant Y that are known to have a common entity as the majority shareholder. If Company X determines that it would get the best deal in quality and price for software for its machinery from Y and both X and Y are offering their products strictly on prevailing market terms based on competitive pricing, then it would be contrary to X's commercial interests not to procure this software from Y merely because they have common ownership. Hence, related party transactions may also be beneficial, depending upon the terms of the transaction.

The various types of RPTs that are commonly observed are:

- Financial assistance through provisions of loans, guarantees and collateral
- Asset sales and purchases between related parties
- The sale, purchase or supply of any goods, materials or services in the ordinary course of business
- Bailouts

Some related party transactions are conducted for the purpose of exchanging products or services, which should occur at an arm's length basis. Some products or services do not have comparable benchmarks in the marketplace, however, as they are available only within a closed group. For example, a pharmaceutical conglomerate holds all of its patents with one company. If other companies have to manufacture those products, they might have no choice but to transact with the related party for using such rights. In that case, there might not be any transaction available in the marketplace that can serve as a useful benchmark to assess whether the transactions was conducted at arm's length.

OECD reports on related party transactions

The OECD-Asian Roundtable Task Force published a Guide to Fighting Abusive Related party Transactions in Asia (2009). The report acknowledged that not all RPTs are abusive. The regulatory framework in a particular jurisdiction may have to strike a balance between the potential abuses of minority shareholders and an unfair regulatory burden on the companies that conduct their business equitably and transparently (which indirectly imposes a cost on all shareholders). Further, the Guide suggests the following criteria for assessing an abusive RPT:

- Who are the parties on either side of the transaction?
- What asset is being transferred?
- How is the asset priced?
- What compensation is involved?
- Are any of the parties in a conflict of interest?
- Why is the asset being transferred? Why now?

The OECD completed its third thematic peer-review exercise on Related Party Transactions and Minority Shareholder Rights. Five jurisdictions were subject to the in-depth review: Belgium, France, India, Israel and Italy (see Chapter on India in the Annex). Subsequently, a meeting was held on 14-15 December 2011 at SEBI Bhavan in Mumbai, attended by senior representatives of SEBI, the Ministry of Corporate Affairs, stock exchanges, professional bodies, industry experts, OECD officials and representatives from the regulatory bodies of Israel and Italy.

The OECD published its report "Related Party Transactions and Minority Shareholder Rights" in 2012 based on the peer-review exercise. Below are a few key messages:

- Globally, the potential to abuse related party transactions (RPTs) is perceived as a critical policy issue. Even though they are rarely banned, jurisdictions have sought to put in place approval processes to minimize the negative potential. Countries' approaches vary, that

is why the report focuses on the experience of five jurisdictions (Belgium, India, Israel, Italy and France) with more general information about 31 others.

- Though the introduction of IFRS (i.e. IAS 24 for RPTs) around the world has introduced an important standard for transparency, alone it is not sufficient. The jurisdictions that were review introduced requirements for ongoing disclosure of material transactions. Defining materiality has been a particular challenge with indications that quantitative criteria might be more effective. Also, continuous monitoring by the regulator might be necessary. Transactions have also been classed by whether they are on market terms and/or whether they are recurrent.

- With regard to approving RPTs, great emphasis has been put on approval by the board, with a tendency to delegate this task to a committee of independent board members. There are frequent questions about how to ensure effective independence of board members from controlling shareholders. Three approaches have been taken that represent good practices. First, shareholders are given a say in approving certain transactions, with interested shareholders excluded. Second, minority shareholders are able to vote directly for a board member of their choice. Third, in some cases a controlling shareholder has a fiduciary duty to other shareholders and the company. An abusive RPT would be against the interests of non-controlling shareholders and thus represent a breach of duty.

- Enforcement is a key issue around the world and remains a challenge. In several of the reviewed jurisdictions steps have now been taken to establish specialized courts and in two, the regulators are now seeking to offset legal fees for derivative shareholder actions.

- In most countries around the world, company groups and concentrated ownership are normal. Under such conditions, RPTs are mainly with the controlling shareholders and/or with members of a company group. This raises particular problems for managing and classifying RPTs. Some inter-company transactions with 100 per cent owned subsidiaries might present no great threat of abuse but others might be of a major concern. In some jurisdictions law and jurisprudence recognize that the directors of a company owe a duty to the company group. In others, a controlling company must take responsibility for their actions.

- The chapter on India states that "Weak enforcement possibilities are the primary reasons why some OECD Principles are not fully implemented. The key principles are*:*

"Principle III.A.2 (minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress). While laws and regulations are in place, effective means of redress is lacking.

"Principle III.C (members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation). This is implemented by laws and regulations even though enforcement might remain problematic.

"Principle V.A.5 (disclosure should include, but not be limited to, material information on related party transactions). Broadly implemented through the listing agreement and accounting standards although disclosure about the company group might need to be better developed.

"Principle VI.D.6 (the board should fulfil certain key functions, including monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions) is broadly implemented by Sections 299 and 300 of the company law although they might need to be tightened to cover conflicts of interest with controlling shareholders and company groups."

Related party transactions – India's perspective

In India, most companies are family-owned and/or closely held (OECD 2012). Hence, the corporate governance framework in India should emphasise monitoring/regulating connected transactions involving controlling shareholders (so called "promoters") and related entities.

Several factors are relevant to any discussion of related party transactions in India and underpin the reason for a large number of such transactions. Given that the number of family-owned businesses is very high, it follows that they will have closer ties with other businesses owned by the same family or its relatives. The desire and opportunity to deal with a known party will be greater.

Also, a large number of listed companies in India are subsidiaries of multinational corporations. Owing to regulations (such as Foreign Exchange Management Act and Regulations) that regulate the flow of capital between the overseas parent and an Indian subsidiary, the companies may engage in certain RPTs to facilitate transfers between the parent company and the subsidiary, without compromising statutory requirements.

While, as noted above, there may be benefits in such arrangements -- such as the higher level of trust involved when dealing with familiar parties and potential efficiencies in the contracting process -- the close relationships can also present problems. The tension between dealing fairly with a familiar party and exploiting shareholders' resources for personal gain becomes magnified in family-owned businesses. The absence of transparency exacerbates the problem by creating an environment in which attempts to siphon off resources go unchecked. Abusive RPTs oppress small and retail investors, undermining confidence in the financial market and thereby adversely affecting the mobilisation of investment.

Legal framework governing related party transactions in India

Existing law does not prohibit RPTs in India. Instead, the law puts into place a system of checks and balances, such as requirements for approval from the board of directors/shareholders, timely disclosures and prior statutory approvals, to ensure that the transactions are conducted within appropriate boundaries. RPTs are required to be managed transparently, so as not to impose a heavy burden on a company's resources, affect the optimum allocation of resources, distort competition or siphon off public resources.

The Companies Act

The Companies Act 2013 contains the definition of related party, as follows:

"Related party", with reference to a company, means

(i) a director or his relative;

(ii) a key managerial personnel or his relative;

(iii) a firm, in which a director, manager or his relative is a partner;

(iv) a private company in which a director or manager is a member or director;

(v) a public company in which a director or manager is a director or holds along with his relatives, more than two per cent. of its paid-up share capital;

(vi) anybody corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;

(vii) any person on whose advice, directions or instructions a director or manager is accustomed to act:

"Provided that nothing in sub-clauses (vi) and (vii) shall apply to the advice, directions or instructions given in a professional capacity;

(viii) any company which is:

(a) a holding, subsidiary or an associate company of such company; or

(b) a subsidiary of a holding company to which it is also a subsidiary;

(ix) such other person as may be prescribed."

The Companies Act 1956 imposes certain conditions when a company is entering into any transaction in which directors have an interest.

- Section 297 of the Companies Act requires board approval for entering into any contract or arrangement with the related parties. This section covers only transactions relating to sale, purchase or supply of any goods, materials and services or for the underwriting of the subscription of any shares in, or debentures of, the company.
- Further, there is a requirement to obtain prior central government approval if the company has paid up capital of more than one core rupees.
- At the same time, section 297 (2) provides exemption to obtaining approvals if:
  - The purchase/sale is for cash and at prevailing market prices,
  - The contract relates to goods, materials and services regularly traded or doing business, provided the value of the contract is less than INR 5000, or
  - In the case of a banking or insurance company, the exemption applies to any transaction in the company's ordinary course of business.
- Section 299 imposes a duty on directors to disclose their interest in other concerns to the board of directors before entering into any contract with the related parties. Section 299 is broader than Section 297, since it covers any contract or arrangement with entities in which a director is concerned or interested.
- Section 300 disallows the director to participate in voting when the board resolution is passed relating to any business in which s/he is interested. The main intention behind this section is to prevent personal gain by the interested director.

- The Companies Auditor's Report Order (CARO) requires the auditor to comment on certain related party transactions and on the reasonableness of those transactions in the audit opinion.

