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Legal Analysis of Related Party Transactions in the BRICS Countries

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Abstract. Legal literature in the past has often debated whether concentrated corporate ownership (i.e. sizeable corporate conglomerates and corporate enterprises owned by business families or the government of a State) in a relatively close market leads to a high volume of related party transactions between the corporations in the respective market. The emerging economies attract substantial foreign investment due to the rapid growth of their markets and the presence of large publicly listed companies. Concentrated ownership structures in these countries tend to result in the expropriation of resources by controlling shareholders for their personal enrichment. There has been a high corporate failure rate due to related party transactions, despite the adoption of regulatory reforms that promote transparency, accountability, and fairness. Listed companies in the BRICS countries are marked by concentrated ownership structures controlled by either a family or the State. Although there are differences in ownership structures as well as indications of agency problems in the United States and the United Kingdom, the BRICS countries have adopted the same legal strategies to prevent unfair or abusive related party transactions in their respective countries, such as the appointment of independent directors, independent audit committees, CEO duality, and disclosure requirements. This study seeks to conduct cross-country comparative research to assess the ways in which the BRICS countries have regulated related party transactions. Each of the BRICS countries has adopted different monitoring mechanisms to prevent abusive related party transactions, which will be examined in the course of this research.

Keywords: related party transactions; concentrated ownership structures; controlling shareholders; BRICS.

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Introduction

Corporate governance has been weak and critical in emerging markets.[1] The ownership structures of entities in emerging markets tend to be relatively concentrated.[2] Families or States typically control the companies in emerging markets through hierarchical chains of ownership called pyramids.[3] These business

1 Michael S. Gibson, *Is Corporate Governance Ineffective in Emerging Markets?*, 38 J. Fin. Quant. Anal. (2003).

2 Collins G. Ntim, *Internal Corporate Governance Structures and Firm Financial Performance: Evidence from South African Listed Firms*, PhD thesis, University of Glasgow (2009).

3 Pier Luigi Marchini et al., *Related Party Transactions, Corporate Governance and Earnings Management*, 18 Corp. Gov. 1124 (2018); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. Fin. Econ. 3 (2000); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. Fin. Econ. 81 (2000).

groups or pyramids, help new entities succeed in the market by offering intra-group financing.[4] Due to the lack of contract enforcement and inefficient judicial systems in emerging markets, intra-group transactions among affiliated parties[5] could be beneficial since they involve minimal information asymmetry and lower transaction costs.[6] On the other hand, the controlling shareholders of such business groups may also create new entities for the diversion of resources. The controlling shareholders often undertake detrimental transactions by means of intragroup transactions in order to extract private benefits that are against the interests of minority shareholders and groups.[7]

Over the last two decades, the BRICS countries have effectively updated their corporate law and governance regulations in an effort to bring transparency and accountability to corporate functioning. However, challenges are yet to be mitigated, especially in related party transactions. A "related party transaction" is a transaction between two related parties for the transfer of services, resources, or obligations, irrespective of whether a price is charged or not. Reports and litigation filed in the various jurisdictions suggest that the controlling shareholders engage in resource diversion by purchasing inventory and assets at inflated prices, selling assets[8] at reduced prices, offering loans without security, borrowing at a higher interest rate[9] than the market rate, and repaying loans to controlling shareholders without complying with the prescribed procedure. The present study investigates the legal strategies adopted in the BRICS countries to prevent abusive related party transactions.

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4 Tarun Khanna & Krishna Palepu, *Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups*, 55 J. Fin. 867 (2000) (May 26, 2020), available at http://doi.wiley.com/10.1111/0022-1082.00229.

5 In Brazil, the majority of transactions in listed companies reported were conducted with subsidiaries, followed by transactions with companies under common control and affiliates and controlling shareholders, *see* OECD, *Latin American Corporate Governance Roundtable Task Force Report on Related Party Transactions*, OECD Publications (2012) (Aug 6, 2019), available at https://www.oecd.org/daf/ca/LatinAmericanReportonRelatedPartyTransactions.pdf.

6 Bjorn N. Jorgensen & Julia Morley, *Are Related Party Transactions Red Flags?*, 34 Contemp. Acct. Res. 929 (2017) (Nov. 27, 2020), available at http://doi.wiley.com/10.1111/1911-3846.12304.

7 Craig Doidge et al., *Private Benefits of Control, Ownership and the Cross-Listing Decision*, 64 J. Fin. 425 (2009) (Nov. 27, 2020), available at https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.2008.01438.x; Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59(2) J. Fin. 537 (2004) (Nov. 27, 2022), available at https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.2004.00642.x.

8 Yan Leung Cheung et al., *Tunneling and Propping Up: An Analysis of Related Party Transactions by Chinese Listed Companies*, 17(3) Pacific-Basin Fin. J. 372 (2009).

9 David E. Weinstein & Yishay Yafeh, *On the Costs of a Bank-Centered Financial System: Evidence from the Changing Main Bank Relations in Japan*, 53(2) J. Fin. 635 (1998) (Nov. 27, 20202), available at https://onlinelibrary.wiley.com/doi/full/10.1111/0022-1082.254893.

Listed companies in the BRICS countries have concentrated ownership structures[10] that are predominantly controlled by either a family or the State. Despite the fact that the United States and the United Kingdom have different ownership structures as well as face agency problems, the BRICS countries have adopted the same legal strategies to prevent unfair and abusive related party transactions in their respective countries, such as the appointment of independent directors, independent audit committees, CEO duality, and disclosure requirements. This study aims to provide a comprehensive analysis of the legal strategies employed to regulate related party transactions in the BRICS countries (including the definition of related parties, the definition of related party transactions, the ex-ante and ex-post approval requirements for related party transactions, and the disclosure requirements of related party transactions).

The following section examines the agency problems that arise as a result of the concentrated ownership structures that exist within the BRICS countries. Sections 2 and 3 analyze the legislative frameworks regulating related party transactions in the BRICS countries. Section 4 concludes the study and also offers a few policy recommendations.

1. Ownership Structures and Agency Problems in the BRICS Countries

The vast majority of the listed companies in the BRICS countries have concentrated ownership structures that are either family-controlled or State-controlled. In a concentrated ownership structure, independent managers lack effective control over the company owing to controlling shareholders.[11] In Brazil, the government is the core player in the majority of concentrated state-owned companies. State controllers are reluctant to relinquish their positions in corporate governance despite the incidence of multiple frauds in state-owned entities. Due to the prevalence of

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[10] The ownership structure in Brazil is highly concentrated, consisting of family-owned business groups, the state, and its affiliates; *see, e.g.*, Flávio M. Rabelo & Flávio C. Vasconcelos, *Corporate Governance in Brazil*, 37 J. Bus. Ethics. 321 (2002) (Nov. 17, 2020), available at https://link.springer.com/article/10.1023/A:1015249300794. In Russia, state-owned entities control through pyramid corporate ownership structures; *see* Alexander Abramov et al., *State-Owned Enterprises in the Russian Market: Ownership Structure and their Role in the Economy*, 3 Russ. J. Econ. 1 (2017). The majority of Indian companies owned by business groups are controlled through pyramidal ownership structures; *see, e.g.*, Jayati Sarkar, *Ownership and Corporate Governance in Indian Firms*, in S. Balasubramanium & D.M. Satwalekar (eds.), Corporate Governance: An Emerging Scenario 217 (2010) (May 20, 2019), https://www.nseindia.com/research/content/CG_9.pdf. The listed entities in China are controlled by private investors and governments through pyramid structures; *see, for e.g.*, William Bradford et al., *Cash Dividend Policy, Corporate Pyramids, and Ownership Structure: Evidence from China*, 27 Int'l Rev. Econ. Fin. 445 (2013). In South Africa, the majority of listed companies have pyramidal ownership structures. At the end of 2002, 56.2% of the market capitalization of JSE listings was controlled by four companies, *see* Gedeon J. Rossouw et al., *Corporate Governance in South Africa*, 37 J. Bus. Ethics. 289 (2002) (Nov. 29, 2020), available at https://link.springer.com/article/10.1023/A:1015205511601.

