

***THE REGULATION OF RELATED PARTY TRANSACTIONS IN THE  
ETHIOPIAN FINANCIAL SECTOR: WITH SPECIAL FOCUS ON  
BANKS***

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**February, 2013**

**Addis Ababa University  
College of Law and Governance Studies  
School of Law Post Graduate Program  
In Business Law Stream**

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BANKS***

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**A thesis submitted to Addis Ababa University School of Law in partial fulfillment  
for the requirements of Degree of Master of Laws in Business Law.**

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**ADDIS ABABA,  
ETHIOPIA**

**ADDIS ABABA UNIVERSITY  
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## **Abbreviations and Acronyms**

Directive No.Sib/1/1994: Licensing and Supervision of Insurance Business Directive  
No.Sib/1/1994

Directive No.SBB/29/2002: Amendment of Single Borrower Loan Limit Directive  
No.SBB/29/2002

Directive No.SBB/30/2002: Amendment of Limitation on Loans to Related Parties  
Directive No.SBB/30/2002

Directive No.SBB/39/2006: Amendment for New Bank Licensing and Approval of  
Directors and CEO Directive No.SBB/39/2006

Directives No.SBB/53/2012: Credit Exposures to Single and Related Counterparties  
Directives No.SBB/53/2012

Directives No.SBB/54/2012: Requirements for Persons with Significant Influence in a  
Bank Directives No.SBB/54/2012

IAS: International Accounting Standard

IFASB Statement No. 57: International Financial Accounting Standard Board Statement  
No. 57

Proclamation No.84/1994: Licensing and Supervision of Banking Business Proclamation  
No.84/1994

Proclamation No.286/2002: Income Tax Proclamation No.286/2002

Proclamation No.592/2008: Banking Business Proclamation No.592/2008

Proclamation No. 626/2009: Micro-Financing Business Proclamation No. 626/2009

## **Abstract**

The main purpose of the research paper is to examine whether or not the regulation of related party transaction in the financial sector in general has got due attention and whether the regulation of related party transactions in the Ethiopian financial sector was adequate or not in particular. In this regard, it can be said that though we may get many researches and literatures dealing with corporate governance issues, there are relatively a few researches and literatures which deal with the regulation of related party transactions. Even, the available materials provide with the related party transactions in the non-financial sector in general. However, the regulation of related party transactions in the financial sector is different from non-financial sector. Even if related party transaction has a great effect on a company, financial sector and the economy of a given country, the attention given to it was relatively little. Companies and countries began to regulate related party transactions after the occurrences of several financial company collapses thought to be mainly affected by abusive related party transactions.

Besides, the discussion in the regulation of related party transactions in the Ethiopian financial sector comes to the conclusion that its regulation is not given proper attention and is not adequate in general. For example, the important legal regulation instruments in the regulation of related party transactions in the financial sector such as the requirements of disclosure and approval of related party transactions are not available in Ethiopia. Besides, the concepts of materiality and immateriality of related party transactions and their distinction is not provided in the existing Ethiopian laws. Even if an attempt is made to define related parties from the context of commercial banks, there is no definition for related party transactions. In addition, the available relevant law in Ethiopia is simply concerned with the limitation of loans of commercial banks to their related parties. Hence, other types of related party transactions are not regulated well in the existing Ethiopian laws. On the other hand, the remedies and sanctions in case of violations of regulations of and abusive related party transactions are not provided in Ethiopia. Particularly, the application of class action and/or derivative suits to the claims of abusive related party transactions in the Ethiopian financial sector is not provided clearly.

Finally, it should be remembered that great efforts were exerted to indicate the concerns, gaps and problems in relation to the regulation of related party transactions in the financial sector in general and in the financial sector in Ethiopia in particular and finally come up with some possible solutions.

**Key words:** related party, related party transactions, abusive related party transactions, arms length basis, disclosure and approval

## **Unit One- Introduction**

This is an introductory chapter dealing with: background of the study, objectives, statement of the problem, scope, significance, limitations and methodology used.