Accounting standards

To enhance disclosure of related party transactions, the Institute of Chartered Accountants of India (ICAI) introduced Accounting Standard 18-Related-Party Disclosures, which requires companies to disclose RPTs in their financial statements. Under Accounting Standard 18-Related Party Disclosures (AS 18), "parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions." A related party transaction means "a transfer of resources or obligations between related parties, regardless of whether or not a price is charged."

The following are examples of related parties pursuant to AS-18:

- Holding companies, subsidiaries and fellow subsidiaries
- Associates and joint ventures
- Individuals (including their relatives) having voting power giving them control or significant influence
- Key management personnel (KMP), including their relatives
- Enterprises where individuals, their relatives or KMP have the ability to control or exercise significant influence.

Currently, this definition of a related party is used to identify the transactions for making disclosures in the Annual Report. The definition is also referred to in determining related party transactions for the purpose of compliance with the Listing Agreement. The section of the Annual Report on managerial remuneration, loans/advances due from directors and subsidiaries and the auditor's report (which may certify/qualify certain transactions) may provide important supplementary information on transactions with related parties. In its commitment to converge Indian Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS), ICAI has published Indian Accounting Standards 24 on Related Party Disclosures, which substantially reflects the standards set forth in International Accounting Standard (IAS) 24.

IAS 24, which deals with related party transactions, has a wider definition and coverage of related party transactions. The definition of related party under IAS 24 is: *"A related party is a person or entity that is related to the entity that is preparing its financial statements"*

The term "related" has further been defined to include persons having the ability to exercise control/joint control or significant influence over the reporting entity. Further, members of the family and entities under common control are covered under this definition. The IAS 24 definition of related parties includes the KMP of the parent company within the related party framework. Furthermore, this definition covers co-ventures or co-associates and requires extended disclosures for compensation of KMP under different categories. IAS 24 also mandates disclosure of the amount of related party transactions; in comparison, Indian AS 18 requires the disclosure the volume of transactions either as an amount or as a proportion.

India also announced a roadmap to converge with IFRS and has published converged Accounting Standards Ind AS. Ind AS 24 corresponds to IAS 24 and deals with related party transactions. While Ind AS 24 has a similar definition of related parties as IAS 24, it is much more comprehensive and seeks to address some of the present concerns in its wider scope and more specific disclosure requirements.

The Income Tax Act 1961

A disclosure that a related party transaction was made during the year serves little purpose, unless one takes into account the terms of the transaction and the tax implications. Section 40 A (2) of the Income Tax Act disallows the expenditure incurred in respect of specified persons (related parties) if the tax assessing officer considers the expenditure excessive and unreasonable.

Auditing and Assurance Standard 23 imposes duty on the auditor to identify and disclose RPTs in the financial statements.

Equity Listing Agreement

As per Clause 49 of the Equity Listing Agreement, the audit committee (a committee on which two-thirds of the directors and the chair are independent) should review the RPTs, whistle-blower mechanism and internal control, among other areas (Clause 49).

Further:

a) The audit committee shall periodically consider a statement in summary form of transactions with related parties in the ordinary course of business.

b) The audit committee shall evaluate details of material individual transactions with related parties that are not in the normal course of business.

c) The audit committee shall review details of material individual transactions with related parties or others that are not on an arm's length basis, along with management's justification for those transactions.

Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have a personal interest or that may pose a potential conflict with the interests of the company at large (for example, dealing in company shares and commercial dealings with bodies under common management) (Clause 49).

SEBI has taken certain steps to prevent abusive RPTs, such as a requirement that listed companies provide a fairness opinion of any independent merchant bankers employed by the company to their shareholders on schemes involving mergers with unlisted companies and comprehensive disclosures regarding related party transactions in the offer documents for public and rights issues.

SEBI Circular

Further, to encourage minority shareholders and institutional investors to participate in the voting process of the listed companies, SEBI has issued circulars dated October 05, 2011 and March 15, 2010 requiring listed companies to disclose the voting patterns to the stock exchanges and asset-management companies of mutual funds to disclose their voting policies and their exercise of voting rights on their websites and in Annual Reports. The Ministry of Corporate Affairs' and SEBI's initiatives on e-voting (see below) will also facilitate dispersed minority shareholders' exercise of their voting rights in General Meetings.

Areas to be addressed[1]

There are ways that a company may circumvent the legal requirements of disclosures and approvals, by disguising related party transactions as ordinary transactions. A few examples are:

- If Company P wants to enter into a contract with Company Q in which there is a common director or a director and his relative or

associate has a pecuniary interest, a third entity, R, is introduced in which the common director or his relative, associate or partner does not have any apparent interest and P then enters into a contract with R; R separately enters into one or more counter–contract(s) with Q. Since P and R, and R and Q, are not related parties, the deal does not fall within the purview of related party transactions and accordingly disclosure requirements are not activated.

- If Company P proposes to enter into a contract with Company Q and the companies have a common director, the common director resigns from the board of Q before entering into the contract and is then reappointed after the contract is executed.

Further, some widely prevalent examples of RPTs are described below:

- A publicly listed company funds promoter-owned (*i.e.* controlling shareholders) group companies to conduct research, and the patents and trademarks are registered in the name of the promoter-owned group companies. The publicly listed company pays a significant amount of royalties to these companies.

- The land and building on/in which the premises of the listed company are situated, owned by a promoter or promoter-owned group companies, and a significant amount is paid to such companies as rent.

- The lack of effective control over managerial remuneration to related parties, where controlling shareholders dictate managerial remuneration (which even the remuneration committee is forced to accept), is a significant problem.

The effectiveness of independent directors in monitoring major RPTs should be scrutinised, since they play a significant role as part of the audit committee in reviewing major RPTs.

In the wake of the Satyam fraud -- in which the company chairman admitted in 2009 that the company's accounts had been falsified, to the tune of some USD 1.5 billion -- (See Box A.1 in Annex) the need for reviewing India's corporate governance framework came to the forefront; there was only technical compliance in that case, and decisions were taken without regard to the rationale underlying relevant accounting principles or whether the transactions made business sense. The Satyam case highlighted inadequacies in the existing legal provisions designed to prevent abusive RPTs in India. Based on the deliberations with OECD representatives and market participants, the following suggestions and courses of action have evolved.

Suggestions

Defining related party transactions

Related party transactions are one of the most widely used ways that controlling shareholders exploit the rights of minority shareholders. Formulating a comprehensive definition of the term "related party" is one of the basic steps in the regulation of RPTs. An accurate and comprehensive definition should cover all modes of direct and indirect related party transactions that management/directors or controlling shareholders might undertake.

Adoption of the wider definition of related parties as provided in Ind AS 24 may help to bring more related party transactions into its purview and ensure more specific disclosures. However, the definition under Ind AS 24, which is akin to that under IAS 24, might not address the concerns expressed above.

At the India-OECD Policy Dialogue held in New Delhi on 5-6 March 2013, it was suggested that the best way to bring indirect RPTs within the ambit of the regulatory framework would be a hybrid approach providing for a principles-based definition supported by objective rules. Keeping in mind its enforceability, however, most of the participants agreed that the criteria for identifying a related party be kept as objective as possible since subjective criteria would be difficult to implement. While some participants suggested that there should be a harmonised definition of RPTs that can be used uniformly across all laws/regulations, others suggested that it would be better to have separate definitions considering the different regulatory objectives/requirements set forth in different statutory regimes, as is the case in some jurisdictions such as Israel.

It was suggested that using "control" alone to identify related parties would not be sufficient and that "influence" should also be considered. Further, it was pointed out that relationships should be determined over a period of time and not just at a certain point. There were suggestions that certain types of RPTs may be categorised as "abusive" unless proven otherwise.

Accordingly, the experts concluded that the definition of RPTs should be hybrid in nature: a principles-based definition ensuring better coverage, supported by objective rules ensuring better enforceability. The definition should also take into account direct and indirect influence, and not be confined to the control element for identifying a related party.

Approval of major RPTs by a "majority of the minority"

Many abusive RPTs are undertaken between company groups controlled by the majority shareholders. In such cases, requiring shareholder approval of RPTs might not serve the intended purpose, as the controlling shareholders would have a sufficient majority to obtain shareholder approval of an abusive RPT. Hence, some developed jurisdictions mandate approval of such RPTs by a majority of the minority or by "disinterested" shareholders. Nevertheless, experience in some jurisdictions like Israel has shown that classifying shareholders as disinterested might pose practical difficulties. It may be advisable to clarify legal presumptions and definitions for the purpose of determining an interested shareholder. In addition, each shareholder who votes in the General Meeting should notify the company before the vote on whether or not s/he has a personal interest in the approval of the transaction, to help the company classify him/her as interested or disinterested. Furthermore, some jurisdictions have imposed safeguards to prevent abuse by minority shareholders by requiring a minimum percentage of votes that must be obtained to block a resolution.

