

Capital Markets Hotline

March 02, 2023

CONSULTATION PAPER ON REVIEW OF CORPORATE GOVERNANCE NORMS FOR A HIGH VALUE DEBT LISTED ENTITY

INTRODUCTION:

On September 07, 2021, in a bid to increase transparency and accountability of corporate entities, the Securities and Exchange Board of India ("SEBI") extended the applicability of corporate governance requirements under Chapter IV of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR") to listed entities having listed non-convertible debt securities ("NCDs") ("September 07 Amendment").¹

In a step to further streamline the corporate governance norms for such companies, SEBI released the Consultation Paper on Review of Corporate Governance Norms for a High Value Debt Listed Entity ("Consultation Paper") on February 08, 2023.² Vide this Consultation Paper, SEBI has proposed to alter the applicability of the corporate governance norms to HVDLEs and carved out a new framework for approval of Related-Party Transactions ("RPT") within specified HVDLEs.

In this hotline, we have reviewed the new norms as proposed by SEBI vis-a-vis the existing Chapter IV of LODR, along with our analysis of this development.

SNAPSHOT OF THE EXISTING REGIME (LODR AND SEPTEMBER 07 AMENDMENT):

Applicability:

As per the existing Chapter IV of LODR as amended by the September 07 Amendment, corporate governance norms shall be applicable to a listed entity which: (a) has NCDs listed on a stock exchange and (b) the outstanding value of such listed NCDs is INR 500 crores or more ("High Value Debt Listed Entities/HVDLE"). Broadly, Chapter IV imposes significant corporate governance norms on HVDLEs in relation to the manner of constitution of the board of directors, constitution of additional committees, annual audits, establishment of a vigil mechanism and the procedure for approval of RPTs.³ In case the outstanding value of the listed NCDs of such HVDLE crosses this threshold during a financial year, the entity shall ensure compliance with Chapter IV within a period of 6 months from the date such threshold is crossed.⁴

The applicability of Chapter IV was on a 'comply or explain' basis until March 31, 2023, post which these requirements are binding on HVDLEs. Additionally, the LODR regime envisages continued applicability of Chapter IV once the outstanding value of the listed NCDs of such HVDLE crosses the prescribed thresholds, regardless of whether the outstanding value falls below INR 500 crores at a later point of time.

Framework for RPTs:

Regulation 23 of the LODR lays down the corporate governance norms for RPTs in HVDLEs. As per Regulation 23, all listed entities shall formulate policies prescribing thresholds for the "materiality" of RPTs and procedures governing such RPTs through a policy that is approved by the board of the listed entity. "Materiality" of RPTs is determined by verifying whether the RPTs (either individually or taken together with previous transactions during a financial year) exceed INR 1000 crore or 10% of the annual consolidated turnover of the listed entity in the last audited financial statement (whichever is lower).

As per Regulation 23, all RPTs and any subsequent material modifications to such RPTs would require the approval of the audit committee of the listed entity (which shall allow only independent members to vote for such proposals). For material RPTs or any subsequent material modifications thereon, prior approval is required from the shareholders, which specifically disbars related parties of the listed entity from voting for such RPTs. This restriction is applicable irrespective of whether the related party is a related party to the specific RPT being considered for approval. However, such prior approval is not required if the material RPT is entered into by the subsidiary of a listed entity not being party to such RPT.

The following transactions are exempted from the aforesaid procedure of approvals under the LODR:

- a transaction entered into between two government companies;
- a transaction entered into between a holding company and its wholly-owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval; and
- transactions between two wholly-owned subsidiaries of a listed holding company whose accounts are

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Analysing SEBI's Consultation Paper

KEY AMENDMENTS PROPOSED IN THE NEW REGIME (CONSULTATION PAPER):

Necessity of the Consultation Paper:

As per the September 07 Amendment, approval from shareholders for material RPTs excludes voting by any shareholder who is an RPT to the listed entity, irrespective of whether the shareholder is an RPT for that particular transaction. For multiple HVDLEs, this creates an absurdity wherein no shareholder is eligible to vote in relation to an RPT, as most of their shareholders are related parties. Thus, there is an “impossibility of compliance” with Regulation 23 of the LODR, as no shareholder may be able to vote to approve an RPT. This is also because the exemption carved out under Section 188 of the Companies Act, 2013 (“**Companies Act**”) (which permits related party shareholders to vote on RPTs in companies where 90% or more members are relatives of promoters or related parties) is currently inapplicable to HVDLEs governed by LODR.