### **1.1. Background of the Study**

The issue of regulation of related party transactions in general and in the financial sector in particular has not been given due attention. It is only since recent times, particularly after the occurrences of financial frauds and accounting scandals that the issue got some attention and that countries began to regulate it. In spite of some attempts, there is still difficulty of getting literatures and researches specifically addressing the regulation of related party transactions in the financial sector. The available literatures mainly deal with corporate governance in general. Besides, they generally deal with the regulation of related party transactions mainly on non-financial companies, especially those publicly listed companies. But, it should be noted that the regulation of financial companies and institutions is different from non-financial companies.

For these reasons, I wanted to conduct my research on this topic in the Ethiopian financial sector. To the best of my knowledge, this issue is not yet researched in Ethiopia. So, I want to contribute something in this area. To be honest, I originally proposed to conduct my research on another topic (that is, Regulation of Insider Trading on the Stock Markets: the Potential Challenges and Lessons for Ethiopia). However, this topic was not approved. After this, my advisor, Professor Tilahun Teshome, suggested me with the idea of conducting a research on this topic and after looking at some of the relevant materials, I was so interested to do my research on this.

## **1.2. Objectives of the Study**

### **1.2.1. General Objective**

The General Objective of the study is to examine whether or not the regulation of related party transactions in the financial sector Ethiopia is adequate.

### **1.2.2. Specific Objectives**

The major specific objectives include:

- Dealing with the concepts of related party transactions in financial sector in general.
- Explaining why the regulation of financial sector is different from non-financial sector in general and in regulation of related party transactions in particular.
- Discuss how and when the regulation of related party transactions began.
- Discuss the concerns and the types of related party transactions.
- Looking at the major theories on related party transactions.
- Indicating the sanctions and remedies in case of abusive related party transactions.
- Explaining the mechanisms used in regulation of related party transactions.
- Discussing definitions of related party and transactions in Ethiopian financial sector.
- Examining whether or not the regulation of related party transaction is adequate in Ethiopian financial sector.

## **1.3. Statements of the Problem**

There are several problems to be addressed in this paper. However, the main focus will be on the following issues. The first problem is with respect to the meaning of related party and related party transactions. Thus, their definition is important in that there is the belief that without their proper definitions, an attempt to deal with other issues such as disclosure, approval and reporting requirements will not be successful. Particularly, the definition of related party transactions in the Ethiopian financial sector is not clearly provided.

The other problem is with regard to determining the existence of related party transactions in the financial sector, especially in Ethiopia. This is because identifying related party transaction is a difficult activity, though it is not absolutely impossible. Thus, it what will be important to address this issue. Particularly, it will be necessary to explain the different transactions which may indicate the existence of related party transactions. Further, the discussion on the different organs who can help in this area is relevant. A related problem here is how to classify related party transactions in to normal (legitimate) and abusive ones. Even here, the issue of classification is not an easy task. Thus, the help of some indicators of related party transactions are also relevant here. Again, determining whether or not the related party transaction was concluded on arms length will be crucial in this regard.

Another point to be raised here is with regard to the issue whether or not all related party transactions involve conflict of interest. As mentioned above, related party transactions can be either normal or abusive. If we say that not all related party transactions involve conflict of interest, it will be necessary to specifically answer when will conflict of interest arise? In addition, it is relevant to raise here the reason why separate regulation of related party transactions in the financial sector becomes necessary. This is because while some argue that separate regulation will cause regulatory fragmentation and redundancy, others argue that separate regulation of financial sector is necessary. This argument is considered especially from the context of regulation of microfinance institutions.

There also arises the need to explain the organ that has the responsibility for identification of related party transactions in the financial sector in Ethiopia. Article 9 of the Credit Exposures to Single and Related Counterparties Directive No.SBB/53/2012 provided generally that each commercial bank has the responsibility to identify related party transactions. But, this provision does not specifically answer the organ that has that responsibility. Therefore it will be important to explore the general tendency and the experience of other countries in this regard.