As suggested by SEBI, Section 188 of the Companies Act 2013 contains a similar provision prohibiting interested shareholders from voting on transactions with related parties. This provision would help mitigate the inherent conflicts of interest presented by shareholder approval of abusive RPTs.

In some jurisdictions like Israel, a transaction relating to terms of employment of a controlling shareholder or his/her relatives requires a renewed approval every three years. In case RPTs are carried out on a continuous basis, whether there should be any validity period for approval of such recurring RPTs may also be considered. This matter was also deliberated at the India-OECD meeting in New Delhi. It was proposed that the approval by disinterested shareholders of recurring RPTs be valid for three years and that fresh approval are sought upon the expiry of this period.

Pre-approval by the audit committee and third-party evaluation of RPTs

Currently, the audit committee reviews RPTs periodically after RPTs have taken place. Such reviews are of limited use, given that the transaction cannot be undone even if the audit committee expresses a negative opinion.

This handicap can be removed if the audit committee is required to approve major RPTs. There were suggestions at the India-OECD Policy Dialogue that the audit committee be responsible for examining the RPTs and their impact on the company and shareholders. It was further suggested that the audit committee be responsible for deciding whether an RPT is abusive and to provide a certification to this effect. Finally, it was suggested that reasons for the audit committee's approval of a transaction should be disclosed.

The Companies Act 2013 mandates *interalia*, the constitution of an audit committee with a majority of independent directors. It also requires the audit committee to approve or modify transactions with related parties. The committee is required to specify the reasons for its classification of a transaction as extraordinary or material, or as non-extraordinary or non-material. The committee may classify these terms in advance and annually based on its own criteria, scrutinise inter-corporate loans and investments, and value undertakings or assets of the company wherever necessary. The duties of the audit committee in this regard shall be as specified in the terms of reference authorised by the board. Furthermore, the Companies Act 2013 grants the committee the authority to investigate any matter falling under its domain as well as to obtain professional advice from external sources and have full access to information contained in the company's records. These provisions would address the aforementioned issues.

Immediate and continuous disclosures rather than periodic ones

Currently, RPTs are disclosed to stock exchanges on a periodic basis. This limits the effectiveness of the disclosure, as the information is available to investors considerably later than when the transactions were concluded.

Certain jurisdictions, such as Italy and Israel, have provisions mandating immediate disclosure of major RPTs. This would help with better scrutiny of the transactions by investors, the public and regulators, thereby limiting the scope for abusive RPTs. At the India-OECD Policy Dialogue, participants agreed that there is a need for more frequent disclosure of RPTs. It was also proposed to mandate that management certify that all material RPTs have been disclosed. It was suggested that immediate disclosure of RPTs would

address the information asymmetry caused by non-disclosure to public shareholders. In addition, it was suggested that the focus be on increasing not only the frequency of disclosures, but also on the quality of information disclosed. Accordingly, it was agreed that SEBI should consider amending the listing agreement to require listed companies to disclose major RPTs immediately upon entering into such transactions. This should include both capital and revenue (recurrent RPTs) transactions.[2] If the shareholders need to pre-approve at the General Meeting, disclosure should be made before the meeting.

The disclosures should include all relevant details about the transaction that may be considered important to a reasonable investor or to a reasonable shareholder for the purpose of voting at the meeting, including, *inter alia*:

- The description of the main terms of the transaction;
- The name of the controlling shareholder who has a personal interest in the transaction, and the nature of his/her personal interest;
- The reasons of the audit committee and the board of directors for approving the transaction and the reasons of the directors opposing it, if any;
- The manner in which the consideration was determined and the name of each director who has a personal interest in the transaction and the nature of his/her interest.

Requiring approval by shareholders for divestment of major divisions/subsidiaries

Divestment of major subsidiaries and the hiving off of major divisions of an undertaking do not require shareholders' approval under the existing legal framework. There have been cases where a major subsidiary or division was transferred to controlling shareholders after getting the approval of the board of directors. Section 292 of the Companies Act 1956 provides that the powers for investing funds of the company have to be exercised by the board only in its meeting by means of resolutions passed at the meeting (*i.e.* they cannot be passed through circulation). Section 293 (1) (a) of the Companies Act 1956 requires shareholders' approval for selling off the whole or a substantial part of an undertaking. There is, however, no specific requirement regarding the sale of the shares in a subsidiary (*i.e.* divestment) in the Act. This has led to abuses committed by controlling shareholders divesting the major subsidiaries, without proper valuation, to the companies, that are indirectly owned by them.

The matter was discussed at the India-OECD Policy Dialogue in New Delhi. It was noted that the Companies Act 2013 is silent on this issue. As SEBI's powers under the SEBI Act 1992, to prescribe listing conditions are in addition to but not in derogation of the provisions of the Companies Act, it was suggested that SEBI amend the listing agreement requiring the listed companies to obtain shareholders' approval in the case of divestment of shares in major subsidiaries.

Approval of managerial remuneration by disinterested shareholders

The remuneration paid to CEOs in certain Indian companies is generally higher than that of their foreign counterparts, and there is no justification given for this. The Companies Act, 1956 specifies the limit on managerial remuneration and provides for central-government approval for remuneration beyond the limit. The overall cap placed on managerial remuneration is 11% of net profits of the company, also according to the Companies Act 2013.

Most Indian companies are managed by promoters, which raises concerns about excessive remuneration to executives forming part of the promoter/promoter group. This can result in abusive related party transactions.

Section 188 of the Companies Act 2013 prohibits interested shareholders from voting in related party-transaction approvals. In line with this, it was suggested to consider requiring companies to obtain approval by shareholders whereby interested/related parties abstain from voting on managerial remuneration beyond a certain limit.

Fiduciary responsibility of controlling shareholders

Controlling shareholders, better known as promoters in India, who manage the company owe a fiduciary responsibility to the minority shareholders and to the company as a whole. There have been cases where controlling shareholders have used the company for their personal interest while sacrificing the overall interest of the company and of its shareholders -- mostly through abusive RPTs.

Current laws/regulations do not explicitly set forth the fiduciary responsibilities of the controlling shareholders.

In the UK, the Financial Conduct Authority (FCA) has proposed reinstating the express provision that a listed company must be capable of acting independently of a controlling shareholder and its associates. Accordingly, the FCA has proposed definitions for controlling and

independent shareholders. Further, a proposal has been made to mandate that a listed company enter into a relationship agreement when it has a controlling shareholder, and that the agreement complies with content requirements set forth by the FCA which may include, *interalia,* the following:

- transactions and relationships with a controlling shareholder are conducted at arm's length and on normal commercial terms;
- a controlling shareholder must abstain from any act that would have the effect of preventing a listed company from complying with its obligations under the Listing Rules;
- a controlling shareholder must not influence the day-to-day running of the company at an operational level or hold or acquire a material shareholding in one or more significant subsidiaries;
- the relationship agreement must remain in effect for as long as the shares are listed and the listed company has a controlling shareholder.

The requirement for a relationship agreement will apply to a listed company on a continuous basis. It is also proposed that all material amendments to the relationship agreement be subjected to a shareholder vote, which would exclude a controlling shareholder, in order to give independent shareholders a say on how the relationship between the listed company and a controlling shareholder is managed and how it develops going forward. In determining what constitutes a material change, the listed company should consider the cumulative effect of all changes since the shareholders last had an opportunity to vote on the relationship agreement or, if they have never voted, since the listing.

At the India-OECD Policy Dialogue, it was pointed out that recognising the fiduciary responsibility of the controlling shareholders would help prevent abusive RPTs that by their very nature would conflict with the interests of the non-controlling shareholders and hence would lead to a breach of the fiduciary duty. It was also pointed out that in some jurisdictions like France; such a breach is treated as a criminal offence. In view of this, SEBI might consider introducing specific fiduciary responsibilities for controlling shareholders and evaluate the feasibility of mandating a relationship agreement between the company and the controlling shareholder specifying the duties and responsibilities of controlling shareholders.

Improving selection mechanism for independent directors

Currently, the appointment and removal of independent directors is done through election by a majority. Thus, independent directors occupy their position at the request of the controlling shareholders and therefore must act in accordance with the will of the majority. This, in effect, hinders these directors from expressing their opinions independently and honestly and thereby limits their efficacy and defeats the purpose of appointing independent directors. Some jurisdictions, like Italy and Israel, have provisions for the appointment of independent directors by minority shareholders, which ensures more independence. Various international practices on appointment of independent directors were discussed at the India-OECD Policy Dialogue in New Delhi. It was suggested that controlling shareholders not be allowed to vote in the election of independent directors so as to ensure the latters' independence.