In this regard, SEBI analysed the shareholding patterns of 138 HVDLEs and noted that a significant number of HVDLEs have closely held shareholding patterns which are dominated almost entirely by related parties, with such parties having 90% shareholding and above in most cases.⁶ Thus, a need for change was identified so as to increase transparency by involvement of other stakeholders of the HVDLE. To tackle this concern, SEBI proposed a new framework (involving debenture holders) in the process of approval of material RPTs as an agenda item for shareholder meetings of HVDLEs.

Applicability:

The thresholds for classifying as an HVDLE under the Consultation Paper continue to correspond with the September 07 Amendment. Additionally, the obligations under the Consultation Paper will apply even when the HVDLE falls below such threshold. In the Consultation Paper, SEBI has proposed that these norms shall apply till the outstanding value of the listed NCDs of such HVDLEs reduces below the threshold and continues to so remain for a period of 3 consecutive years (as reviewed on the last day of every financial year).

Framework for RPTs:

The following process has been prescribed under the Consultation Paper by SEBI for HVDLEs **that possess only listed non-convertible debt securities where 90% or more shareholders (in number) are related parties**:

- **Approval by debenture holders of material RPT as an agenda item:** Debenture holders are to have a right (but not obligation) to approve having a material RPT as an agenda item for discussions during shareholder meetings, prior to occurrence of the said meeting. They have a period of 7 days to submit their objections upon receipt of an agenda item indicating approval for an RPT.
- **Certificate from practicing company secretary:** Objections provided by the debenture holders shall be scrutinized by a practicing company secretary, who shall issue a certificate containing information about the total number of responses received, objections and no-objections received. This certificate must be issued within 3 days from the date of receipt of the last such objection and shared on the website, with regulators and stock exchanges.
- **Approval from board:** In case objections are received from debenture holders holding 75% or more in value, the board shall withdraw the agenda for approval of the material RPT. It is pertinent to note here that the 75% of value as mentioned above shall be 75% of debenture holders who have responded to the notice by the company. The shareholders will also have to be informed of such withdrawal. If no responses are received from the debenture holders, it is assumed that there are no objections and the material RPT can be taken up as an agenda.
- **Approval by shareholders if agenda item not withdrawn:** If the agenda is not withdrawn by the board owing to the fact that there are no-objections or objections by debenture holders holding outstanding debentures below the aforementioned thresholds, the material RPT would be put to vote in front of the shareholders. In such a voting, all shareholders, including related parties, can vote.

A tabular representation of the process and timelines is as follows:

Sr. No	Event	Timeline
1	Dispatch of notices to the shareholders for general meeting for approval of material RPT	T
2	Dispatch of copy of the agenda to debenture holders	T
3	Time period for debenture holders to submit their responses	T+7
4	Scrutiny by practicing company secretary	T+10
5	Dissemination of certificate from practicing company secretary to company, stock exchanges, shareholders, debenture holders and debenture trustee	T+11
6	Board to decide whether the agenda	No specific

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

	to be retained or withdrawn based on certificate	mentioned timeline
7	E-voting starts if agenda not withdrawn (assuming 3 days)	T+18
8	General Meeting	T+21

NDA ANALYSIS:

Alignment with the Companies Act:

By creating the framework for HVDLEs having 90% or more related party shareholders, the Consultation Paper borrows from Section 188(1) of the Companies Act, which allows related party shareholders to vote on RPTs if 90% or more of the members are related to the promoter or are related parties.⁷ In essence, the thresholds for trigger of debenture holder participation in approving agenda items under the LODR are now aligned with those used to determine the manner of voting for RPTs under the Companies Act.