[11] Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94(3) J. Pol. Econ. 461 (1986).

concentrated and pyramidal ownership structures,[12] the legal environment in Brazil is characterized by weak and inadequate legal protection for minority shareholders.[13] In Russia, the ownership structure is highly concentrated with the majority of the shareholders owning 50% of the ownership on average.[14] The enforcement of corporate governance in Russia is limited due to the co-existence of weak formal and strong informal institutions in the country.[15]The legislation's imperfections and controlling shareholders have led to the expropriation of minority shareholders[16] even under the dividend payout policy. Due to such high share capital concentration, controlling shareholders and managers are able to expropriate resources for personal enrichment. In India, family-owned companies are strongly guided by their religious convictions, and shared values play a dominant role in organizing the companies' affairs as they strive to base their decisions on trust. The implementation of corporate governance has been questionable despite good corporate governance legislation.[17] India's complex ownership structures have been developed since the post-reform market.[18] The presence of business groups is now one of the unique characteristics of India.[19] Indian corporate governance system is governed by an informal mechanism that is based on reputation, reciprocity, and trust. As a result, small and medium enterprises face severe issues of limited recourse to the legal system and corruption. In China, the listed entities are controlled by private investors and governments through pyramid structures. According to the MSCI China Index, the majority of control held by the shareholder or shareholder group (including the State in State-

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12 Dante Mendes Aldrighi & Roberto Mazzer Neto, *Evidence on Capital Ownership and Voting Structures of Publicly Traded Companies in Brazil*, 61 Brazilian J. Pol. Econ. 129 (2007) (Nov. 29, 2020), available at http://www.scielo.br/scielo.php?script=sci_arttext&pid=S0034-71402007000200001&lng=en&nrm=iso&tlng=pt.

13 Vicente Lima Crisóstomo & Isac de Freitas Brandão, *The Ultimate Controlling Owner and Corporate Governance in Brazil*, 19(1) Corp. Gov. 120 (2019).

14 Yoshiro Miwa & J. Mark Ramseyer, *Banks and Economic Growth: Implications from Japanese History*, 45 J. L. Econ. 127 (2002).

15 Sergei Guriev & Andrei Rachinsky, *Ownership Concentration in Russian Industry* (2004); Sergei Guriev & Andrei Rachinsky, *The Role of Oligarchs in Russian Capitalism*, 19(1) J. Econ. Perspect. 131 (2005).

16 I. Berezinets et al., *Dividends on Common and Preferred Shares: The Relationship with the Ownership Concentration in Russian Public Companies*, 1(2) J. Econ. Soc. Dev. 48 (2014).

17 Puneeta Goel, *Implications of Corporate Governance on Financial Performance: An Analytical Review of Governance and Social Reporting Reforms in India*, 3 Asian J. Sustainability & Soc. Resp. 4 (2018) (Dec. 14, 2020), available at https://ajssr.springeropen.com/articles/10.1186/s41180-018-0020-4.

18 Shakti Deb & Indrajit Dube, *Corporate Governance Disclosure for Complex Ownership Structure in India*, 10 Indian J. Corp. Gov. 143 (2017) (June 6, 2019), available at http://journals.sagepub.com/doi/10.1177/0974686217730937.

19 Sytse Douma et al., *Foreign and Domestic Ownership, Business Groups, and Firm Performance: Evidence from a Large Emerging Market*, 27 Strategic Mgmt. J. 637 (2006) (Dec. 9, 2019), available at http://doi.wiley.com/10.1002/smj.535.

owned enterprises) is over 30% in 81.9% of constituents.[20] Such highly concentrated ownership structures create a conflict of interest between controlling owners and minority shareholders,[21] leading to the expropriation of resources. Additionally, the capital market structure of China favors founders having controlling powers in the companies through the exercise of superior voting powers through a dual-share class structure, the dominance of controlling shareholders over management, and incorporation in a management-friendly jurisdiction.[22] The enforcement of abundant written corporate governance legislation in China is limited because of weak formal and strong informal institutions (such as culture and traditions).[23] In South Africa, the ownership structure of companies consists of principal shareholders who predominantly own and control the ownership.[24] Furthermore, the majority of listed companies in South Africa have pyramidal ownership structures. At the end of 2002, 56.2% of the market capitalization of companies that were listed on the Johannesburg Stock Exchange (JSE) listings was controlled by only four corporations.

The agency problems in concentrated ownership structures differ from those experienced in dispersed ownership structures. In dispersed ownership structures, like those prevalent in the United States and the United Kingdom, the principal provides remuneration to the agents (directors) for the management of the company and generating profits for the principal. In dispersed ownership structures, the interests of institutional investor block holders are aligned with the company's interests. However, in concentrated ownership structures, promoter block holders' interests do not align with the interests of minority shareholders. The majority of central agency problems[25] in concentrated ownership structures arise due to conflicts between the majority, or controlling, and minority shareholders.[26] In concentrated ownership structures, the managers are also the controlling shareholders, who implement decisions to favor themselves by expropriating the interests of the minority shareholders. Such controlling shareholders may be detrimental to the company as their interests do not align with those of non-controlling shareholders.[27]

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20 MSCI, *China through an ESG Lens*, MSCI (Jan. 10, 2020), available at https://www.msci.com/gics.

21 Yi Jiang & Mike W. Peng, *Principal-Principal Conflicts during Crisis*, 28 Asia Pacific J. Mgmt. 683 (2011).

22 *Id.*

23 Sergei Guriev & Andrei Rachinsky, *The Role of Oligarchs in Russian Capitalism*, 19 J. Econ. Persp. 131 (2005).

24 MSCI, MSCI Corporate Governance in Emerging Markets (2017).

25 Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & Econ. 301 (1983) (June 28, 2019), available at https://pdfs.semanticscholar.org/94a8/f1e59b6424fd96ad7e28588efa04fccf042b.pdf .

26 Jeffrey N. Gordon et al. (eds.) *Convergence and Persistence in Corporate Governance* (2004).

27 Shleifer & Vishny, *supra* note 11.

In Brazil, agency problems between controlling and minority shareholders arise due to weak institutional enforcement and concentrated ownership structures.[28] In Russia, agency conflicts arise due to weak investor protection norms, high ownership concentration, and non-transparency in ownership structures.[29] In India, agency conflicts between majority and minority shareholders are exacerbated by weak enforcement mechanisms and legal protection for minority shareholders[30] while in China, the agency problems between controlling and minority shareholders subsist within State-owned entities and family-owned companies.[31] In South Africa, agency conflicts that arise between the majority and minority shareholders often leads to expropriation by controlling shareholders who possess significant control rights despite having a low equity stake.[32]

In all of the BRICS countries, the issue of agency problems between controlling and minority shareholders remains a significant challenge in providing equitable treatment to shareholders and expropriating resources by controlling shareholders. Due to undeveloped economies and weaker legislations in these countries, pyramidal ownership structures have been prevalent in emerging markets.[33] From a corporate governance perspective, the transparency in ownership and control structures that allows for the identification of the related parties plays a vital role for investors in assessing the risks of expropriation associated with such listed entities. On the other hand, non-transparent ownership structures facilitate controlling shareholders to indulge in abusive related party transactions for private benefits.[34] Therefore, a regulatory framework that is designed to prevent abusive related party transactions is paramount from the investors' perspectives as it plays an essential role in protecting minority rights.

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28 Christopher W. Anderson, *Financial Contracting under Extreme Uncertainty: An Analysis of Brazilian Corporate Debentures*, 51(1) J. Fin. Econ. 45 (1999).