Section 150 of the Companies Act 2013 sets forth the manner that companies appoint independent directors from a data bank maintained by such institution, body or association as may be notified by the central government. Further, Section 151 of the Companies Act 2013 provides that a listed company may have one director elected by small shareholders under the terms and conditions as may be prescribed, where "small shareholders" is defined as a shareholder holding shares of nominal value of not more than INR 20 000 (equivalent to USD 333) or such other sum as may be prescribed. Listed companies may be required to appoint one or more small-shareholder directors. Furthermore, there is an enabling provision in the Companies Act 1956 and Companies Act 2013 for appointment of directors through proportional representation or cumulative voting, which if implemented would help ensure much-needed balance in the Board and would address the issues in the current appointment mechanism of independent directors.

Certain jurisdictions, like Israel, specify the duration of office of external directors. Further, the controlling shareholder cannot prevent the re-appointment of an independent director for an additional three-year term if a majority of minority shareholders approve the appointment.

Clarity on liabilities and on remuneration of independent directors

There is a need to bring in risk-return parity[3] to the post of independent directors to attract high-quality people onto boards. Currently, there is no clarity on the liability of independent directors, and their remuneration (only sitting fees in most cases) is considered to be inadequate in view of their associated responsibilities and risks. The Companies Act, 2013 explicitly

defines the duties that directors have towards the company, its employees, its shareholders and the community as a whole; it has also established a code for independent directors. Nevertheless, the Companies Act 2013 makes the independent director liable only for acts of omission or commission that occurred with his/her knowledge, attributable through board processes and with his/her consent or connivance or where s/he had not acted diligently. Although the Companies Act, 2013 provides that an independent director shall not be entitled to any stock options, it allows the payment of fees, reimbursement of expenses and profit-related commissions. These provisions, if enacted, would address such issues.

Providing training to independent directors on the business of the company

Independent directors should be properly trained on the various aspects of identifying; analysing and preventing abusive RPTs. Periodic training may be mandated. The India-OECD Policy Dialogue included discussions on the need for a formal training framework for independent directors. While it was suggested that formal training may be required only for newly appointed directors, the importance of an induction programme for independent directors to improve their competency and effectiveness was also noted. In addition, it was suggested that the training be based on a gap analysis, with provisions in the articles enabling and encouraging the training of directors.

Improving investor education for better participation at General Meetings

Investor education has been hailed as the key to improving governance standards and preventing abusive RPTs. It would improve not only the level of participation in General Meetings but also the quality of deliberations at the meetings. SEBI has been a leader in conducting investor education and awareness programmes. The Ministry of Corporate Affairs' and SEBI's initiatives on E-voting will also facilitate dispersed minority shareholders' exercise of their voting rights in General Meetings.

Another important factor to improve the level of participation in General Meetings rests with institutional investors. Institutional investors such as mutual funds are regulated entities and are expected to exercise voting rights in fiduciary capacity keeping in mind the interest of beneficial owners. Therefore, they are duty bound to exercise their voting power in matters which are perceived to harm the interest of the beneficial owners. It remains to be seen whether the recent SEBI requirement to enhance

disclosure on voting policies is sufficient. If not, consideration could be given to introduce further measures to encourage greater institutional investor participation in shareholder meetings if there is a RPT on the agenda that they believe could harm their unit holders.

Provision for regulatory support to class action suits

Regulation 5 (2) of SEBI (Investor Protection and Education Fund) Regulations, 2009 provides that the Investor Protection and Education Fund created by SEBI may be used, *interalia*, for aiding SEBI-recognised investors' associations to undertake legal proceedings (not exceeding 75% of the total expenditure on legal proceedings) in the interest of investors in securities. Although there are provisions for oppression and mismanagement, there is no express recognition of class action/derivative lawsuits in the Companies Act 1956. Section 245 of the Companies Act 2013, however, expressly provides for class action suits, and Section 125 provides for the re-imbursement of expenses incurred in class action/derivative suits from the MCA's Investor Education and Protection Fund.

The importance of strengthening private-sector enforcement by extending support for class action and derivative suits was discussed at the India-OECD Policy Dialogue. It was suggested that class action suits by investors can play an effective role in enforcement, for which an investor protection fund can be used to offer financial support for such actions. Participants noted that the current provisions in the SEBI Regulations and Companies Act 2013 would address the issue.

Establishment of specialised courts

A lack of specialized courts to try commercial cases is a major obstacle to effective enforcement. The Companies Act 2013 provides for the establishment of Special Courts for the speedy trial of offences under the Companies Act. Section 436 provides that all offences under the Companies Act shall be subject to trial only by the Special Court established for the area where the offence is committed. The Act also empowers the Special Courts to try "in fast track" any offence under the Companies Act that is punishable with imprisonment for a term not exceeding three years. The India-OECD Policy Dialogue also highlighted the need for these courts to try corporate offences and noted that the provisions in the Companies Act 2013 are expected to speed up the enforcement machinery dealing with abusive RPTs.

There are two modes for regulating RPTs: approval-based controls, which require approval by the board of directors/shareholders, and disclosure-based controls required under AS-18. The focus should not be on making approval norms stringent but on making them effective. At the India-OECD Policy Dialogue, it was pointed out that, while a "name and shame" approach would help reduce the incidence of abusive RPTs, a little bit of "pain" should also be induced to ensure effective enforcement of the regulatory framework for RPTs.

Conclusions

Many, if not most, of the listed companies in India are majority-owned by families with varied business interests, and, related party transactions are prone to misuse by controlling shareholders for their personal interest. Motivated by the owners' financial gain and desire for perpetual control, the abusive transactions can range from the transfer of assets/liabilities or sale of securities at an unfair price to an outright bailout of related parties on unreasonable terms. Thus, in India, related party transactions endanger the interaction between majority and minority shareholders, with serious implications for the development of financial markets.

The India-OECD Policy Dialogue explored these issues in depth and highlighted the need for a comprehensive definition to identify related party transactions. In view of the need for wider coverage, including of indirect RPTs, coupled with the ease of enforcement, it was suggested to advance a hybrid definition for RPTs. The conference also discussed the need to support private-sector enforcement, requiring the immediate disclosure of RPTs and improving the effectiveness of the approval framework by requiring approval by a majority of disinterested shareholders[4]. Strengthening the role of independent directors and introducing a whistle-blower mechanism were also suggested[5] as effective measures to tackle abusive RPTs.

The meeting also suggested increasing the quality of disclosure of RPTs to shareholders and improving shareholder participation through e-voting. Finally, it was suggested that SEBI carry out certain changes in the listing agreement to address these and other concerns. As noted above, the Companies Act 2013 would address many of the concerns discussed in this paper.

Notes

1. The areas to be addressed were identified through the SEBI-OECD policy dialogues held in December 2011and March 2013 in India.
2. In Hong Kong, China, and in Malaysia, the thresholds for such disclosures are reviewed every few years to reflect the volume and size of transactions in those markets. In the case of recurrent RPTs, approval is required from shareholders at the AGM for the following year based on the estimated size of transactions.
3. It is reported that while Independent Directors have almost similar responsibilities as that of non-independent directors, they have been observed to be paid comparatively less. Therefore, the suggestion to design their pay commensurate with the risk they face.
4. Disinterested shareholders' refers to shareholders who do not have any special interest in the proposed resolution or who are not the beneficiaries of the proposal contained in the resolution.
5. Though not discussed in-depth in the report, it was suggested during the India-OECD Policy Dialogue that strengthening the whistle-blower mechanism would help mitigate abusive RPTs to some extent.

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Annex

India Peer Review of Related Party Transactions and Minority Shareholder Rights, OECD, 2012

http://www.oecd.org/daf/ca/corporategovernanceprinciples/50089215.pdf

This Annex on India describes the structure of listed companies and especially the concentration of ownership and the use of company groups all of which are related to the type and intensity of related party transactions. The corporate governance framework that has been established to manage such transactions and to protect minority shareholders is analysed and the potential for improvements discussed. Reference is made to the scheduled review of company law by the parliament.

India has a major listed company sector and has been pursuing improved corporate governance standards since 1998 when the country produced one of the first substantial codes of best practice in corporate governance in Asia. Further improvements followed during the first decade of the century including the introduction by the Securities and Exchange Board of India (SEBI) of Clause 49 in the Listing Agreement covering corporate governance. This Clause was further developed in 2004 in relation to the role of independent directors and audit committees. However, the Satyam fraud of late 2008 (see Box 4.1) which also involved a controversial related party transaction that was approved by independent directors, indicated a need for further measures.

Both SEBI and the Ministry of Corporate Affairs (MCA) have reacted with, inter alia, new rules by SEBI in February 2009 requiring greater disclosure by controlling shareholders (i.e. termed promoters in India) of their shareholdings and any pledging of shares to third parties. However, some investors (e.g. ACGA, 2010) believe that more needs to be done about the heart of the problem in India: the accountability of controlling shareholders (i.e. promoters) to other shareholders. This is compounded by over-burdened courts, and limited enforcement resources for the two main institutions, the Company Law Board (CLB) of the MCA and SEBI. The MCA has drafted a new company law that was being considered by

Parliament at the time of writing. The proposed Bill contains some far reaching measures to improve the rights of shareholders and to facilitate implementation. It is thus a good time to review the situation.