In addition, the paper tried to discuss and examine whether or not remedies and sanctions are available in case of abusive related party transactions in the financial sector, particularly in Ethiopia. Generally, clear remedies and sanctions are provided in other countries in abusive related party transactions. But, in Ethiopia these remedies and sanctions are generally provided in violations of different laws of the financial sector. So, attempt was made to deal with the remedies and sanctions on this area.

Furthermore, it is raised here the reason why regulation of related party transactions in Ethiopian financial sector becomes necessary these days. Is that because there is prevalence of related party transactions in Ethiopia currently? This issue is also examined with respect to Ethiopia's request for accession to the membership of World Trade Organization. Finally, the paper tried to examine whether or not the regulation of related party transactions is adequate in the financial sector in Ethiopia. The paper concludes that it is not adequate by raising some points in support of this conclusion. The researcher also tried to come up with some recommendations.

#### **1.4. Scope of the Study**

The study is limited both in the geographic area and the subject matter of discussion so that it will be confined to the regulation of related party transactions in the Ethiopian financial sector. Even here, it is confined to the discussion of banks, insurance companies and micro-finance institutions.

#### **1.5. Significance of the Study**

This study deals particularly on the regulation of related party transactions in the Ethiopian financial sector. Thus, the researcher hopes that this paper will generally have some important contributions. It is intended to serve as a reference material for those who are interested in the issue of regulation of related party transactions in the financial sector in general and in the Ethiopian financial sector in particular. For example, it will serve as an input for the regulators of the financial sector in Ethiopia with respect to regulation of

related party and related party transactions. In addition, researchers who are interested to conduct on the same issue will find this paper useful. Finally, it is hoped that other persons who want to have a detailed knowledge on the regulation of related parties and their transactions will benefit from this paper.

### **1.6. Limitations of the Study**

The main limitations which should be mentioned here include: difficulty of getting relevant reference materials, monetary constraints, and time constraints. With regard to reference materials, it was difficult to get materials specifically dealing with the regulation of related party transactions in the financial sector. Besides, it was difficult to get relevant cases on the regulation of related party transactions in the Ethiopian financial sector. The monetary constraint here is that interviewing and distributing questionnaires and its collections involves monetary cost and at that time the thesis grant was only 2500 birr so that it did not sufficiently cover the costs. But, after finally submitting the paper, an additional 2500 birr was given. Finally, the time constraint here is that the last deadline for the submission of the thesis was not fixed so that I was rushing to submit it as soon as possible so that I had not sufficient time to edit well my paper. But, after submitting my paper, I sat idle for about three months. Besides, many of my questionnaire participants were not clear with the questions and some of them were not willing to answer the questions. So, I had to go back for about three times to collect them.

### **1.7. Research Methodology and Organization of the Paper**

Generally both primary and secondary resources such as books, journals, laws including Codes, Proclamations, Directives, questionnaires and interviews and one case are used.

Some points should be said to in relation to the interviews and questionnaires.

Generally about 7 persons were interviewed. Five of them are from the National Bank of Ethiopia. All the questions provided in the annex were raised to all of the five participants. However, two of my interviews were from different professions, one attorney and the other, a lecturer at Addis Ababa University Law School.

The questions raised to the latter participants were mainly with respect to shareholders derivative and class actions. All the interview participants were selected purposely because I believe that these persons have better knowledge on the area. The names and other particulars of the persons interviewed are provided in the appendices. The reader is kindly requested to refer that.

With regard to questionnaires, it should be mentioned here that, originally, I had the idea of distributing the questionnaires to banks, insurance and microfinance institutions randomly. But, several interviews I held with persons in different divisions of the National Bank of Ethiopia informed me that it is not necessary to do so in relation to insurance companies and microfinance institutions. This is because they are not yet well regulated. Hence, I decided to distribute them to banks only. Accordingly, more than 65 questionnaires were distributed to 10 different banks, public and private banks including the National Bank of Ethiopia in general. But, only 27 questionnaires were replied. And in some cases, the respondents did not answer all questions. Most of the banks were selected mainly because they were nearby banks to the researcher. But, attempt was made to include 4 private banks, 5 branches of the Commercial Bank of Ethiopia, which is a public bank and the Central Bank, National Bank of Ethiopia. However, note that except for National Bank of Ethiopia, the questionnaires were actually distributed to participants by the respective branch or head manager of each bank. The names of the banks are provided in the appendices and readers are kindly requested to refer that. Finally, with regard to the questionnaires, it should be mentioned here that many of the participants had no good understanding on the issues of regulation of related party transactions. Despite modest attempts made by the researcher on questionnaires and interview analysis, the research remains doctrinal.