29 Lucy Chernykh, *Ultimate Ownership and Control in Russia*, 88 J. Fin. Econ. 169 (2008) (Nov. 17, 2020), available at www.elsevier.com/locate/jfec.

30 Jayati Sarkar & Subrata Sarkar, *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India*, 1(3) Int'l Rev. Fin. 161 (2000) (Dec. 15, 2020), available at https://onlinelibrary.wiley.com/doi/full/10.1111/1468-2443.00010.

31 Donald C. Clarke, *Corporate Governance in China: An Overview*, SSRN Electron. J. (2003) (Nov. 27, 2020), available at https://papers.ssrn.com/abstract=424885.

32 Randall Morck et al., *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease*, NBER Working Paper Series in Concentrated Corporate Ownership, National Bureau of Economic Research Inc. 319–72 (1998) (Dec. 11, 2020), available at https://www.nber.org/papers/w6814.

33 Stijn Claessens & B. Burcin Yurtoglu, *Corporate Governance in Emerging Markets: A Survey*, 15 Emerging Mkts. Rev. 1 (2013).

34 Lucy Chernykh, *Ultimate Ownership and Control in Russia*, 88 J. Fin. Econ. 169 (2008).

2. Analysis of the Regulatory Frameworks for Related Party Transactions in the BRICS Countries

Apart from specific regulations that apply largely to listed companies, each of the BRICS countries have incorporated the regulatory framework for related party transactions into their basic company law legislation or corporate governance codes. For instance, CVM Instruction 552/2014 and Annex 30-XXXIII regulate related party transactions of Brazilian public companies. South Africa and China regulate related party transactions in their respective countries through the JSE Limited Listing Requirements and the Rules Governing the Listing of Shares on the Shenzhen Stock Exchange (2018 Revision) stock exchange regulations. Federal Law No. 208-FZ regulates related party transactions of Russian joint-stock and limited liability companies. In India, related party transactions in listed companies are regulated under the SEBI, i.e. Securities and Exchange Board of India (Listing Obligations Disclosure Requirements) Regulations 2015.

2.1. Defining "Related Parties"

In concentrated ownership structures, the controlling shareholders have the ability to collude with the management in order to expropriate resources through related party transactions.[35] Identifying related parties and the actual beneficiary of the transaction is essential for monitoring abusive related party transactions. Examples of related parties to the company include material or controlling shareholders, key managerial persons, executive and non-executive directors, any affiliated group of companies, joint ventures, etc. The related parties are differently defined in each of the BRICS countries. Related parties can be divided into two primary categories, namely: (a) individuals, such as beneficiaries, intermediaries, agents, controlling shareholders, and so on; and (b) entities, such as holding companies, subsidiary companies, group affiliated companies, etc.

2.1.1. Related Parties as Natural Persons

Brazil, China, India, and South Africa consider key managerial personnel to be related parties because they significantly influence the management of the companies. However, Russia does not consider key managerial personnel to be related parties unless they are part of the board of directors or management board. In Russian public companies, the joint executive body, which includes department heads, deputy general directors, the vice president, and others who exercise management decisions, is also not considered a related party for the same reason of not being part of governance bodies.[36] Thus, the

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[35] Shleifer & Vishny, *supra* note 11.

[36] Anastasia Kossov & Dimitri Lovyrev, *Related Party Transactions: International Experience and Russian Challenges*, OECD Publications 1 (2014).

transactions that take place with such persons in Russia do not require approval. In concentrated as well as complex concentrated ownership structures, it is exceedingly difficult to identify the ultimate controller of the company. Controlling shareholders are categorized in two ways; shareholders who possess control via shareholding either directly or indirectly. The controlling shareholders holding a share ownership that exceeds the threshold percentage (directly or via entities) are recognized as related parties in all of the BRICS countries. The ownership concentration in India, Brazil, China, and Russia is significantly higher compared to South Africa. However, India,[37] Brazil,[38] and Russia[39] (with an ownership concentration of 20%, 50%, and 50%, respectively) have adopted higher thresholds for classifying controlling shareholders having direct or indirect control as related parties, whereas South Africa[40] and China[41] (with ownership concentrations of 10% and 5%, respectively) have adopted low thresholds.

In India, the regulations consider controlling shareholders who are part of the promoter or promoter group of the listed issuer and have a shareholding of 20% or more as related parties. Recently, SEBI's Report of the Working Group on Related Party Transactions[42] has recommended including any person or entity belonging to a promoter or promoter group as a related party, irrespective of shareholding. They have further recommended including those shareholders (persons or entities) holding, either directly or indirectly (along with their relatives), 20% or more of the equity stake in the listed company within the ambit of a related party.

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37 Any person who is, or within the 12 months preceding the date of the transaction was, entitled to exercise or control the exercise of 10% or more of the votes able to be cast on all or substantially all matters at general or annual general meetings of the listed company, or any other company that is its holding company, *see* SEBI (Listing Obligations Disclosure Requirements) Regulations 2015, Regulation 2(zb).

38 A controlling shareholder is defined as an individual or a legal entity, or a group of individuals or legal entities by a voting agreement or under common control, which: (a) possesses rights that permanently assure it a majority of votes in resolutions of general meetings and the power to elect a majority of the corporation officers; and (b) in practice, uses its power to direct the corporate activities and to guide the operations of the departments of the corporation, *see* Federal Law No. 6,404/76 (Brazil) sec. 116.

39 The person is considered a controlling person and potentially a related party if it has the right of direct or indirect disposal of more than 50% of votes in the supreme management body of the controlled company or the right to appoint or elect the general director or more than 50% of the collegial management body of the controlled company on the basis of shareholding in the controlled company, shareholding agreement, and so on, *see* Art. 81.1 of Federal Law No. 208-FZ (Russia).

40 Any person who is, or within the 12 months preceding the date of the transaction was, entitled to exercise or control the exercise of 10% or more of the votes able to be cast on all or substantially all matters at general or annual general meetings of the listed company, or any other company that is its holding company; *see* Chapter X of the JSE Listing Requirements, sec. 10.1 (South Africa).

41 Shareholders holding more than 5% interest either directly or indirectly in the listed company, *see* Chapter X of the Rules Governing the Listing of Shares on the Shenzhen Stock Exchange and the Shanghai Stock Exchange, sec. 10.1.3 (China).

42 SEBI Report of the Working Group on Related Party Transactions (2020) (Jan. 31, 2020), available at https://www.sebi.gov.in/reports-and-statistics/reports/jan-2020/report-of-the-working-group-on-related-party-transactions_45805.html.

In the case of indirect ownership, apart from holding shares through the entities, the ultimate controllers can exercise control through powers entrusted to them in the company's charter or by any agreement. In Brazil and India, any person or entity with control or significant influence over the listed issuer is considered a related party. Furthermore, Brazil, India, and China use flexible and open-ended terms such as "significant influence" or "control" (as per the IAS 24 Related Party Disclosures) to identify all direct and indirect related parties of a company. In contrast, Russia and South Africa consider persons or entities having the power to issue legally binding decisions or controlling entities as related parties. In concentrated ownership structures, this enables ultimate controllers to transfer resources across group companies through an opaque web of complex ownership structures. In such ownership structures, the controlling shareholders, by using leverage strategically, try to enhance their control[43] by means of shareholding and exercising control or significant influence.