The chapter first outlines the structure of ownership and control in India and the major role of company groups and controlling shareholders. It then examines evidence of RPTs and the incentives that could lead to abuse. It next reviews the current regulatory framework and the enforcement record of the two principal agencies. Finally, an assessment of the implementation status of the relevant OECD principles is presented and suggestions made for possible future actions, some of which might be included in the new company law.

The ownership and control of Indian listed companies

India is characterised by concentrated ownership and by the widespread use of company groups, often in the form of pyramids with a wide basis (in many different activities and companies) and with a number of levels. There are some 6000 listed companies in India on two primary stock exchanges but many have a very small free float and some 2500 are suspended from trading. One study of the 1470 companies listed on the National Stock Exchange indicated that as of March 2010 controlling shareholders (i.e. promoters) held 57 per cent of all shares and institutional shareholders about 20 per cent (Bhardwaj, 2011). One study (Balasubramanian et al., 2009) of 300 companies indicated that 142 included a shareholder with an ownership stake higher than 50 per cent. A further 100 included a shareholder holding 30-50 per cent of the equity. Studies summarised by Chakrabarti et al, 2008 found that promoters held 48 per cent of shares in a sample of 2500 listed manufacturing companies; around 51 per cent in group companies and 46 per cent in standalone companies. The study also suggested that actual holdings are likely to exceed 50 per cent since holdings are often hidden in the form of other corporate bodies in a pyramid structure or individual shareholders.[1]

Table A.1. **Ownership of Indian listed companies**

Largest shareholder ownership stake	Number of firms	Per cent
75% and more	19	7%
50.01%- 74.9 %	123	43%
40.01-50%	61	21%
30.01-40%	42	15 %
20.01-30%	26	9%
Up to 20%	18	6%

Source: Balasubramanian et al 2009, P. 19, Table 12

Of the firms sampled by Balasubramanian et al, 2009, 165 of them (a little over a half) are part of an Indian business group which includes one or more other public firms. This is broadly supported by another study of 500 large Indian companies of which in 2003, 378 were affiliated with a group (Sarkar, 2010). The study also cites a data base (Prowess) that in 2006 identified 2922 firms affiliated with 560 Indian owned groups, a predominant majority of these identified with specific families (Sarkar, 2010, page 299). The number of such groups is compounded by their size: for all firms, the share of total assets of affiliated firms was around 70 per cent in 2006 and amongst the top 500 firms, it was around 80 per cent (Sarkar, page 301).

Concentrated ownership and group company structures are associated with a particular structure of boards. One study found that 40 per cent of Indian companies had a promoter on the board and in over 30 per cent of cases they also served as an executive director (Chakrabarti et al, 2008, page 17). Executives of one group company often serve on the boards of other group companies as outside directors. Potentially concerning, Sarkar reports that independent directors are also related to company groups, with about 67 per cent of their directorships in group affiliates, and notably 43 per cent of directorships concentrated within a single group.[2]

The fact that independent directors are appointed by controlling shareholders (i.e. promoters) might have a significant impact on their perception of their duties. One study noted that all the independent directors in the study (admittedly a small and not fully disclosed sample) viewed their role principally as that of strategic advisors to the promoters and most did not perceive their role as monitoring management and controlling shareholders (Khanna and Mathew, 2010). This is probably just as well for them: another study noted that "if controlling shareholders cease to be pleased with the efforts of an independent director, such a director can be certain that his or her term will not be renewed". (Varottil, 2010).[3]

Nevertheless, a recent study (Chakrabarti, et al 2010) suggests a more nuanced position. From event analysis occasioned by the resignations of many independent directors in the wake of the Satyam scandal, it appears that resignations particularly by those independent directors with business/accounting knowledge and on audit committees led to lower (excess) returns (i.e. they are valued by shareholders). However, for tightly held family companies there was little impact, suggesting that independent directors are not regarded as effective in such companies.

Within groups, a common structure involves pyramids and cross holdings of shares. As a result, there is a significant difference between cash and control rights in group firms (so called wedge).[4] This can present

opportunities for moving resources from one company in which the controller has low cash flow rights to another where the rights are higher. One method for shifting is via related party transactions.

Evidence indicates that groups are controlled by a single management entity that sets the strategic vision, the philosophy and management practices of a group, often through the inclusion of family members on the boards of affiliates (see Sarkar page 307 and references therein). This can lead to the issuance of debt by a group company in favour of others that could go against the interest of minority shareholders in group affiliates (Kakani and Joshi, 2006).

In sum, the structure of Indian listed companies creates incentives that, unless balanced by corporate governance arrangements, company law and financial regulation, is conducive to related party transactions that might violate minority shareholder rights.

Defining and disclosing RPTs: The Indian Accounting and Listing Standards

The Indian accounting standards relevant to RPTs is AS18 which is close to IAS 24 (Table A.2). The statutory body responsible for preparation of accounting standards has announced a convergence with IFRS and has already prepared the standards. However, implementation has been delayed from the target date of 2011. AS18 clearly recognises the case of a company being controlled by another making transactions between them a RPT. Noteworthy is the requirement for separate disclosure by both the subsidiary and the holding company. A materially significant transactions report must be provided to the holding company by a subsidiary and published. Thus India is similar to Italy, Israel and Belgium for reporting intra-group transactions separately.

Table A.2. **Key differences between AS18 and IAS24**

AS18	IAS 24
Excludes non-executive directors from the definition of key management personnel by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.	Key management personnel under IAS 24 include non-executive directors.
Does not provide any exemption in case of disclosure requirements. Accordingly, the financial statements of holding and subsidiary would be self-contained.	No disclosure of transactions is required in parent financial statements when they are made available or published with the consolidated financial statements; and in financial statements of a wholly owned subsidiary if its parent is incorporated in the same country and provides consolidated financial statements in that country.
Does not require disclosure in circumstances where making disclosures as per the requirements of the standard would conflict with the duties of confidentiality of the reporting enterprise as specifically required in terms of a statute or by any regulator or similar competent authority.	IAS 24 is silent in this regard.
The definition of the term related party provides that parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.	The definition of related party as per IAS 24 does not include the expression "at any time during the reporting period".
AS18 clearly lists the relatives of an individual, viz. spouse, son, daughter, father, mother, brother and sister.	IAS 24 does not state clearly who the "close members of the family" are.
Recognises one more situation in the definition of control, i.e. control of the composition of the board of directors in the case of a company or of the corresponding governing body in case of any other enterprise such as a foundation.	Defines control as ownership, directly, or indirectly through subsidiaries, of more than one half of the voting power of an enterprise, or a substantial interest in voting power and the power to direct, by statute or agreement, the financial and operating policies of the management of the enterprise.

Source: http://rbidocs.rbi.org.in/rdocs/PublicationReport/docs/18353.doc

Some investors such as ACGA (2010) have noted significant weaknesses in the structure and operation of the Indian auditing profession which could mean weak implementation of the standard. Among other things, they propose consolidation of the profession to improve the resources of partnerships, lifting of artificial caps on the number of audit trainees and audit partners; establishing an independent regulatory body for the audit profession; and the adoption of recommendations establishing mandatory rotation of audit partners and the clarification of the audit committee's responsibility regarding auditor independence.

Experience of RPTs

Related party transactions are widespread and are significant in value. An analysis of company reports by the stock exchanges of 50 companies indicates that loans, advances, and guarantees account for a high percentage of net worth of the reporting companies, with subsidiaries and associated companies accounting for the bulk (see Annex 4.A1).[5] Key management personnel, individuals and relatives accounted for an insignificant share. Payment for research accounted for 8.8 per cent of net worth and involved subsidiaries. Although based on a small sample, other studies broadly support the results. One study of over 5000 firms for the period 2003-2005 reported that most RPTs occurred between the firm and "parties with control" as opposed to management personnel as in the US (as quoted in Chakrabarti et al, 2008).[6] Group companies consistently report higher levels of RPTs than stand alone companies.

Other information also indicates that RPTs are quite common with one study (Balasubramanian et al, 2009) of 301 companies noting that 275 replied that they had reported RPTs to shareholders. Clause 49 (see below) requires firms to disclose materially significant RPTs to shareholders. Nearly 80 per cent said that they have policies requiring RPTs to be on arm's length terms. RPTs appear to be important in terms of size with some 20 per cent of firms reporting RPTs greater than 5 per cent of revenues (Table A.3). The analysis undertaken in support of Annex 1 also indicates RPTs as a high share of revenues.