Now we come to deal with the organization of the paper. For the sake of clarity and convenience, the paper is arranged into six chapters. The discussion goes from general to specific concepts of regulation of related party transactions. Thus, the first chapter is an introduction and deals with the background of the study, the objectives, statement of the

problem, the scope, significance, limitations, and the methodology used briefly. The second chapter is about the “Concepts, Historical Background, Concerns and Theories on Related Party Transactions.” Hence, this chapter mainly deals with the following major issues: Definitions, Historical Background, Nature, Indicators, Concerns, and the major Theories of Related Party Transactions. The third chapter is on the “Regulation and Methods of Regulation of Related Party Transactions in the Financial Sector in General.” This chapter is concerned with the Methods of Regulation of Related Parties Transactions in the Financial Sector in General and specifically with the Regulation of Related Party Transactions in Banking, Insurance Companies and Microfinance Institutions in particular. The fourth chapter deals with the “Enforcement Mechanisms and the Sanctions and Remedies in Abusive Related Party Transactions in Financial Sector in General.” This chapter tries to discuss the available methods of enforcement mechanisms and sanctions and remedies in case of abusive related party transactions. Here, we can see that chapters two, three and four address the issues of related party transactions in the financial sector generally.

On the other hand, the fifth chapter is the main body of the paper and it is specifically concerned with the discussion of “Regulation of Related Party Transactions in the Financial Sector in Ethiopia: with special focus on Banks. In this unit, the following major sub-topics are included: Definitions of Related Party and Related Party Transaction in Ethiopia, Regulation of Related Party Transaction in Banks, Insurance companies and Microfinance institutions, enforcement mechanisms and the sanctions and remedies and derivative and class actions in case of abusive related party transactions in the financial sector in Ethiopia. Finally, the sixth chapter comes up with conclusions and recommendations.

## **Chapter Two- Concepts, History and Theories of Related Party Transactions in the Financial Sector in General**

In this chapter, efforts will be made to deal generally with the regulation of related party and related party transactions in the financial sector and related issues. But, before going to the main discussion, it will be important to deal with some introductory points first.

### **2.1. General Points**

Even if it is not the very purpose of this paper to deal in detail with the issues of regulation, it is hoped that some concepts and issues of regulation will help in better understanding the whole idea of this unit and the paper. Accordingly, brief discussion on regulation will be made below. Though there are different definitions forwarded by different scholars for regulation, here only some general definitions are considered. For example, regulation is generally defined as the instrument used by a state to limit the behaviour of firms and / or individuals, mostly in the name of public good.<sup>1</sup> Besides, when defined widely, regulation includes any intervention in the market that changes behavior from what it otherwise would have been.<sup>2</sup> At this juncture, it should be noted that there are generally two major theories of regulation. These are: the Normative and the Positive theories.<sup>3</sup> The Normative theory states that the purpose of regulation is to correct market failures and improve social welfare.<sup>4</sup> On the other hand, the Positive theory provides that the purpose of regulation is to serve the interest of powerful groups (capture theory).<sup>5</sup> However, it should be generally noted that, unlike many other sectors of the economy, the government/ public sector currently involves in the finance sector in most countries with different roles such as: as the regulator of financial institutions, as owner of financial institutions, as a market participant, as a fiduciary agent and through

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<sup>1</sup> . Péter Kaderják: “Theory and Principles of Regulation,” May 7-11, 2007, Baku, Azerbaijan, p.3.

Available @ [www.narucpartnerships.org/Documents/1C\\_Theory\\_and\\_principles](http://www.narucpartnerships.org/Documents/1C_Theory_and_principles) - -

<sup>2</sup> . Stiglitz: “New Perspectives on Regulation,” The Tobin Project, Inc, 2009, p.23.