2.1.2. Related Parties as Legal Persons

There has been a growing predominance of pyramidal companies engaging in various complex business transactions in an attempt to circumvent the law and appropriate funds for their personal benefit. Related party transactions serve to facilitate operations and financial activities in group-controlled companies, which often have limited resources and weak contract enforcement procedures. [44] These transactions also help to reduce overall transaction costs and increase efficiency in business groups.[45] In South Africa, however, there are listing restrictions on pyramid companies, as they are frequently used to retain control despite holding less than the majority of shares. The JSE Listing Requirements in South Africa also prohibit the listing of second-stage new pyramids (which refers to a pyramid company that is a subsidiary of an established pyramid company). There has been the unbundling of conglomerates[46] since 2000 in an effort to have better transparency in South Africa. In Russia, affiliated entities, such as group companies, associate companies, and joint ventures, are not considered related parties unless they are the controlling entity[47] of the company or they have the power to give binding instructions to the company.

43 Andrew Ellul, *Control Motivations and Capital Structure Decision*, SSRN Electron. J. (2011).

44 Khanna & Palepu, *supra* note 4.

45 *See* Jin Chang & Jaebum Hong, *How Much Does the Business Group Matter in Korea?*, 23 Strategic Mgmt. J. 265 (2002) (May 26, 2020), available at http://doi.wiley.com/10.1002/smj.224.

46 By the end of 2000, only 3% of listed companies were pyramid companies. *See* Oman, P. Charles et al. (eds.), *Corporate Governance in Developing, Transition, and Emerging-Market Economies*, OECD Centre 1 (2003).

47 An entity, either directly or indirectly, having more than 50% votes in the supreme management body of the controlled entity or having the right to appoint more than 50% of the collective management body of the controlled entity due to its participation in the controlled entity and/or based on simple partnership, trust management, etc. *See* Art. 81.1 of Federal Law No. 208-FZ (Russia).

Moreover, the Russian Federation Supreme Court has clarified that[48] legal entities controlled by related parties are not entitled to participate in voting.

The IAS 24 (Related Party Disclosures) definition of a related party includes not only entities belonging to the same economic group but also entities that are sponsored by the listed issuers' employees through a post-employment benefit plan (such as in India and Brazil), entities under the control of the related party (adopted in all BRICS countries), and a related person who possesses substantial influence over the entity (exclusively in India and Brazil). In addition to an enumerated list of related parties, China has also adopted a general provision where any individual or legal entity having a special relationship with the listed company can be considered a related party if determined by the China Securities Regulatory Commission, the Exchange, or the listed company itself. China and South Africa both consider individuals or legal persons as deemed related parties if they have been related parties within the last twelve months preceding the date of the related party transactions.[49]

In complex concentrated ownership structures, controlling shareholders of a listed entity may also control other private entities. Due to a lack of transparency in determining the related parties of the listed entity, it is difficult for minority shareholders to determine the transaction's fairness. Overall, among the BRICS countries, South Africa and China have adopted more stringent criteria in their definition of related parties as natural and legal persons compared to other jurisdictions. Both countries have set lower thresholds for determining controlling shareholders and consider former related parties to have a conflict of interest for a period of twelve months preceding the transaction date. Most importantly, South Africa also imposes restrictions on listed pyramid companies to prevent conflicts of interest with minority shareholders.

2.2. Defining "Related Party Transactions"

According to the International Accounting Standards 24 (IAS 24), related party transactions are defined as a transfer of services or resources between a listed issuer and a related party, irrespective of whether the price is charged. There are different types of related party transactions, such as material, nonmaterial, exempted, and recurrent related party transactions.

2.2.1. Defining "Material" Related Party Transactions

The materiality thresholds of related party transactions are based on the assets' numerical value or percentage ratio. The numerical value of materiality determines the impact on minority shareholders. For instance, Brazil employs a combination of

48 On 26 June 2018, the Plenary Session of the Supreme Court of the Russian Federation issued Ruling No. 27 on Disputing Major Transactions and Interested Party Transactions.

49 *See* Chapter X of Rules Governing the Listing of Shares on the Shenzhen Stock Exchange and the Shanghai Stock Exchange, sec. 10.1.6 (China), and Chapter X of the JSE Listing Requirements (South Africa), sec. 10.1.

numerical and percentage ratios of assets for determining the materiality threshold of related party transactions. However, it excludes related party transactions that take place between the listed issuer and its direct or indirect subsidiaries. The materiality percentage ratio (5%) for public disclosure is the lowest in Brazil of all the BRICS countries. Having a materiality percentage ratio that is lower than average helps protects the interests of minority shareholders. In India, the SEBI Working Group on related party transactions[50] also recommended decreasing the materiality threshold from 10% to 5% in order to prevent companies from circumventing the approval procedures, which was possible due to high threshold values. As a result, the percentage threshold was reduced to 5% to be on par with other jurisdictions such as Malaysia, Singapore, and the United Kingdom. Further, they have recommended the incorporation of a numerical threshold of a 1000 crores; however, in the case of a company with a negative net worth, this numerical threshold is not applicable. The JSE[51] Listing Requirements in South Africa specify different materiality thresholds for small related party transactions, which entail fewer appraisal or audit requirements. Moreover, the JSE Listing Requirements also specify an increased materiality threshold[52] of 10% for mid-cap companies listed on the Alternative Exchange (ALTx).

2.2.2. Exempted Related Party Transactions

Controlling shareholders, at times, covertly tunnel out resources under the garb of the ordinary course of business. Such related party transactions escape scrutiny even if they are abusive. Brazil,[53] China,[54] Russia,[55] and South Africa[56] exempt those related party transactions that are undertaken in the ordinary course of business at arm's length pricing from audit or appraisal but with certain restrictions. For instance, the Brazilian Corporate Governance Code[57] recommends that companies voluntarily define the different categories of related party transactions. China exempts recurrent related

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50 SEBI Report of the Working Group on Related Party Transactions, *supra* note 42. Related party transactions Working Group Report 2020, February, after reviewing the data of the Top 500 listed companies in the past five years.

51 Chapter X of the JSE Listing Requirements (South Africa), sec. 10.7.

52 Chapter X of the JSE Listing Requirements (South Africa), sec. 21.

53 CVM Resolution 642/2010 (Brazil).

54 Chapter X of Rules Governing the Listing of Shares on the Shenzhen Stock Exchange and the Shanghai Stock Exchange, sec. 10.2.12 (China).

55 Article 81.2 of Federal Law No. 208-FZ if the listed issuer has executed similar transactions over a long period of time with similar terms and conditions.

56 Exempts related party transactions in the ordinary course of business if the percentage ratios referred to in para. 9.6 are equal to or less than 10%; *see* Chapter X of the JSE Listing Requirements (South Africa), sec. 9.1(d).

57 Article 5.3 of the Brazilian Corporate Governance Code – Listed Companies of 2016.

party transactions relating to day-to-day operations from audit or appraisal. But such transactions must be approved in the shareholders' meeting or the board meeting if they are being undertaken for the first time. Additionally, the Chinese Listing Rules require disclosures of such transactions in the annual report about the performance of such agreements as well as the shareholders' or board's considerations in case of a modification or renewal of an agreement of such transactions. It also requires an evaluation of recurrent related party transaction agreements with pricing principles, transaction cost, gross transaction amount, terms, and time of payment.[58] Such economic evaluations of related party transactions in China help in the prevention of transaction abuse. The Brazilian Corporate Governance Code[59] recommends that companies voluntarily define the different categories of related party transactions. Russian Federal Law exempts related party transactions undertaken in the ordinary course of business at an arm's length price over a period of time but requires the execution of such transactions by credit institutions.[60] The Supreme Court of Russia[61] in 2014 interpreted 'ordinary business activities' as customary operations carried out in a company engaged in a similar business and having similar capital and turnover. But the burden of proof for related party transactions that are outside the purview of the ordinary course of business lies on the plaintiff.[62] In South Africa, the scrutiny of related party transactions in the ordinary course of business is based on a percentage ratio[63] equal to or less than 10%. However, if the issuer, or listed company, or its subsidiary is a financial institution dealing in funds and undertaking related party transactions that are not for the benefit of the shareholders, the determination is to be made by the JSE.[64] India does not provide any exceptions from audit appraisals for related party transactions that occur in the ordinary course of business.

