Amendments to SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 - payments relating to royalty and brand usage

1. Objective

1.1 The purpose of this memorandum is to seek guidance from the Board in relation to the provisions contained in Regulation 23(1A) of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 for determining the percentage of payments relating to royalty or brand usage.

2. Background

2.1 In June 2017, SEBI instituted a Committee under the chairmanship of Shri Uday Kotak to make recommendations to SEBI for improving standards of corporate governance of listed entities in India. The Committee submitted its report detailing several recommendations on October 5, 2017.

2.2 With respect to royalty and brand payments to related parties, the Committee made the following recommendation:

"A number of companies make payment towards royalty/brand usage. While royalty payments are recognized as there is value in brand strength and product technology, which drive sales or margins, shareholders must comprehend the terms and conditions of such payouts. Therefore, the Committee encourages all companies to make better disclosures on the value a company derives from a brand or technology for which it has agreed to pay royalty, brand, or technical fees to the parent company/promoters. Where royalty payout levels are high and exceed 5% of consolidated revenues, the Committee believes the terms of conditions of such royalty must require shareholder approval.

The Committee therefore recommends that payments made by listed entities with respect to brands usage/royalty amounting to more than 5% of consolidated turnover of the listed entity may require prior approval from the shareholders on a "majority of minority" basis. This sub-limit of 5% will be considered within the overall 10% limit to determine material related party transactions."

However, the Ministry of Corporate Affairs (MCA), in its letter to the Committee dated October 3, 2017, as annexed to the Committee report, suggested a lower threshold of 2% instead of 5%.

2.3 The report of the Committee was placed on the SEBI website for public comments. In addition to public consultation, meetings were also held with Ministry of Finance (MoF) and MCA since many of the recommendations involved various aspects of the Companies Act, 2013 and both the Ministries had flagged certain issues (including the issue pertaining to royalty payments) which required deliberation.

2.4 Based on an analysis of public comments received and the consultation with the Ministries as stated above, among others, the following amendments were made to SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 requiring approval of shareholders for payments relating to royalty and brand usage:

> "..a transaction involving payments made to a related party with respect to brand usage or royalty shall be considered material if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceed <u>two</u> percent of the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity."

In other words, an approval from shareholders on a majority of minority basis was required if the payments made to a related party with respect to brand usage or royalty exceeding 2% of the annual consolidated turnover of the listed entity. The amendment was to come into effect from April 1, 2019.

3. <u>Representations received and deferment:</u>

3.1 Subsequent to the amendments, representations were received from some entities and industry associations seeking to review the amendments, primarily either to increase the limit to 5% as recommended by the Kotak Committee/ remove the requirement altogether. In order to discuss the representations, a meeting was held in DEA on December 13, 2018 at Delhi wherein it was decided that the existing provision 2% be continued.

3.2 However, SEBI continued to receive industry representations including through the Government where the following issues/concerns were, inter-alia, raised with respect to the aforesaid amendments:

a. Kotak Committee recommendation: While the Kotak Committee recommendation was to require shareholder approval beyond 5%, the same was reduced while amending the Regulations to 2% which is inconsistent with the recommendations of the Committee.

b. Criticality of royalty & risk of rejection by minority shareholders: The continuing success of companies is highly dependent on technology driven innovations for which technology transfer from the parent is critical. There could arise a situation where the minority shareholders could disapprove the royalty which would be a serious impediment in the flow of technology & would hurt a company's competitiveness. All stakeholders, including the minority shareholders would also lose in such cases.

c. Other laws relating to royalty:
   - Till 2009, royalty was subject to approval from the Government if payments exceeded 5% of sales/8% of exports/USD 2 mn p.a. This was discontinued from 2009 onwards and as on date, there are no limits by the Government on royalty payments. Further, royalty rate has always been in excess of 2%.
   - Under Companies Act, 2013, thresholds were introduced for different types of RPTs which were applicable only prospectively to fresh agreements and not agreements that were valid and subsisting when the thresholds were laid down.
   - Ministry of Finance in 2015 had not agreed to a proposal for seeking re-introduction of restrictions on royalty payments for preventing excessive outflow of foreign exchanges saying that it would send a negative signal to foreign investors/ would be retrograde.

d. Disincentive for listing of Indian subsidiaries/associates of foreign companies:
   Since the aforesaid amendment is only applicable for listed companies, this may disincentivise listing of subsidiaries/ associates of foreign companies in India. This

may encourage more unlisted subsidiaries/ associates of foreign companies to operate in India with better technological knowhow thereby placing their listed counterparts at a disadvantage.

e. Devotion of considerable time and effort by management: The process of getting shareholder approval every year would require the company's top management devoting considerable time & cost in educating shareholders across the world before voting takes place; this would reduce profits & hurt minority shareholders.

f. The measure would adversely impact "Make in India" policy, R&D and innovation, FDI inflow, etc.

g. Impact on international partnership agreements: Significantly, subsequent to the meeting referred in 3.1 above, SEBI has received representations where apprehensions have also been expressed that this might affect certain international partnership agreements between the Government of India and governments of certain foreign countries and that it may hinder manufacturing where foreign collaboration is involved.

3.3 In view of the aforesaid representations received and issues raised, it was felt that the matter may merit re-examination. Since the amendment was effective April 1, 2019, it was placed before the Board that the implementation of the same may be deferred for a period of three months i.e. till June 30, 2019. The Board approved the said proposal and deferred the implementation of the provision till June 30, 2019.

4. Re-examination and proposal:

4.1 Pursuant to the Board meeting, letters were sent to MCA, MoF and DIPP seeking copies of past studies on the subject, if any, done by MCA/MoF/ DIPP respectively. While, no past studies have been provided as on date by MCA/MoF/DIPP on the subject, MCA, vide letter dated April 29, 2019, has stated the following:

- Barring a handful of companies, there seems to be little resistance from the industry at large;

- From media reports, it is learnt that Nestle India Ltd., which had initially represented against the 2% threshold, has now opted for prior approval for a 5 year royalty plan from its shareholders on a majority of minority principle;
- If such a long term plan is allowed, the apprehension of any sort of uncertainty associated with annual approvals would cease to exist and companies would be more comfortable in seeking long term approval of royalty from shareholders on a majority of minority principle;
- Further, a higher threshold could be considered for India specific technology development.

4.2 An analysis has been done of certain large listed entities with respect to the amounts paid by them as royalty during the past three financial years, ending with financial year 2017-18. A summary of such royalty payments, turnover and the royalty amount as a percentage of the turnover (consolidated basis) is placed at Annex A.

5. <u>Proposal</u>

In light of the above, the Board may like to guide on the issue of determining the percentage of payments made to a related party with respect to brand usage or royalty that would require an approval from shareholders on a 'majority of minority' basis and authorize the Chairman to take consequential and incidental steps to give effect to its decision in this regard, including through amendments to SEBI Regulations, issue of circulars etc. as may be required.

(The Board Memorandum must be read in conjunction with the press release issued on June 27, 2019 and minutes of the meeting)

This has been excised for reasons of Confidentiality