Available @ [www.tobinproject.org/books-papers/new-perspectives-regulatio](http://www.tobinproject.org/books-papers/new-perspectives-regulatio) - 26k

<sup>3</sup> . Supra note 1, p.9.

<sup>4</sup> . Ibid.

<sup>5</sup> . Ibid

direct intervention in the operations of the market.<sup>6</sup> Nevertheless, because of its importance to the entire economy of a country, the financial sector is subject to much more intensive and intrusive regulation than other sectors of the economy for the following reasons: the financial sector creates conflicts of interest for the public sector due to the fact that the public sector has responsibility for setting the rules of behaviour and the public sector is a major participant in the financial sector and failure on the part of the public sector to set good governance principles within its regulatory agencies is likely to undermine the capacity of these agencies to enforce good governance principles on private sector firms operating in the finance sector.<sup>7</sup> It should also be noted that there is a wide market failure in the financial sector which makes government intervention through regulation important.<sup>8</sup>

Generally, financial sector regulation has a number of purposes/objectives. For example, in addition to the objective of ensuring the safety and soundness of the financial system, there are several other social and economic objectives of financial sector regulation.<sup>9</sup> Thus, especially after occurrences of several financial crises in many parts of the world, there is a wider agreement on the need for regulation currently. But, there is still no agreement on how to enforce the regulations. Though there cannot be a single answer on this issue of enforcement, some of the possibilities include multiple oversight and broad system of checks and balances. It is clear that regulation in general and multiple oversights in particular involves costs. But, it is also argued that the costs of regulation are far less than the costs of mistakes or failure of intervention.<sup>10</sup> In addition, it is stated that another possibility is to ensure that the voice of those whose interests are likely to be

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<sup>6</sup> . Jeffrey Carmichael and Dani Kaufmann: “Public Sector Governance and the Finance Sector,” Washington DC, June 2001, p.11.

Available @ [unpan1.un.org/intradoc/groups/public/documents/apcity/unpan0](http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan0) - - .

. Note however that the direct intervention of the government in the operations of the market is regarded as its major role.

<sup>7</sup> . Ibid, p.p.11-12.

<sup>8</sup> . Supra note2, p.15

<sup>9</sup> . Ibid, p.20

<sup>10</sup> . Ibid, p.19. Government interventions include: disclosure of information, restrictions on incentive schemes such as conflicts of interest, restrictions on ownership, restrictions on particular behaviors and taxes designed to induce appropriate behaviors.

hurt by failure are well represented in the regulatory structures.<sup>11</sup> It is further suggested that simple and transparent regulatory systems with limited regulatory discretion may be more immune to regulatory capture and that in many circumstances the cost is far less than the benefit that arises from regulatory certainty, especially in the financial sector.<sup>12</sup>

Despite the fact that detailed discussion on regulation<sup>13</sup> is important, the paper is limited in scope to the discussion of regulation of related party transactions in the financial sector since other details of regulation are beyond its scope. But, before going to the main discussion on related party transactions, some general points in this regard should be made first as follows. It should be noted that the concept of related party transactions and its regulation are very important for a company and other stakeholders in that they have a lot of implications in several areas such as accounting reporting, auditing, tax compliance, strategic management, corporate governance and law.<sup>14</sup> Thus, in all the above areas, having clear concepts of related party transactions is crucial in general. To begin with, there are no adequate literatures and researches dealing specifically with the regulation of related party transactions in the financial sector because they generally focus on the corporate governance issues.<sup>15</sup> Besides, even some of the available articles and literatures on related party transactions mainly discuss on the non-financial institutions, especially on listed public companies.<sup>16</sup> However, it should be clear that the

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<sup>11</sup> . Ibid,p.19

<sup>12</sup> . Ibid, p.20

<sup>13</sup> . For details about regulation in Ethiopia, please see, Solomon Abay: Designing the Regulatory Roles of Government in Business: The Lessons from Theory, International Practice and Ethiopia's Policy Path," Journal of Ethiopian Law, Vol. XXIII, No. 2, December 2009, p.p. 66-131.