2.2.3. Prohibition of Loans to Management or Controlling Shareholders

Loans to the controlling shareholders have been often used as a means to expropriate the company's resources.[65] In some jurisdictions, related party transactions with controlling shareholders or managers have been subject to stringent fairness

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58 Chapter X of the Rules Governing the Listing of Shares on the Shenzhen Stock Exchange and the Shanghai Stock Exchange, sec. 10.2.13 (China).

59 Article 5.3 of the Brazilian Corporate Governance Code – Listed Companies, *supra* note 57.

60 Article 5 of Federal Law No. 395-1/1990 on Banks and Banking Activity (Russia).

61 Ruling of the Plenary Session of the Supreme Court of the Russian Federation, Moscow No. 27, 26 June 2018.

62 *Id.*

63 *See* Chapter X of the JSE Listing Requirements (South Africa), sec. 9.5.

64 JSE Listing Requirements (South Africa), sec. 10.4.

65 Guohua Jiang et al., *Tunneling through Intercorporate Loans: The China Experience*, 98 J. Fin. Econ. 1 (2010).

scrutiny or even complete prohibition. For instance, the Brazilian Corporate Governance Code explicitly prohibits voluntary loans in favor of management or controlling shareholders. Therefore, it is rare for Brazilian companies to prohibit, i.e. place restrictions on the granting of loans to controlling shareholders or related parties.[66] In China, listed companies are prohibited from giving loans to supervisors, directors, or senior officers. India also prohibits granting loans to directors under section 185 of the Companies Act, 2013. In South Africa, the Companies Act, 2008 imposes restrictions on the provision of loans or security for directors. Despite such restrictions, block holders in complex ownership structures succeed in tunneling resources through transactions involving related parties. Russian legislation permits loans to directors, provided they are approved by disinterested directors if the transaction involves a related party.

2.2.4. Related Party Transactions by Subsidiaries of a Listed Entity

The related party transactions undertaken by subsidiaries of listed issuers are not subject to scrutiny in all BRICS jurisdictions. This leads to numerous abusive related party transactions whereby controlling shareholders, through their subsidiaries, dispose of assets at undervalued prices or purchase overpriced assets.[67] In both China and South Africa, related party transaction regulations apply to subsidiaries of the listed company. However, Brazil has adopted a broader scrutiny of related party transactions. As a result, related party transactions undertaken by listed issuers, including those involving companies directly or indirectly controlled by the listed issuers and exceeding the materiality thresholds, must comply with approval and disclosure norms. The JSC Law in Russia and the Listing Regulations in India apply to listed issuers only and are inapplicable to related party transactions undertaken by subsidiaries. Recently, a number of listed big companies in India were under the scanner of abusive related party transactions undertaken via subsidiaries.[68] Therefore, the SEBI working Group[69] has recommended widening the ambit of related party transactions to also include transactions undertaken between the listed issuer or its subsidiaries with the related party of such a listed issuer or its subsidiary. It has further recommended mandatory scrutiny of such transactions by an audit committee. This comprehensive overhaul will increase regulatory compliances for listed companies and subsidiaries in India, with the end goal of curbing abusive related party transactions.

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[66] Ricardo Pereira Câmara Leal et al., *One Decade of Evolution of Corporate Governance Practices in Brazil*, SSRN Electron. J. (2015) (Nov. 29, 2020), available at https://papers.ssrn.com/abstract=2611372.

[67] Kossov & Lovyrev, *supra* note 36.

[68] *Is Arm's Length Price Way Out for Big Firms Caught in the Governance Net?*, The Financial Express, 9 October 2019 (Oct. 1, 2021), available at https://www.financialexpress.com/industry/is-arms-length-price-way-out-for-big-firms-caught-in-the-governance-net/1730534/.

[69] Bharat Vasani, *SEBI Working Group on Related Party Transactions: Will the Net Be Cast Too Wide?*, Companies Act, SEBI, 5 February 2020 (Apr. 3, 2020), available at https://corporate.cyrilamarchandblogs.com/2020/02/sebi-working-group-on-related-party-transactions-will-the-net-be-cast-too-wide/.

3. Oversight of Related Party Transactions in the BRICS Countries

A well-informed decision-making process and vetting related party transactions are essential for effective governance.[70] Related party transactions are monitored through various measures, such as board approval, statements on fairness issued by the board, shareholders' approval, voting restrictions on "interested" directors and shareholders, and appraisals from auditors and independent advisers. Board approval as a means of regulatory oversight is followed in many jurisdictions[71] specifically for nonmaterial related party transactions, in order to expedite such transactions. Furthermore, prudent board members seek the help of lawyers and accountants to examine complex transactions. The transactions to be approved should be examined thoroughly in order to determine whether or not these transactions are, in reality, in the best interest of the company and its shareholders. Shareholders' approval, as a parameter, also plays a vital role in vetting the information they provide for approving related party transactions. Additionally, the opinions of an independent audit committee or independent advisors help shareholders make the appropriate decisions in the approval mechanism that are in the best interests of the company.

3.1. Directors' Approval

Board approval is the primary level of scrutiny for related party transactions. The BRICS countries have all adopted different approaches to including board approval as an indicator in determining related party transactions. The Brazilian Corporate Governance Code for listed companies[72] recommends having related party transaction policies approved by the board of directors, excluding members with a potential conflict of interest. As a result, the majority of related party transactions are approved at the board level in Brazil. However, the board has no general responsibility to monitor conflicts of interest or oversee related party transactions. Russia[73] follows an ex-post litigation approach whereby courts review most transactions. Since the July 2016 amendment, all related party transactions in Russia do not require any approval unless requested by the sole executive body, a member of the collective executive body, a member of the supervisory board, or shareholders holding at least 1% of voting shares. However, any

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70 N. Hosseinyan et al., *The Role of Corporate Governance on the Relationship Between Related Party Transactions and Firm Value*, CMLG2015 – The 3rd International Conference on Management Leadership and Governance (Aug. 5, 2019), available at https://search.proquest.com/abicomplete/docview/1781636780/fulltextPDF/8DC9214D929041B6PQ/101?accountid=151027.

71 Provisions for board approval are common; two-thirds of jurisdictions surveyed require or recommend board approval of certain types of related party transactions; *see* OECD Corporate Governance Fact Book 2019 (2019) (July 2, 2019), available at https://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.

72 The Brazilian Corporate Governance Code – Listed Companies of 2016, *supra* note 57.

73 Article 83(1) of Federal Law No. 208-FZ (Russia).

related party transactions undertaken without approval in Russia can be challenged by any member of the supervisory board or its shareholders holding at least 1% of voting shares for one year. In Russia (if requested) and in China, the related party transactions must be approved by more than half of the non-related directors. If the required quorum of three non-related directors in China and two non-related directors in Russia is not satisfied, then such transactions must be approved by non-related shareholders. Russia also prohibits persons who are or have been, in the last year preceding the date of related party transactions, members of sole executive directors or collective executive directors, managers, and senior officers,[74] of the company, from participating in the decision-making process of related party transactions in a public company. In India, the board's approval is required for specific transactions as per section 188 of the Companies Act, 2013, in addition to the disclosure of related party transactions in the directors' report. In material related party transactions, the majority of minority shareholders' approval approach is followed (all related parties, irrespective of whether they are interested in the transactions or not, are restricted from voting). In South Africa, directors are obligated by fiduciary duty to provide a "fairness opinion"[75] on related party transactions after being advised by an independent adviser.