Some studies suggest that RPTs have been to the detriment of minority shareholders and to valuations. Using a sample of 600 of the1000 largest (by revenues) listed companies in 2004 and after controlling for other corporate governance characteristics, one study found that firm performance is negatively associated with the extent of RPTs for group firms (as quoted in Chakrabarti et al 2008). For standalone firms where RPTs would be with insiders, the relationship was positive (see section on empirical studies below).

Table A.3. **Related party transactions**

Characteristics	Required	Firms with characteristic	Mean (median)
RPT disclosed to shareholders	(2004)	275 (94%)	
Firm requires RPTs to be on arms length terms		230 (78%)	
Company has outstanding loans to insiders	(1956)	20 (7%)	
Company rents real property to or from insider		50 (20%)	
RPTs are >1% per cent of revenues		142 (67%)	
RPTs are > 5% of revenues		42 (20%)	16 (10)
Board reviewed at least one RPT in last year		107 (60%)	14 (6)
Board reviewed at least 5 RPTs in last year		63 (36%)	

Source: Balasubramanian, et al. 2009, Table 14

An important question is the extent to which abusive RPTs are possibly disguised. Some scandals such as that at Satyam (Box A.1) indicate the abusive character of some RPTs. Some studies focus on identifying resource flows and the nature of incentives to identify possibly concealed RPT called tunnelling. One such study is by Kali and Sarkar, 2011 who examine the nature of group diversification and the structure of the control/cash flow wedge to the major or controlling company. The findings are only indicative, but they do suggest that firms in which controlling shareholders cash flow rights are highest (i.e. the firm is located to the top of the pyramid) benefit most from a positive shock to firms elsewhere in the group.7 One method of transferring resources that has also been identified is where group companies take on high leverage for the benefit of other group firms, but ones it should be stressed with different shareholders. Accounting research has also pointed to earnings management and discretionary accruals. CEO duality, where the top executive also chairs the board, and the presence of controlling shareholders as inside directors are related to greater earnings management (see Chakrabarti et al, 2008 for a review of research).

Box A.1. The case of Satyam

Satyam Computer Services Limited proposed to acquire stakes in Maytas Infrastructure Limited and Maytas Properties Limited both of which were controlled by the controlling shareholder (i.e. promoter) of Satyam: RamalingaRaju. Satyam Computers informed the Exchanges on December 16, 2008 that their Board of Directors at its meeting that day had approved proposals to acquire a 100 per cent stake in Maytas Properties Limited and a 51 per cent stake in Maytas Infrastructure Limited. In the announcement it was mentioned that the total outflow of the acquisition was expected to be US$ 1.3 billion for Maytas Properties and US $ 0.3 billion for 51 per cent stake in Maytas Infrastructure Limited. The RamalingaRaju group held around 8.60 per cent of equity in Satyam Computers and 36.64 per cent of the equity capital of Maytas Infrastructure Limited, whereas Maytas Properties limited was an unlisted company belonging to the Ramalinga Raju group.

Several media reports questioned the action of the Board of Satyam Computers regarding the rationale for diversification of an information technology company into the real estate sector and the rationale for paying a huge consideration for acquiring stakes in the entities owned by the group of the controlling shareholder. Further, the media reports questioned the role and the duties of the independent directors since the deal was approved unanimously by the Board of Satyam Computers. Due to adverse investor sentiment, the price of the ADRs of Satyam Computers listed in NYSE fell 55 per cent from its close the previous day.

Subsequently, Satyam Computers made an announcement on Dec 17, 2008 stating that it was not going ahead with its proposed acquisition of Maytas Properties and Maytas Infrastructure, in light of the feedback received from the investor community. An independent director resigned on December 25, 2008, stating that she had voiced reservations about the transaction during the board meeting, but had failed to cast a dissenting vote to ensure that her views were put on the record. It transpired that the compensation package of one of the independent directors was more than seven times that of the other independent directors and well above the market rate. It turned out that he was undertaking consulting work for the company, something that should have barred him from being an independent director.

Following the Satyam scandal and the Nimesh Kampani case,[8] independent directors around India recognised their potential liability. As a result it is reported that at least 620 resigned in the year following the scandal (Khanna and Mathew, 2010).

Another aspect of the case is that it showed that the independent directors remained focused only on fair valuation and on obeying SEBI and Company Law regulations. The business case does not appear to have been considered. Moreover, the independent directors did not actually commission the valuation. The Chair claimed that this had been undertaken by a reputable audit company, a claim strenuously denied by the big audit partnerships.

The approach to protection of minority shareholders

This section first reviews the RPT relevant sections of the company law and outlines minority shareholder rights. It then reviews the very important listing requirements that concern corporate governance: Clause 49.

Company law and the listing requirements

In India, all public firms must have audit committees and a one share, one vote capital structure. There is a single tier board. Directors' duties are not fully specified but there is a highly developed jurisprudence that establishes the fiduciary duties of directors. However, as noted by the 2004 ROSC (The World Bank, 2004) enforcement and implementation of laws and regulations remain important challenges even though progress has been significant.

General features of the Company Law

The Companies Act that is currently in the process of revision includes six main sections relevant to related party transactions and the protection of minority rights and, taken together, suggest that India has the law in place and thus has partially implemented principle III.C (Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation). The main elements are:

- **Section 295** states that companies shall not make any loan, or give any guarantee or provide any security in connection with a loan to their directors (or directors of their holding company) or any partners or relatives of any of their directors, or any firms in which any of their directors (or relatives of a director) is a partner, without first obtaining the approval of the central government. This does not appear to cover group firms taking on leverage for financing other group firms.[9]
- **Section 297** requires directors to seek board consent for contracts with the company in which they or a relative are interested. For bigger companies (having paid up share capital of INR 1 crore or more), the approval of the Central Government is required in addition to the board's consent.
- **Section 299** states that directors must disclose at a meeting of the board any direct or indirect interests in existing or proposed contracts or arrangements entered into by the company.

- **Section 300** bars directors from voting on, or participating in any board discussions regarding any contract or arrangement in which they are directly or indirectly interested. Exemptions are provided for private companies that are not subsidiaries or holding companies of public companies. The Central Government can override this clause in favour of individual companies if it feels that it would "not be in the public interest to apply any of the prohibitions in this section". This has never happened with the exception of some state owned companies.

- **Section 314** requires that director remuneration be approved by the Central Government if it exceeds INR 250 000 a month.

- **Section 173** states that where any business that is to be transacted at a meeting of the company relates to, or affects any other company, the extent of shareholding interest in that other company of every director and the manager, if any, of the first mentioned company shall also be set out in the explanatory statement if the extent of such shareholding interest is not less than twenty per cent of the paid up share capital of that other company. This clause mainly refers to RPTs covering equity transactions and shareholders' approval of amalgamations or sale of substantial parts of the undertaking.

It should be noted that the penalties for non-compliance with the company law have been, with the exception of loans to directors and associates that are a criminal offense, minimal (see section below on enforcement) although it is expected that they will be increased with the next revision of the law: the penalty for contravening the law is a mere INR 5 000 (approximately USD 100). In addition, there are also separate fines for violating the listing Clause 49 which are now more significant being recently revised to INR 2.5 million. There are other provisions in the company law prescribing consequences, including penalties, for violation of RPT-related legal and regulatory provisions. Some of the relevant provisions are as follows although it is expected that the new Company Law will increase the level of punishment:

- Failure to make disclosures of interest or variation from prescribed procedure of disclosure of interest by an interested director constitutes an offense and the director may be punished with a fine which may extend to INR 50 000.

- An interested director who votes in a matter in which he is interested is punishable with a fine which may extend to INR 50 000.

- Such a director would be liable to cease office and failure to do so may subject him to prosecution.
- They would also have to refund remuneration received after cessation of his directorship.
- Non-compliance of provisions for maintenance of a RPT register may lead to monetary sanctions, which may be levied on the company and on every officer in default, and the fine may extend to INR 5 000 for each default.

Rights of minority shareholders in the Companies Act

Other sections of the Companies Act specify a number of rights for minority shareholders although enforcement is weak (see below). The rights include:

- In the case of different classes of shares, the rights attached to them can only be changed with the consent of 75 per cent of holders of that class and holders of at least 10 per cent can apply to the courts for cancellation of the changes.
- 100 or more members or a tenth of the total number of shares whichever is less can apply to the Company Law Board (CLB) for protection against oppression and mismanagement. The Ministry of Corporate Affairs can also approve an application even if the minimum requisite number of members is not fulfilled. In case of oppression or mismanagement by a major shareholder, the minority shareholder can apply for investigation or apply to the tribunal.
- An extraordinary general meeting can be called by shareholders with 10 percent of the total number of shares.
- 200 members or more, or members holding 10 per cent of the total voting power may request an investigation into the affairs of the company,
- Members holding at least 10 per cent of voting power can demand polls in a general meeting.
- Transparency issues are handled mainly through listing requirements and accounting standards.