<sup>14</sup> . Alexandra Corlaci and Adriana Tiron Tudor: "Related Party Transactions – Overview," *Annales Universitatis Apulensis Series Oeconomica*, 13(2), 2011, p.4.

Available @ [econpapers.repec.org/RePEc:alu:journl:v:2:y:2011:i:13:p:6](http://econpapers.repec.org/RePEc:alu:journl:v:2:y:2011:i:13:p:6) - 15k -

<sup>15</sup> . But, this does not mean that the issue of related party transactions has no connection with the concept of corporate governance. In fact, they are related in that abusive related party transactions are thought mainly to be the results of poor/weak corporate governance in general. The idea here, however, is that the discussion on corporate governance is general but the discussion on the regulation of related parties and their transactions is specific. Thus, the general discussions on corporate governance may not usually be fit to and adequately address the concerns of regulation of related parties and related party transactions.

<sup>16</sup> . Joseph A. McCahery and Erik P.M. Vermeulen: "Corporate Governance Crises and Related Party Transactions: A Post-Parmalat Agenda," p.1.

Available @ [www.accf.nl/uploads/corp\\_gov\\_crises\\_and\\_related\\_party\\_transactions](http://www.accf.nl/uploads/corp_gov_crises_and_related_party_transactions)

regulation of financial institutions is different from regulation of non-financial institutions.<sup>17</sup> This is especially true in the regulation of related party transactions.

It can also be said that due attention was not and still is not yet given to the regulation of related parties and their transactions in general and on the financial sector in particular in many countries. To be specific, it is only since recently especially after the occurrences of some financial scandals and reporting frauds, such as Enron, World.com and Parmalat<sup>18</sup> and in many parties of the world as a result of abusive related party transactions that countries began to regulate such transactions. For example, the US Sarbanes-Oxley Act of 2002<sup>19</sup> is enacted for such purpose. Further more, it can be mentioned here that the European Commission has announced, on May 2003, its plans to increase transparency of related party relations and their transactions and to improve disclosures about corporate practices.<sup>20</sup> The same is true for Asian countries and other African countries in general. It should also be mentioned here that, particularly before the sudden collapse of the Parmalat group, there was a misperception that the financial frauds and boardroom scandals were only limited to American companies. But, the collapse of Parmalat made it clear that every company, including European companies, may be a victim of internal fraud and scandal irrespective of the: geographic location, kind of industry or size of the company.<sup>21</sup> The Enron and Parmalat scandals also show the assistance of auditors in making complex related party relationships and transactions that are motivated by fraud or illicit earnings management. On the other hand, it should be noted that there is widespread agreement, since recently, on the need to regulate related party transactions, but not on what transactions should be subject to deterrent regulation.<sup>22</sup> That is why there are some differences among countries in the details of regulation of related party transactions especially in case of prohibition and limitation of some types of related party

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<sup>17</sup> . Kern Alexander: "Corporate Governance and Banking Regulation," Working Paper 17, Cambridge Endowment for Research in Finance, University of Cambridge, June 2004, p.3.

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<sup>18</sup> . Supra note 16,p.p.1-3

<sup>19</sup> . Ibid,p.1

<sup>20</sup> . Ibid, p.p. 1-2

<sup>21</sup> . Ibid, p. 13

<sup>22</sup> . Ibid, p.14

transactions. Thus, it can be safely said that the concept of and the regulation of related party transaction is not one size-fits-all situation. This is because, related party transaction policies vary in length and the level of detail, particularly as to the description of the due diligence process necessary to identify the existence of transactions. Again, some policies impose the burden entirely on the primary reporting entities to inform the law department of related party transactions, while others impose the responsibility on the company to conduct independent diligence.<sup>23</sup> Note again that policies differ on whether only reportable transactions must be approved by a board of directors. Thus, some policies provide that the law department reviews the transaction first to determine whether it requires disclosure. Then only a reportable transaction would be further reviewed and approved or ratified by the relevant board of directors. However, other policies require that the board committee should be informed of and approve all transactions, regardless of whether the transactions will ultimately be disclosed. Finally, there is also a mixed approach where policies provide for both concepts, by fully informing the board committee of all existing transactions but having the committee formally approve only those which will be disclosed.<sup>24</sup> Therefore, though there is a need to be in line with international standards and guidelines, the regulation of related party transaction should be contextualized and localized to be fit with the human and other resources of the concerned country.