3.2. Independent Directors' Appraisals

Independent directors play an essential role in the governance of related party transactions. However, the degree of independence granted differs in each of the BRICS countries. The prevention of abusive related party transactions depends upon the degree of independence. In Brazil, neither shareholders nor an independent board[76] committee approves related party transactions. In Brazil, listed companies, for instance, in Novo Mercado and Nivel 2 must appoint at least 20% of independent members (Nivel 2) or 2%, whichever is greater, to serve on their boards. The listed companies in other listing segments (namely, Nivel 1, Bovespa Mais, and Bovespa Mais Nivel 2) do not have such requirements.

The Russian Code of Corporate Governance assesses the independence of directors by examining the ties between businesses and the government. It provides a relatively narrow definition of independent directors, confining it to those who have not been a company manager or a related party to the company for the past year.[77]

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74 Article 83(3) of Federal Law No. 208-FZ (Russia).

75 Chapter X of the JSE Listing Requirements (South Africa), sec. 10.4.

76 Novo Mercado and Nivel 2 listed companies must follow the requirement that 20% or 2% of directors be independent, whichever is lower.

77 White Paper on Corporate Governance in Russia – OECD (May 27, 2020), available athttp://www.oecd.org/newsroom/whitepaperoncorporategovernanceinrussia.htm. Article 83(1) of Federal Law No. 343 of 7 Feb. 2016, "On Amendments to the Federal Law on Joint-Stock Companies," with effect from January 2017, additionally disqualifies directors who are or have been for the past one year, members of the supervisory board, a manager, a member of the collective executive body, or any

It also disqualifies a person from being the independent director if such a person is associated with the company, a substantial shareholder, material trading partners, competitors, or the government.[78] In addition, the Russian Corporate Governance Code mandates one-third of independent directors on the board.

In order to prevent conflicts of interest and minimize the risk of abusive related party transactions, the companies are recommended under the Russian Corporate Governance Code[79] to adopt a comprehensive approach to addressing conflicts of interest and develop systematic measures to prevent the manifestation and settlement of conflicts of interest. The inclusion of a definition in internal documents, along with an expanded list of reasons to identify the interests of members of the board of directors and other persons stipulated by law is one of the important tools for managing conflicts of interest. However, the problem of identifying the interested party in each related party transaction presents a complex challenge for the board of directors in the decision-making process.

In India, independent directors[80] are not allowed to have a material financial relationship with the listed entity or its associate company (including their holding and subsidiary entities), nor are they allowed to be related to the promoter of the listed issuer, its holding, or a subsidiary company. Similarly, listed companies in China prohibit independent directors from having any relationship with the listed company or its significant shareholders.[81] However, most member boards in State-owned enterprises in China do not have a majority of independent directors, with 75% of the chairperson positions being held by executive directors.[82] Both India and China refer to family, social, or business connections as criteria to assess the independence of directors. South Africa adopts international best practices to assess the independence of directors under Corporate Governance for South Africa 2016 (King IV Code). This Code places an obligation on the board to determine the directors' independence in terms of their character and mandates them to disclose their justifications for classifying directors as independent.

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person whose spouse, parents, children, etc. are holding office in the management bodies or a person controlling the management of the company, from participating in the approval mechanisms of related party transactions.

78 Article 2.4 of the Russian Corporate Governance Code.

79 *Id*. Art. 2.1.

80 SEBI (Listing Obligations Disclosure Requirements) Regulations 2015, Regulation 16.

81 Article 49 of the Code of Corporate Governance for Listed Companies in China.

82 Corporate Governance in China (2017) (Jan. 10, 2020), available at http://www.hkex.com.hk/eng/newsconsul/hkexnews/2017/170616news.htm.

3.3. Shareholders' Approval

The presence of a controlling shareholders' coalition[83] undermines the fairness of the approval mechanism in cases of failures in identifying interested or related shareholders. Shareholders' rights in terms of granting approval to related party transactions are relatively limited in Brazil, as the majority of transactions are approved at the board level. In Brazil, none of the listing segments of B3 mandate shareholders' approval for related party transactions. Furthermore, it is important to note that in Brazilian listed companies, controlling shareholders are also a part of the boards of executives or directors of the companies.[84] Based on the findings of several studies,[85] it has been found that listed companies in Brazil that have a single controlling shareholder's body have a smaller number of outside directors. This situation also results in more conflicts of interest between the controlling and minority shareholders, ultimately leading to the expropriation of resources. In India, shareholders' approval is required for material-related party transactions whereby it disqualifies all related parties, whether interested or not, when approving related party transactions. The SEBI working group[86] in India has also recommended controlling shareholders and promoters (irrespective of their shareholding) be disqualified from participating in the approval mechanism.

The listing requirements[87] in China have laid down specific criteria for determining interested shareholders, such as being a counterparty to the transactions, under the direct or indirect control of the counterparty, under the direct or indirect control of a legal person or organization or natural person who is a counterparty, etc. In Russia, the mandatory disinterested shareholders' approval is required for only a small number of related party transactions.[88] In the annual general meeting, public companies are required to submit a report, duly signed by the sole executive body and approved by the board of directors, on the related party transactions that were entered each reporting year. The Russian and Chinese legislations fail to provide adequate measures

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83 OECD, *Flexibility and Proportionality in Corporate Governance*, Corporate Governance, OECD Corporate Governance Committee (2018) (May 27, 2020), available at https://www.oecd-ilibrary.org/governance/flexibility-and-proportionality-in-corporate-governance_9789264307490-en.

84 Eduardo Schiehll & Igor Oliveira Dos Santos, *Ownership Structure and Composition of Boards of Directors: Evidence on Brazilian Publicly-Traded Companies*, 39 RAUSP J. USP 373–84 (2004) (Jan. 24, 2020), available at www.bovespa.com.br.

85 *Id.*

86 SEBI Report of the Working Group on Related Party Transactions, *supra* note 42.

87 Chapter X of the Rules Governing the Listing of Shares on the Shenzhen Stock Exchange and the Shanghai Stock Exchange, sec. 10.2.2 (China).

88 Shareholders' approval in Russia is required if interested-party transactions account for 10% or more of the book value of the company's assets or if a transaction involves the sale of more than 2% of ordinary shares or of privileged shares comprising 2% of all shares of the company, *see* Article 81.1 of Federal Law No. 208-FZ (Russia).

in the scrutiny of whether related shareholders have been classified correctly or not. However, the JSC legislation in Russia has given certain rights to minority shareholders, defined as those holding 1% of the shares, to challenge related party transactions passed without approval. The Supreme Court of the Russian Federation has further clarified that formerly approved related party transactions can also be challenged. The Plenum of the Supreme Court has distributed the burden of proof between the plaintiff and the counterparty in cases of being challenged in bad faith. In cases of absence of approval, the burden of proof lies on the company. In cases of approved transactions, the burden of proof of damages to the company lies on the plaintiff. Further, the plaintiff bears the burden of proving the counterparty's awareness of the disputed transaction and the absence of appropriate approval for such transactions. These limitations create obstacles for minority shareholders when attempting to challenge the validity of related party transactions.

In South Africa, shareholders are required to pass ordinary resolutions for related party transactions crossing the material threshold of a percentage ratio of 5% or more of the market cap. However, the shareholders' approval is not required if a positive fairness expert opinion is obtained for small related party transactions ranging between 0.25% and 5% of the percentage ratio.[89] The country's legislation also disqualifies related parties and their associates from participating in the approval process of related party transactions. The shareholders' approval requirements differ, for example, for companies listed on AltX, which is specifically designed for small and mid-cap companies in South Africa. The AltX-listed companies[90] require resolutions from their ordinary shareholders for related party transactions with a ratio of more than 50%. The shareholders' approval is not mandated for small related party transactions between 10% and 50% of the percentage ratio if a positive fairness expert opinion is obtained. In small related party transactions,[91] if the independent advisor finds such transactions unfair, then the transaction has to go through the usual requirements governing related party transactions.

