CFA INSTITUTE
Centre for Financial Market Integrity

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Mr Shri Bhave
Chairman
Securities and Exchange Board of India
Plot No: C4-A, "G" Block
Bandra Kurla Complex, Bandra (East)
Mumbai, 400-051, India

Dear Mr Bhave,

On behalf of our members, the CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") and the Indian Association for Investment Professionals ("IAIP") are writing to express our views regarding current regulations in India protecting investors from abusive related-party transactions ("RPTs"). The recent occurrences at Satyam Computers where the chairman, Mr Raju, tried to pass an abusive related-party transaction as a deal that would "deliver greater shareholder value" highlights inadequacies in the current corporate governance regulations, particularly those involving RPTs.

The Companies Act, 1956, Clause 49 of the Listing Agreement and Accounting Standard 18 on RPTs focus predominately on disclosure requirements however, with the exception of Section 297 of the Companies Act, there is little mention of any approval processes. While timely disclosure is very important, it is only one part of the process. For example, disclosures in annual reports are reported long after the transactions are completed, therefore they are not the most effective way of protecting shareholders' rights.

The Satyam case highlights weaknesses in the current regulatory framework and corporate governance practices as discussed below:

**1. Shareholder Approval**

Currently in India, RPTs only require board approval and do not require independent shareholder approval. We believe shareholder approval is an effective way to determine the fairness of RPTs to minority shareholders. The additional level of approval is especially important for companies where there is no separation of ownership and control, as in the case of Satyam.

The Satyam board did not take the proposal to acquire the two infrastructure companies to shareholders and subsequently investors reacted to the transactions by punishing the stock after the announcement. Shareholders continued to voice their dissent with the board at the analyst meeting, infuriated that the proposals were not taken to an AGM or EGM but rather approved unilaterally by the board.

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*To improve investor protection against RPTs we believe material transactions - specifically those that involve the transfer of assets and those that could lead to the dilution of minority stakeholders – should be subject to shareholder approval in a voting by poll, with the related parties abstaining from the vote.*

**2. "Truly" Independent Non-Executive Directors ("INEDs")**

Currently Clause 49 recommends that at least 50% of the board and at least two-thirds of the audit committee are INEDs. INEDs have an important role on corporate boards, they have a responsibility to monitor management and ensure board decisions are made for the benefit of all shareholders.

At the time of the Satyam board meeting which approved the two RPTs, six of the nine directors on the board were INEDs and the audit committee consisted of four members, all of which were INEDs. Board minutes showed that at least three INEDs raised questions about the motivation for the deals and the valuation of the target companies, however the end result was still unanimous approval for the two acquisitions. This brings to question the role of the INEDs on the board and whether they were 'truly' independent or if they were appointed just to 'rubberstamp' board proposals.

*The representation of INEDs on the board and audit committee as specified in Clause 49 is consistent with best practice in Asia. However, given the questionable independence of the INEDs at Satyam and the high concentration of ownership by promoters in India, it seems as though companies may be complying with the letter of the law rather than the spirit*

**3. Independent Valuations**

In Clause 49 of the Listing Agreement the audit committee has powers to obtain outside professional advice. However, there is currently no specific requirement for RPTs to be reviewed by an independent advisor.

At the time of the announcement, and during the analyst conference call, Satyam did not disclose the name of their advisor, even after a series of questions from analysts. It was not until after the release of the Satyam board minutes that the company disclosed that Ernst & Young provided an independent valuation for one of the acquisition targets. In this case, the INEDs, especially those in the audit committee failed to apply due diligence. They approved a material US$1.6 billion transaction without extensive review, based on a so called 'independent' valuation, which in fact was provided by Ernst & Young for a purpose other than for Satyam's proposed takeover.

*Under all circumstances, material RPTs should be reviewed by an independent adviser to ensure only fair market valuations are applied. The company should identify the adviser, and disclose their findings in a timely manner to shareholders, including in the disclosure whether the transaction is fair and reasonable and in the best interest of shareholders. It is the responsibility of the board, especially the audit committee, to seek outside expertise which is independent from management.*

**Summary**

In situations where managers are also majority shareholders, effective investor protection mechanisms are essential to protect shareholders' from abusive RPTs. We have identified

three important initiatives, however each individual layer needs to be effectively implemented to ensure that shareholder rights are not compromised. We believe that RPTs (that reach the approval and disclosure thresholds) should be:

1. *Reviewed by an independent advisor*, to ensure that only fair-market valuations are applied;
2. *Approved by "disinterested" directors;*
3. *Disclosed to investors in a timely manner* – ideally to the local stock exchange; and
4. *If material, approved by shareholders* in a voting by poll with related parties abstaining from the vote.

The CFA Institute Centre in Asia Pacific recently released, "*Related-Party Transactions: Cautionary Tales for Investors in Asia*," a study which introduces readers to the prevalence of RPTs in the region and shows how they can affect the interests of minority shareholders. Focusing on Hong Kong, China and South Korea, the study highlights and discusses the nature and motivation of these transactions. It explores the effectiveness of current regulations aimed at protecting shareholders' interests and proposes ways to better protect shareholders from abusive RPTs. We have enclosed a copy of this report for your reference.

We respectfully ask you to review current regulations on RPTs to improve investor confidence. More rigorous approval processes, increased disclosure to shareholders and truly independent INEDs are necessary to ensure investor protection and improve shareholders' rights.

Yours sincerely,

Kha Loon Lee, CFA
Head, Asia Pacific

CFA Institute Centre for Financial Market Integrity

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Enc: *Related-Party Transactions: Cautionary Tales for Investors in Asia*, CFA Institute Centre, 2009

cc: Mr J. Capoor, Non-Executive Chairman, Bombay Stock Exchange
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