The rights of shareholder meetings are strictly limited. Certain proposals such as disposing of substantially all of the company's assets, the issuance of further shares and inter-corporate loans and guarantees exceeding 60 per cent of its paid-up share capital and free reserves, or 100 per cent of its free

reserves require shareholder approval, some by way of special resolution. RPTs do not require shareholder approval. An earlier version of the new Companies Law that is believed to have been retained in the new version requires shareholder approval of RPTs exceeding some prescribed limit that would be established by regulation later. The vote would be through a special resolution: the votes cast in favour of the resolution in person, or by proxy, should be not less than three times the number of votes, if any are cast against the resolution i.e.75 per cent majority. The SEBI Board has further recommended to the Ministry of Corporate Affairs a crucial addition that the new law include a provision for listed companies, stating that shareholders may not be permitted to vote on such proposals in which they have an interest. Once there is a general clause in the Companies Act, SEBI could always impose the requirement through changing the listing agreement (Clause 49 below).

Up till the present such a proposal may not have made much sense because of deficiencies in the way shareholder meetings have been conducted. One study noted that "shareholder meetings and proxy voting practices in India –like many parts of Asia—lack efficiency and accountability". Voting processes need to be modernised to reflect best market practices and the growing global interest in active share ownership (ACGA, 2010, p. 6). Among their key recommendations, they call for conducting voting on all resolutions at AGMs and EGMs by poll rather than by a show of hands that often occurs at present, and allowing proxies to speak at meetings, irrespective of whether the company law is amended on this point.

The ACGA study notes correctly that in theory it should not be too difficult for a proxy or group of proxies to call for a poll. Section 179 of the Companies Act states that "any member or members present in person or by proxy" may call for a poll if they hold shares in the company giving them not less than 10 per cent of total voting power or on which the aggregate sum of not less than INR 50 000 (USD 1 054) has been paid up. However, they do point out that in practice it is often far from straight forward since in part, some custodian banks will not do so *i.e.* request a poll on the basis of proxies received (ACGA, 2010, P. 17). On the other hand, it should be noted that "important matters" are according to the Company Law voted by postal ballots, allowing investors to have their shares counted on issues of "significance".

However, with the Government's Green Initiative in the Corporate Governance of April 2011, the situation could improve significantly in some areas. Notification of Annual General Meetings (AGMs), a source of complaint, can be through the internet and meetings can be via video conference. Platforms for electronic voting will be permitted by approved

agencies. Whether it will address some of the problems rose above remains to be seen.

Directors duties

The companies' law imposes liabilities on directors for violation of various clauses of the law, but as in many other jurisdictions it does not set out their duties in great detail. Rather, these have evolved over time through jurisprudence and these might be codified in the current revision of the law. For example, a director should take reasonable care in performance of his duties. As in Australia and the UK, courts have stressed that the duty of directors does not stop at a "to act bona fide" requirement. They have evolved a doctrine called the "proper purpose doctrine". Even if directors honestly believe that their actions are in the best interests of the company, actions done with improper motive are liable to be set aside. Directors are in a position of trust so that their probity and conduct should be above suspicion. Directors must not exercise their powers for personal aggrandisement. However, if their action is in the wider interest of the company, the decision cannot be struck down on the grounds that it has incidentally benefitted directors in their capacity as shareholders.

The current company law does not make explicit reference to the problems that arise for directors in a company group in following central directions. Nor does it explicitly refer to related party transactions apart from if it involves self-dealing. More generally, there is a clear notion of the duty of loyalty to act in the interest of the company, two court cases from 2004 affirming the duty. The issue of following group company strategy even at the cost of the company does not appear to have been dealt with. As noted above, the listing requirements contain a number of directions with respect to RPTs for independent directors some of which it is believed will be taken into the new company law.

Clause 49 of listing requirements; the Indian "Corporate Governance Code"

An important aspect of the Corporate Governance framework in India concerning related party transactions is Clause 49 issued by SEBI as a key section of the listing agreement. It is sometimes called a code even though most of its provisions are now mandatory. The most recent version dates from 2004 and includes a minimum number of independent directors on boards with the definition widely defined, and an audit committee which includes independent directors (Box A.2). With respect to RPTs:

- audit committees shall review annual financial statements (before submission to the board for approval) with particular reference to

several factors, one of which is disclosure of related party transactions;

- audit committees shall also review, on a more general basis, any statements of "significant related party transactions (as defined by the audit committee) submitted by management";
- listed companies must periodically give their audit committees a summary statement of "transactions with related parties in the ordinary course of business" as well as details of "material individual (related) transactions that are "not in the normal course of business" or not done on an arm's length basis ("together with management's justification for the same").
- For subsidiaries, a significant transactions report must be given to the holding company's board along with the board minutes of the subsidiary.

Clause 49 also requires listed companies to submit a quarterly compliance report on corporate governance to stock exchanges. One element of this disclosure is the basis of related party transactions. Companies must also include a section on corporate governance in their annual reports and it is suggested that they include "disclosures on materially significant related party transactions that may have potential conflicts with the interests of the company at large".

For more general aspects of Clause 49 which are mandatory and relevant for minority protection see Box A.2. Of particular note is the reliance on independent directors for minority protection in general and RPTs in particular. A key requirement is that if the chair is also an executive or a major shareholder, there is a requirement for 50 per cent of independent directors, the definition of which is fairly wide (e.g. a material pecuniary relationship with the holding company is prohibited). The provision is intended to counter- balance the powers of a controlling shareholder on the board but as noted above might be less effective in practice.

Box A.2. The main corporate governance elements of the listing standards: Clause 49	
Characteristics	**Clause 49**
Director independence	• Requirement 50% independent directors if chairman is executive director or is related to any promoter (i.e. controlling shareholder) or a person occupying a management position or one level below the board, or 33% if the chairman is a non-executive • Definition: no pecuniary relationship with the company, not related to board or one level below board and no prior relationship with the company for the last three years • Nominee directors of nationalized financial institutions considered independent
Board requirements and limitations	• Meet four times a year, with a maximum of 3 months between meetings • Limits on number of Committees a director can be on (10) but only 5 for which director can be chair of Committee • An Ethical Code of conduct is required
Audit committee composition	• At least 3 directors, with at least two thirds independent • All financially literate • At least one having accounting or financial management experience
Audit committee role and powers	• Minimum 4 meetings a year with gap between them not to exceed 4 months • Broad role—review statutory and internal auditors as well as internal audit function, obtain outside legal or other professional advice, and review whistleblower program if one exists
Disclosures	• Material related party transactions • Accounting assumptions and deviations from standards • Risk management • Annual report including discussion of the adequacy of internal controls, significant trends, risks and opportunities • Proceeds from offerings • Compensation for directors including non-executives and obtain shareholders approval • Details of compliance history for last three years • Corporate governance reports (and disclosure adoption, if any, of mandatory and non-mandatory requirements)
Certifications	• CEO/CFO – financial statements , effectiveness of internal controls, inform audit committee of any significant changes • Auditor or company Secretary—compliance with corporate governance standards
Subsidiary companies	• At least one independent director of holding company should sit as a director on board of material non-listed Indian subsidiary • Significant transactions report to holding company board, along with subsidiary board's minutes. This will be published in the annual report of the parent company.

Source: Author's calculations.

The enforcement record

Compliance with Clause 49 has been enforced by both the Bombay (BSE) and National (NSE) Stock Exchanges. The chosen method appears to be through suspensions either of a short term nature or in some cases for a considerable period. De-listing is rarely used. As of March 2011 the (BSE) had suspended 1405 companies out of 5067 listed companies on account of non-compliance with the listing agreement.10 The NSE had also suspended 97 companies out of 1559 listed companies. The bulk of the problem appears to be with the important state owned enterprises (Public Sector Undertaking: PSU) and smaller companies, with the top companies mostly compliant. The issue for the State-owned enterprises (SOEs) (PSU) concerns independent director requirements since SEBI has ruled that government nominees on PSU boards are not independent per Clause 49's requirements.

SEBI is also involved in enforcing Clause 49 which contains certain penalty provisions, the strongest and least used being de-listing. Financial penalties for directors of non-compliant firms were introduced in 2004, effective from 2006. The regulator brought its first enforcement proceedings in September 2007: 15 were private companies and five were PSUs (Afsharipour, page 390). It has been more effective in blocking Initial public offerings (IPOs) if companies fail to meet the standards. Due to the overburdened Indian courts (see below) there is little enforcement through private litigation, increasing the responsibility of SEBI and its need for enforcement resources.

In cases of violation of the Listing Agreement, SEBI has the power to appoint adjudication officers to levy penalties. In the past three years, adjudicating officers have levied penalties on six companies for violations of the provisions pertaining to Corporate Governance (Clause 49). There is in principle no limit to fines and promoters (controlling shareholders) can even be banned.