3.4. Audit Committee's or Independent Experts' Appraisal

In the majority of jurisdictions within the BRICS countries, the opinions of auditors or other independent experts on the approval mechanism of related party transactions are mandated. Such an opinion helps minority shareholders take appropriate decisions in approving related party transactions. In Brazil, neither the opinions of auditors nor independent experts are required for sanctioning related party transactions. In India, dominant controllers have the power to easily influence the other board members in decision-making. Therefore, in India, all related party

89 JSE Listing Requirements (South Africa), sec. 10.4.

90 Chapter X of the JSE Listing Requirements (South Africa), sec. 21.12.

91 *Id*.

transactions in listed companies, whether material or nonmaterial, require approval from audit committees comprised of a majority of independent directors. Recently, the SEBI Working Group Report[92] on related party transactions has further recommended enhancing the burden of monitoring related party transactions of the listed issuer and its unlisted subsidiaries by the audit committee. The SEBI has also recommended that careful scrutiny be applied by the audit committee in cases where the beneficiary of related party transactions involving a listed issuer or a subsidiary is a related party of the listed issuer or its subsidiary. In complex ownership structures, unless the audit committee is provided with accurate and transparent information, it will be difficult for them to ascertain the actual beneficiary. Moreover, there are no criteria laid down in the recommendation that can be used to assess the beneficiary.

In Russia, the 'beneficiary test' is broad enough to determine a related party, including any person who appears to demonstrate obligations or receive entitlements.[93] Prior to the board's approval, it is recommended to obtain an opinion of value, also known as an independent appraisal, for examining risk factors associated with reports duly signed by the sole executive body and approved by the board of directors on the related party transactions entered into each reporting year. Further, the company's audit committee is mandated to examine the accuracy of such a report in Russia. The Russian Corporate Governance Code[94] recommends the committee consist entirely of independent directors or, at least, be chaired by an independent director and include only non-executive directors. Effective July 2018, all public companies in Russia are mandated to have an audit committee on the supervisory board.[95] The Code also recommends having an independent appraiser to determine the market value of the asset under any related party transactions.[96]

In China, if a listed company's related party transactions exceed the threshold of RMB 30 million and more than 5% of the book value, the company has to provide an independent appraisal or auditor report, and such a transaction has to be submitted for shareholders' consideration. In China, the audit committee of listed companies comprises at least one-half of the independent directors, with at least one of them specializing in accounting. Finally, in South Africa, all related party transactions require a "fairness opinion" from an expert. This expert opinion is also attached to the circular for disclosures.[97]

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92 SEBI Report of the Working Group on Related Party Transactions, *supra* note 42.

93 Bernard S. Black et al., *Corporate Governance Indices and Firms' Market Values: Time Series Evidence from Russia,* 7 Emerging Mkts. Rev. 361 (2006) (Nov. 17, 2020), available at www.elsevier.com/locate/emr.

94 Article 1.3.1 of the Russian Corporate Governance Code.

95 Danil Guryanov et al. *Russia*, in Willem J. Calkoen (ed.), The Corporate Governance Review – Edition 10, The L. Reviews (2020) (Nov. 30, 2020), available at https://thelawreviews.co.uk/edition/the-corporate-governance-review-edition-10/1222296/russia.

96 Article 313 of the Russian Corporate Governance Code.

97 Chapter X of the JSE Listing Requirements (South Africa), sec. 10.9.

4. Disclosure Requirements for Related Party Transactions in the BRICS Countries

The timely disclosure of related party transactions and the transparency of corporate ownership structures are regarded as two of the key priorities for protecting investors and lowering companies' costs to access capital.[98] In concentrated or complex ownership structures, controlling shareholders and directors have the ability to easily manipulate related party transactions for their personal financial enrichment as they are the ultimate controllers of the companies. Based on such information, investors can challenge any abusive related party transactions for any irregularities. As a result, inadequate disclosure requirements and a lack of transparency structures are significant concerns in emerging markets. In concentrated ownership structures, the minority shareholders depend on the disclosure of information as a means to minimize information asymmetry.[99] Each of the BRICS countries has different disclosure requirements in place for better transparency of related party transactions, ranging from following IAS 24 disclosure standards, making public announcements, providing detailed circulars to shareholders, ensuring immediate disclosures, and establishing decision-making procedures.

Brazil, Russia, and South Africa have all adopted the IAS 24 disclosure standards for ex-post disclosures of related party transactions. Russian companies are given the option to adopt either the IAS 24 disclosure requirements or local standards. In Brazil, there are specific disclosure requirements for related party transactions in complex intra-group ownership structures, including the negative impact of any form of influence exerted by the holding company.[100] However, certain highly risky related party transactions[101] between the listed issuer and direct or indirect controlled companies are not required to be disclosed. In addition, the listed companies are required to report material related party transactions within seven business days. For example, Brazilian listed companies are required to disclose detailed announcements about related party transactions, including a description of the transactions themselves, the related parties involved, the companies' decisions describing their participation, detailed justifications for such transactions, pricing procedures, and the reasons that led to the transaction with a related party and not a third party.[102] The listed companies may also, at the

98 Kossov and Lovyrev, *supra* note 36.

99 Alfred Wagenhofer, *Voluntary Disclosure with a Strategic Opponent*, 12 J.Acct. Econ. 341 (1990).

100 *Id.*

101 *Id.* clarifies that certain transactions are not to be deemed "transactions between related parties" and do not need to be disclosed, such as transactions between the issuer and its direct or indirect controlled companies, transactions between entities controlled directly or indirectly by the issuer, and remuneration of the administrators, with a few exceptions.

102 *Id.*

management's discretion, elect to disclose nonmaterial related party transactions. In Russia, public companies must send a fifteen-day notice to non-related shareholders and board members, indicating the price, subject matter, name and nature of related parties, as well as the material terms or procedures before undertaking related party transactions. The country also has ex-post disclosure requirements for related party transactions, such as disclosure of such transactions within two days in corporate event notices as well as within 45 days in quarterly reports, annual reports, and prospectuses.[103]However, Russian legislation mandates the disclosures of shareholders with holdings exceeding the threshold of 5%, which creates difficulties in identifying related parties. This amendment was enacted in October 2010[104] after the 'OECD Russia Corporate Governance Roundtable Report[105] on Related Party Transactions in Russia' recommended the need for disclosure of significant beneficial owners as it was considered a primary concern of weak corporate governance in Russia.

Due to a lack of beneficial ownership transparency, control mechanisms in complex ownership structures, regulatory measures of approval, and disclosure requirements for monitoring related party transactions[106] fail to identify related party transactions. The inadequate disclosure requirements governing related parties affect the rights of minority shareholders, thus giving the related party the ability to participate in the approval of related party transactions. Without an adequate disclosure of the shareholders having beneficial ownership of the company's shares, the regulations governing related party transactions would likely be ineffective. As a result, such transactions are commonly approved as regular transactions. Therefore, it is imperative that disclosure requirements mandate the company as well as its shareholders or beneficiaries to disclose their material interests with the company on a regular basis.

Listed companies in China are required to submit detailed documentation[107] to the stock exchange. Following the submission of such information, listed companies are mandated under section 10.2.9 to release an announcement that includes all of the necessary information, such as a description of related party transactions, the opinions of independent directors, and disclosures of the directors' voting and pricing policies.[108] Listing Regulations in China also mandate the provision to furnish additional information as per section 9.14 if related party transactions involve guarantees.[109] If the

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103 Kossov & Lovyrev, *supra* note 36.

104 Article 30 (19) of Federal Law No. 39-FZ (Russia).

105 Kossov & Lovyrev, *supra* note 36.

106 World Bank Report on the Observance of Standards and Codes for Corporate Governance Country Assessment, Russian Federation, June 2013.