It is generally alleged that the scandals and frauds on abusive related party transactions are the results of regulatory weakness, be it in Europe, America or elsewhere in the world.<sup>25</sup> Specifically, a study conducted in New Zealand concluded that excessive, unregulated, and in some cases, undisclosed related party transactions was one of the reasons for the failure of many financial companies in the country.<sup>26</sup> It is clear at least

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<sup>23</sup> . Ning Chiu and Richard Truesdell : “Disclosure and Approval of Related Person Transactions: Examining the Revised Regulations,” Aspen Publishers, The Corporate Governance Advisor, Volume 17, Number 3 , May/June 2009, p.4.

Available @ [www.davispolk.com/files/Publication/389591e3-ee7a-4a0d-8c91-](http://www.davispolk.com/files/Publication/389591e3-ee7a-4a0d-8c91-) - -

<sup>24</sup> . Ibid

<sup>25</sup> . Supra note 16, p1.

<sup>26</sup> . Duncan C. Jessep, John H. Farrar and Susan Watson: “Related Party Transactions in New Zealand: An Empirical Study of a Flawed System,” p.1.

this time that related party transactions are common to any business in any country and hence, they are not unique to a given country, continent or a given commercial activity. Thus, abusive related party transactions occur in the world both in developed and developing countries and in all markets.<sup>27</sup> But, note that abusive related party transactions involve financial fraud. In particular, some people argue that most financial frauds have their origins in related party transactions and in some companies, even if the transactions were alleged to have been concluded in arm's length, the examination of such transactions found to have benefited the related parties involved.<sup>28</sup> Finally, it should be noted that related party and their transactions are a potential source for material misstatement.<sup>29</sup> Conversely, it is obvious that reliable and transparent financial reporting is particularly relevant in related party transactions in this troubled and abusive environment<sup>30</sup> because difficult economic times increase the possibility that the economic substance of certain transactions may be other than their legal form or that transactions may lack economic substance.<sup>31</sup> After making the above general discussions, it will be important to discuss the meaning of related party and related party transactions.

## **2.2. Definitions of Related Party and Related Party Transactions in General**

To begin with, consistent definitions are considered vital in reducing or avoiding misunderstandings and excessive regulatory burden. Moreover, it is alleged that the starting point for regulating abusive related party transactions is an appropriate definition of related party and it is argued that, without proper definition, measures such as improving disclosure, shareholders' approval process, enhancing the role of auditors,

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<sup>27</sup> . Asia Roundtable on Corporate Governance Workshop on Implementation: "Fighting Abusive Related Party Transactions in Asia," New Delhi, India, 25-26 October 2010, p.4.

Available @ [www1.ifc.org/wps/wcm/connect/ec745f0048a7e74daaf7ef6060ad591](http://www1.ifc.org/wps/wcm/connect/ec745f0048a7e74daaf7ef6060ad591) - -

<sup>28</sup> . Ibid

<sup>29</sup> . Charles E. Landes: "Accounting and Auditing for Related Parties and Related Party Transactions," A Toolkit for Accountants and Auditors, December 2001, p.29.

Available @ [pdfcast.org/pdf/accounting-and-auditing-for-related-partiesa](http://pdfcast.org/pdf/accounting-and-auditing-for-related-partiesa) - 71k -

<sup>30</sup> . Ibid,p.31

<sup>31</sup> . Ibid,p.33

independent directors and regulatory framework are not likely to have an impact.<sup>32</sup> This is because inconsistent definitions spread across various laws and regulations in a country, may both cause confusion for those enforcing them and may result in an unnecessary regulatory burden.<sup>33</sup> Thus, looking first at the definitions of what makes a person a related party and a given transaction a “related party transaction,” is important to have a better understanding of the whole topic. But, before directly going to the definitions, it will be important to say some thing on the use of terminologies. Thus, due to differences in nomenclatures in different countries and companies, the terms related party transactions, connected transactions, related transactions, interested-person transactions, inter-company deals, and intra-group transactions and other terms having the same meaning are used.<sup>34</sup> In this paper too, the use of one of such terms refers to the same concept with the same meaning.