RPTs have sometimes been misused to redirect assets to their advantage. Specifically in the context of listed entities, SEBI notes that the regulatory framework for RPTs is circumvented through: (i) the use of shell companies and unrelated companies that are controlled directly or indirectly by the promoter groups; and (ii) circular transactions.⁸ This problem is only further exacerbated in India, where many listed entities are family owned and controlled.

Involvement of debenture holders in corporate governance:

The Consultation Paper creates a framework for direct involvement of debenture holders in the corporate governance of a company. Given that the provisions of the September 07 Amendment are to apply mandatorily to HVDLEs from April 01, 2023, the release of this Consultation Paper may be considered to be a timely development. Prior to this, debenture holders have traditionally stayed away from the management of the company and have generally relied on covenants in their trust deeds to trigger any rights available to them. Further, as per the current legal regime, Section 71 of the Companies Act prevents debenture holders from having voting rights.

While the Consultation Paper also does not grant any voting rights, it creates a scenario equivalent to obtaining prior clearance from debenture holders for RPTs on meeting agendas. There may be scenarios where debenture holders may raise objections to RPTs without factoring in all relevant reasons / justifications for initiation of the RPT, specifically since the format for providing objections (as provided within the Consultation Paper) is silent on whether the notice for the agenda item sent to such debenture holders is accompanied with all relevant supporting information of the RPT. Additionally, the format for responses to be received from debenture holders indicates that debenture holders are not required to provide reasons for 'objecting' to any RPT agenda item. This may create problems for valid RPTs that receive significant objections from debenture holders.

Parallely, however, it is important to contextualize this development amidst recent occurrences. One of the major aftermaths of a recent short selling saga has been stakeholder deliberations on the (i) extent of debts taken by corporations for expansion and operations; and (ii) the impact of excessive debt on the long-term working of the company, especially in closely held structures. In such corporate structures, RPTs are a common occurrence and need to be effectively monitored to prevent shareholder wealth manipulation, especially in the case of transactions that are able to circumvent the framework of the Companies Act. When assessed in this light, the timely involvement of debenture holders as an additional step may act as a much-needed check on undesirable RPTs.

In this regard, while this is a potential advantage, it is also pertinent to note that debt may be amassed through multiple channels. The Consultation Paper does not clarify the rationale for envisaging participation only from debenture holders (and not other lenders) for approvals on RPTs as agenda items. In capital-intensive sectors (such as financial services), debt obtained as a result of term loans, working capital facilities and refinance facilities from financial institutions are a common occurrence. According to Section 186 of the Companies Act, prior approval of public financial institutions is required in case any investment, loan, guarantee or security is given by the company. While SEBI makes reference to this section in the Consultation Paper to demonstrate the importance of protecting debenture holders (being lenders to the company), it does not clarify why other lenders (not being debenture holders) are to be excluded from the ambit of this framework. Thus, further clarity in this regard (which also indicates SEBI's intent towards the potential role of debenture holders in corporate governance) may be required to fully understand the Consultation Paper.

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You can direct your queries or comments to the authors

¹ Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Fifth Amendment) Regulations, 2021, available at https://www.sebi.gov.in/legal/regulations/sep-2021/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-fifth-amendment-regulations-2021_52488.html

² Consultation Paper on Review of Corporate Governance Norms for a High Value Debt Listed Entity, available at https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-review-of-corporate-governance-norms-for-a-high-value-debt-listed-entity_67898.html

³ Regulations 16-27, Chapter IV of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

⁴ Regulation 15(1A) SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

⁵ Regulation 23(5) of SEBI (Listing Obligations and Disclosure Requirements), 2015.

⁶ Page 3, Consultation Paper on Review of Corporate Governance Norms for a High Value Debt Listed Entity.

⁷ Companies Amendment Act 2017, available https://www.mca.gov.in/Ministry/pdf/CAAct2017_05012018.pdf

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