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Unlisted Subsidiaries: The New Cloaking Device

New regulations leverage the minority shareholder vote to enforce better corporate governance standards. But, companies have found a way around these new regulations: they have begun using unlisted subsidiaries to get away with a lot more.

In the 2014 IiAS survey on 'Institutional Investors' Attitude to Corporate Governance', 74% of institutional investors polled rated opaque related party transactions as the most important corporate governance issue in promoter-managed firms. It's not like every related party transaction is wrong ab initio – just that investors felt they could do absolutely nothing about it, especially if these were egregious. Therefore, when the opportunity came to review the regulation, regulators ensured that all material related party transactions (RPT) were put to shareholder vote. This gave shareholders an opportunity to have their say, and rightfully so.

The new regulations balanced between investor concern and the need to provide managements operating flexibility. Consequently these regulations apply only to the listed company and not to its unlisted subsidiary. Companies seem to have begun exploiting this operational flexibility.

One such example is Cairn India's recent announcement of extending a $1.25 billion loan to a Vedanta Group company. A two-year agreement was signed in the first quarter of 2014-15, and $800 million was disbursed. This disclosure was made on an earnings call – no mention of this in the quarter results nor in company presentations, with the company arguing that it need not be. It shocked investors and their displeasure was evident in the immediate 5% fall in stock price the next morning.

Investors began asking why this transaction was not brought to shareholder vote. That's because loan transactions don't fall under the category of RPTs that need to be brought to shareholders for a vote under the Companies Act 2013. Under the revised Clause 49 of the Listing Agreement, such a transaction would be – but the clock on that begins ticking from 1 October 2014.

Following the market shock and the investor outcry, the company clarified that the loan was given by a subsidiary (unlisted) of Cairn India to a Vedanta Group company. This is a classic maneuver. RPT disclosure and shareholder approval requirements do not apply to unlisted subsidiaries of listed companies. Neither under the Companies Act 2013 nor under the revised Clause 49 of SEBI's Listing Agreement. So a company can continue to do as it pleases through an unlisted subsidiary. At best, shareholders have a say on transactions (once the specified thresholds of materiality are met) between a listed company and its unlisted subsidiary, but not on any transaction undertaken between two unlisted subsidiaries.

Take another example, Redington India. Redington's Managing Director's (MD) and Joint Managing Director's (JMD) remuneration is paid by its

overseas subsidiary. There is a one line mention of the aggregate remuneration paid to both (Rs.86 million in FY14), but no details of individual compensation nor the break-up of the compensation. While the company may have its reasons for this structure, Redington's shareholders will not have a say in the remuneration of the company's senior executives because the remuneration will not be required to put to a shareholder vote. More importantly, the abject disregard for the investors' opinion on executive remuneration is visible in the poor quality of disclosure.

One more recent example is Punj Lloyd's resolution to increase its borrowing limit to Rs.100 bn. Sure enough, on a standalone basis, the company's debt/equity ratio has hovered around 1.5x in the recent past, which would give an impression of a company that raised debt judiciously. But, consolidated debt/equity levels were double, at over 3x on March 31 2014. The company had raised debt in unlisted subsidiaries, for which it did not need any shareholder approval. In case of borrowing resolutions, one may argue that lenders don't lend to a subsidiary without a guarantee from the parent company – and so the inter-corporate transaction of guarantee extended to a subsidiary's debt would be brought to shareholder notice. True as it is, what happens if the subsidiary is indeed the large operating company and the listed company is merely a holding company? The company then gets access to unlimited debt, so long as its internal oversight structures permit it.

It has become more difficult for investors to access the performance of subsidiaries. Companies are required to publish standalone and consolidated results, but are no longer required to disclose subsidiary accounts in their annual reports. Sure, eager investors can write to the company and ask for the subsidiary accounts, but it only means that they can get details of the transaction. Investors still can't do much.

SEBI seems to have taken note from the corner of its eye. The revised Clause 49 relies on the integrity of independent directors in a listed company to monitor the operations of a material unlisted subsidiary. That would be enough if investors were convinced that the independent directors were indeed independent. A majority are not.

While the new regulations have been stronger in their intent and action of protecting the shareholders' rights and in empowering the minority shareholder, these have also tried to balance the agenda between managements and investors. Leaving unlisted subsidiaries out of the regulatory ambit may be seen as providing managements with some operational flexibility. But, companies seem to misuse the provisions to circumvent the intent of the regulation. This will only invite the ire of both investors and regulators. In which case companies must be prepared to pay the price of tighter regulations.

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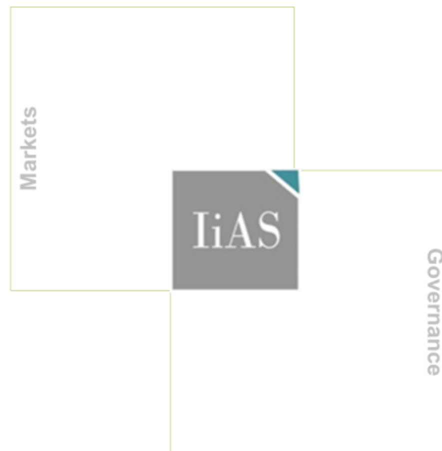

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