While the scope of Indian securities laws are judged to be quite pervasive (Bose, 2005, Batra, 2008), there appear to be significant problems in enforcement, an issue previously noted by the World Bank ROSC in 2004. However, progress is being made. International benchmarks and comparisons are exceedingly difficult, but Bose documents that over the period 1999-2004, SEBI took action in 481 cases (on average a little under 100 per year) as opposed to 2789 cases for the United States' SEC, although the latter regulates a significantly more mature and extensive financial market. Over the last three years about 80 cases have been taken up each year for investigation. As a ratio of companies that are not suspended to the number of companies under their respective jurisdictions, SEBIs figure recently is approximately 0.45 (0.09 including all firms), while that of the

US SEC is 0.52. Bose also points out that in appeals to higher authorities, the decision went against SEBI in 30-50 per cent of cases, but the most recent data indicates that SEBI is now quite successful (out of 182 appeals only 17 were allowed)

Only certain provisions of the Companies Act, especially those pertaining to issuance and transfer of securities are delegated to SEBI. Provisions including the duties of directors and the remedy of oppression/mismanagement by the majority fall under the administrative domain of the Ministry of Corporate Affairs / Company Law Board. However, SEBI is empowered to prescribe listing conditions.

There have been a number of cases covering oppression and mismanagement with the latter being easier to prove. In one case in 2006 (Central Government v. Pentamedia Graphics Ltd), gross violation of statutory provisions and irregularities in relation to sale of assets was judged to be mismanagement. The CLB has wide powers to grant relief such as the removal of some or all directors. In the financial year 2009/2010, 393 applications relating to oppression and mismanagement were received and 219 cases were settled. However, the number of cases pending also increased from 745 to 919 (http://clb.nic.in/2k9-2k10.htm).

In the year 2009/2010, the MCA/CLB started 9 000 prosecutions but had 60 000 pending at the start of the year. With some 7 000 disposed of during the year, 61 700 remained pending at the end of the year. The percentage of convictions to total cases decided was only around 50 per cent but above the longer term average of about one third (MCA, page 50). The bulk of the new filings related to administrative issues such as three copies of the balance sheet to be filed with the registrar (4 000) and the filing of annual returns (3 800). Other cases of more relevance for the issue of this report include: loans to directors, 4 cases; board's sanction for certain contracts in which particular directors are interested, 5 cases; and interested director not to participate in Board's proceedings; 3 cases (MCA, page 48-49).

The problem of enforcement is a more general one in India. In his analysis of RPTs in India, Batra (2008) notes that case arrears and decade long legal battles are commonplace in India. In spite of having around 10 000 courts (not counting tribunals and special courts) India has a serious shortfall of judges. While the US has 107 judges per million citizens, Canada over 75, Britain over 50 and Australia over 41, for India the figure is slightly over 10. He quotes one study that there are 20 million cases pending in lower courts and 3.2 million in High Courts. A dispute contested until all appeals are exhausted can take up to 20 years for disposal, while petitions in High Courts can take between 8 and 20 years. Chakrabarti et al note that in

2004, 63 per cent of pending civil cases was more than a year old, and 31 per cent were over three years old. Automatic appeals, extensive litigation by government, underdeveloped alternative mechanisms of dispute resolution like arbitration, and the shortfall of judges all contribute to the state of affairs in Indian courts. Most important, since the same courts try both civil and criminal matters, and the latter gets priority, economic disputes suffer even greater delays.

In order to improve efficiency of enforcement actions, the MCA proposed to change the CLB to a Tribunal staffed by commercial professionals such as lawyers and accountants. However, due to certain provisions with regard to eligibility conditions and qualification requirements for Chairpersons/Member of the Tribunal, the proposal was successfully challenged before the Supreme Court in 2010. The directions given by the Supreme have been taken into account in the proposed new Company Law. If it is passed as planned a Tribunal will be established.

Assessment and conclusions

India has done a great deal to develop a sound corporate governance framework in recent years to cover the 6 000 listed companies. Clause 49 of the listing requirements establishes a significant framework for RPTs and minority protection. Observers also judge the securities laws to be quite pervasive and to offer important investor protection. The Indian parliament will be considering a new company law and this opportunity should be used to deal with a number of outstanding issues including removing the role of the government in approving some corporate actions that is historical. They need to be returned either to company boards or to the meeting of shareholders.

The situation in India with respect to minority protection and RPTs needs to be assessed in the light of widespread company groups with strong controlling shareholders, and an overburdened judicial system. The resort to control of RPTs via independent directors on the audit committee might not work effectively since in practice independent directors appear to believe that they are advisors to the controlling shareholders. The role of the board and its independent directors needs to be underpinned by the right of shareholders to have a say on certain material transactions. Moreover, given the structure of ownership in India, it is essential that interested shareholders are not permitted to participate in the shareholder vote. The new Company Law and implementing regulation is well advised to introduce these features. Introducing such a right might need to be accompanied by safeguards to avoid potential hold-ups by a small number of investors.

In addition, if as recommended shareholders are given additional rights to approve some RPTs both ex ante and ex post, it will be essential to improve the efficacy of AGMs by, inter alia, ensuring the effective possibility to call for a poll vote rather than a show of hands. The recent decision to publish full results of the voting, including abstentions, is a commendable initiative.

A major issue that needs to be addressed concerns company groups since they are likely to be the source of major RPTs that can be abusive. While intra-group transactions are reported and are regarded as RPTs by the accounting rules and Clause 49, the approach to control of RPTs is heavily oriented to self-serving behaviour by directors and management. Directors' duties are specified in terms of loyalty to the company. Yet the reality is that company groups are widespread with a number of functions conducted at group level. Independent directors often serve on other boards in the group and indeed Clause 49 calls for the independent director of the parent to sit on the board of a non-listed subsidiary. Additional measures need to be considered to recognise the reality of corporate groups, perhaps along the lines taken in other countries reviewed in this report.

Steps need to be taken to strengthen law enforcement by both the MCA/CLB and SEBI and especially to remove civil cases from the overwhelmed court system. While on paper India has strong investor protection, in reality a slow judicial system, marked by overburdened courts makes application and enforcement of those laws far from a simple matter (Batra, 2008). The proposal in the draft Company Law to have a corporate law tribunal comprising judges assisted by professionals needs to be implemented as a priority.

Weak enforcement possibilities are the primary reasons why some principles are not fully implemented. The key Principles are:

- Principle III.A.2 *(Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress)*. While laws and regulations are in place, effective means of redress is lacking.

- Principle III.C *(Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation)*. This is implemented by laws and regulations even though enforcement might remain problematic.

- Principle V.A.5 (*Disclosure should include, but not be limited to, material information on related party transactions*). Broadly implemented through the listing agreement and accounting standards although disclosure about the company group might need to be better developed.
- Principle VI.D.6 *(The board should fulfil certain key functions, including .. monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions)* is broadly implemented by Sections 299 and 300 of the company law although they might need to be tightened to cover conflicts of interest with controlling shareholders and company groups.

Annex notes

1. The study also noted a case where the address provided by a company for a non-promoter shareholder actually turned out to be that of the company's chairman. See also Afsharipour, 2009.
2. The listing requirements call for at least one independent director of a holding company should sit as a director on the board of material non-listed Indian subsidiaries. This is not the reason why the study reports a group concentration of independent directors since the author only covered listed companies.
3. Another study (Aggarwal, 2010) is based on interviews with 16 legal experts working with 50 companies so is not as broad as Khanna and Mathew. It concluded that "there has been no case where an ID has opposed the action of management and the remaining directors have voted in his favour for a valid and just purpose" (p. 130).
4. For a description of calculating control rights and cash flow rights see OECD Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance (2007), Annex A.
5. One reason that loans might be important concerns the practice of making advances to wholly owned subsidiaries for the purchase of land that will be used by other group companies.
6. The quoted unpublished Ph.D. study is by JayashreeSaha, "A study of related party transactions in Indian corporate sector", 2006, from IGIDR.
7. The converse, where controlling shareholders also act to prop-up a failing group firm, has also been observed. See Balassubramanian et al. 2009 for a critique of the shock analysis.
8. Nimesh Kapani was one of India's leading investment bankers and served as an independent director on the board of Nagarjuna Finance from 1998 to 1999. The promoters and executives of the company were later charged under state law with failing to repay depositors. The state government also charged Kampani, who had left the board before any of the allegations surfaced. Kampani avoided arrest and jail by staying in Dubai for nine months until the state court stayed the proceedings against him in October 2009. The event showed the remote possibility of arrest and jail, but panicked many independent directors in India. See Khanna and Mathew, 2010.

9. According to Section 295(2), the regulation shall not apply to any loan made, guarantee given or security provided by a private company unless it is a subsidiary of a public company.

10. For suspended companies, see http://www.bseindia.com/about/datal/suspend.asp

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Corporate Governance

Improving Corporate Governance in India

RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER PROTECTION

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