107 Sec. 10.2.8; the documents that are required to be submitted are the draft announcement, independent director's approval and opinion, agreement of related party transactions and independent experts' appraisal report.

108 Chapter X of the JSE Listing Requirements (South Africa), sec. 10.2.9.

109 *Id.*

transaction value exceeds RMB 3 million, accounting for more than 5% of the absolute value, additional disclosures are required to be made as per section 9.7.[110] The Indian Accounting Standards 24 regulating listed companies in India mandate the disclosure of the following information: the nature of the related party,[111] the parent company, the remuneration of key managerial personnel, as well as all related party transactions. Exempt related party transactions in India are also disclosed in the interests of investors. However, the decision-making process itself, the opinion of the Audit Committee, the opinion of any experts, and the justifications of related party transactions are not required to be disclosed in India. In India, cross-shareholdings and pyramid structures are prevalent in family conglomerates,[112] helping them preserve family control in their various listed entities, and therefore, the disclosure requirements mentioned above are not required to be disclosed in India. Nevertheless, the SEBI Working Group on Related Party Transactions[113] has recently recommended disclosing certain other specific information, such as the recommendations of the audit committee, the information based on which the audit committee has exercised its decision, the unanimous opinion of the audit committee (if applicable), the valuation report, and the counter party's annual total revenues.

In South Africa, listed companies or their subsidiaries are required to disclose related party transactions through a public announcement[114] before entering into any related party transactions. Additionally, within 60 days of such a public announcement, a detailed circular[115] containing all material information must be circulated to the company's shareholders. Doing so helps shareholders make an informed decision before approving such transactions.

Conclusion

This study has sought to compare the regulatory frameworks governing related party transactions in the BRICS countries. In the coming years, the BRICS countries have the potential to influence the world's economic, political, and military power.

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110 Chapter X of the JSE Listing Requirements (South Africa), sec. 10.2.5.

111 It mandates the disclosure of the parent company, joint control entities, subsidiaries, associates, joint ventures, key management personnel and other related entities.

112 MSCI, MSCI CORPORATE GOVERNANCE IN INDIA, (2017) (Jan. 10, 2020), available at www.msci.com.

113 SEBI Report of the Working Group on Related Party Transactions, *supra* note 42.

114 The detailed public announcement should include the name of the related party, the details of the nature and extent of interest of such a related party, the description of the business, rationale of the transactions etc., *See* Chapter X of the JSE Listing Requirements (South Africa).

115 The circular should include responsibility statement, information about related party transactions, major shareholders, material changes, expert consents, directors' interest in transactions, fairness opinion or statement; furthermore, additional information is required if a related party transaction involves immoveable or freehold property.

Hence, the rise of the powers of these countries will have significant implications for the international market.[116] In order to thrive in the international market, the BRICS countries need strong corporate governance that allows for greater transparency and robust management. However, the controlling or principal owners create difficulties when it comes to strengthening the laws regulating related party transactions in emerging markets. Furthermore, companies operating in emerging markets are heavily dependent on related party transactions due to the economic conditions in which they operate. Therefore, too much stringency cannot be adopted in regulating related party transactions.

This comparative study undertaken with regard to the BRICS countries has revealed some interesting insights as well as highlighted the strengths and weaknesses in regulating related party transactions in the context of ownership structures.

The BRICS countries have adopted different monitoring mechanisms to prevent abusive related party transactions. Brazil has adopted stringent regulations with regard to the disclosure requirements of material-related party transactions, but these regulations exclude highly risky related party transactions where controlling shareholders can expropriate from disclosures. On the other hand, Brazil has adopted the most lenient approach when it comes to protecting minority shareholders, as it does not mandate an independent board or shareholders' approval in related party transactions. In order to prevent expropriation by controlling shareholders, Brazil must more effectively oversee the related party transactions in its economy.[117] Russia has adopted an ex-post litigation approach where minority shareholders holding 1% of the shares can challenge related party transactions passed without approval. The reason for this may be that Russia has the fewest listed companies compared to the other BRICS countries.[118] The Supreme Court of the Russian Federation has further clarified that approved related party transactions can also be challenged. This will no doubt reduce the administrative burden on companies for ease of business. But the extent to which it can curb abusive related party transactions will be dependent upon the rights of minority shareholders to challenge such transactions.

India has adopted the utmost stringency in its country's approval requirements for all related party transactions. The "majority of the minority" approach (excluding all related parties) is followed in India for approving material-related party transactions.

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116 Robert C. Bird, *Defending Intellectual Property Rights in the BRIC Economies*, 43 Am. Bus. L.J. (2006) (May 23, 2020), available at https://heinonline.org/HOL/Page?handle=hein.journals/ambuslj43&id=325&div=&collection=.

117 Fernando Lefort, *Ownership Structure and Corporate Governance in Latin America*, 8 Abante 55 (2005).

118 Brazil has 366 listed companies, China has 2,392, India has 5,112, and South Africa has 355. China has added many more listed companies to its exchanges in recent years. Russia's figure has also increased since 2000); but to a lesser degree – the country's number of listed companies has increased from 249 to 327 from 2003 to 2012. The number of truly or fully listed issuers was 103 companies at the end of June 2012. *See* World Bank Report on the Observance of Standards and Codes (ROSC), Corporate Governance Country Assessment, Russian Federation, June 2013.

Yet, regarding disclosure requirements, India has the fewest disclosure requirements compared to Brazil, Russia, China, and South Africa. The Securities and Exchange Board of India, which serves as the country's market regulator, has strengthened the legal framework governing related party transactions by widening the ambit of related party transactions as well as protecting the rights of minority shareholders involved in related party transactions. Since 2018, promoters and promoter groups are now recognized as related parties, and any transactions involving them are categorized as related party transactions. India has also restricted the ability of controlling shareholders to approve related party transactions to only promoters or promoter groups. However, it is important to note that the definition of controlling shareholders in India is also restricted to only include promoters. Due to such a narrower definition, the SEBI Working Group has recommended including controlling shareholders as related parties.

The economic appraisal of related party transactions plays a vital role in detecting expropriation. China has adopted a unique feature to audit or independently appraise material-related party transactions through independent intermediary institutions that are specifically suited for submitting such reports for shareholders' deliberations. Except for South Africa, all of the other BRICS countries require a special resolution for the approval of related party transactions. Nevertheless, the disclosure requirements in South Africa are exhaustive compared to other countries. In fact, South Africa has disclosure requirements equal to or exceeding those of the majority of advanced countries. South Africa is the only country to have adopted a different regulatory framework for mid-cap companies that allows for a good amount of flexibility. Furthermore, there are prohibitions on the listing of pyramid companies in South Africa. The JSE also prohibits listing second-stage new pyramids (another pyramid company of a pyramid company). Such prohibitions should be adopted in other jurisdictions to increase transparency in listed companies.

In several respects, the BRICS countries have worked cooperatively to control abusive related party transactions in ways that are appropriate for their respective local conditions. The BRICS countries have enacted new regulations to prevent abusive related party transactions, including the monitoring of related party transactions that are commonly used in the normal course of business, the requirement that all related party transactions be approved by an audit committee, the exclusion of all related parties from the decision-making process, different threshold levels for large and mid-cap companies, independent expert approval on particular related party transactions, in-depth justification of riskier related party transactions (loans and guarantees), and immediate disclosure of material related party transactions.

However, the legislations governing related party transactions in the BRICS countries have not addressed some significant governance issues arising due to concentrated ownership structures (for example, the monitoring of RPTs in pyramidal companies, similar RPT thresholds for group and non-group companies, the dominance of controlling shareholders on independent directors' appraisals of

RPTs, and a lack of adequate RPT disclosure requirements). This suggests that it is time for the BRICS countries to revamp their regulatory systems for related party transactions taking into their account ownership structure in order to be able to effectively prevent abusive related party transactions.

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