### **2.2.1. Definition of Related Party**

As with definitions for other terms, it is difficult to get a universally agreed definition for the phrase related party. This is because many different terminologies and definitions are used to define related party and related party transactions in different countries and by different scholars in general. However, here the definition provided by the International Accounting Standard 24(shortly known as IAS 24) will be provided. According to IAS 24, a party is related to an entity if:

- (a) Directly, or indirectly through one or more intermediaries, the party:
  - (i) Controls, is controlled by, or is under common control with, the entity (including parents, subsidiaries, and fellow subsidiaries);
  - (ii) Has an interest in the entity that gives it significant influence over the entity; or
  - (iii) Has joint control over the entity;

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<sup>32</sup> . OECD: “Guide on Fighting Abusive Related Party Transactions in Asia,” Corporate Governance Series, September 2009, p.17.

Available @ [www.oecd.org/daf/corporateaffairs/corporategovernanceprincip](http://www.oecd.org/daf/corporateaffairs/corporategovernanceprincip) - -

<sup>33</sup> . Ibid

<sup>34</sup> . A report by the Asia-Pacific Office of the CFA Institute Centre for Financial Market Integrity: “Related-Party Transactions Cautionary Tales for Investors in Asia,” CFA Institute, January 2009, p.15. Available @[www.cfapubs.org/toc/ccb/2009/2009/1](http://www.cfapubs.org/toc/ccb/2009/2009/1) - -

- (b) The party is an associate (see IAS 28 Investments in Associates) of the entity;
- (c) The party is a joint venture in which the entity is a venturer (look at IAS 31);
- (d) The party is a member of the key management personnel of the entity or its parent;
- (e) The party is a close member of the family of any individual referred to in (a) or (d);
- (f) The party is an entity that is controlled, jointly controlled, or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or
- (g) The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.<sup>35</sup>

Some points should be said in relation to the definition above. For instance, it can be inferred that there should be two persons, namely, the party and the entity (reporting entity) in a related party relationship. The party can be an individual or legal person. For example, in a, d, e and g, the party appears to be a human person, whereas in b, c and f, the party looks a legal person. Besides, one can generally observe that the party and the reporting entity will be considered as related parties if: one controls the other, or both are under common control or one has joint control over the other or one has a significant influence over the other, the party is an associate of the entity, or the individual party is part of the key management personnel of the entity or its parent or the individual is intended to be the target of post employment instrument for the benefit of the employees of the entity or employees of entity related to it. Finally, it should be clear that the party and the reporting entity will be related parties if one or more of the lists from “a- g” exist. Thus, there is no cumulative requirement here for being related party. But, note that IAS 24.11 provides exceptions to the above definition of related party. Thus, the following entities/ parties do not fall in the definition above and hence are not related parties. These clear exceptions are: two enterprises simply because they have a director or key manager in common, two venturers who share joint control over a joint venture, providers of finance, trade unions, public utilities, government departments and agencies in the course of their normal dealings with an enterprise, and a single customer, supplier, franchiser,

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<sup>35</sup> . Supra note 16, p.p.19-20

distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.<sup>36</sup>

### **2.2.2. Definition of Related Party Transactions**

In defining related party transactions, two ways can be used generally. The first way is by defining the terms “related party” and “transaction” separately and then combine the ideas of both terms. One can mention here the definitions provided for each term in Palau Bank Act.<sup>37</sup> The other way is one definition for the whole phrase “related party transaction” and this way is prevalent in many laws and also used here.<sup>38</sup> Accordingly, the International Financial Accounting Standard Board Statement No. 57 (shortly known as IASB Statement No. 57) defined related party transaction as “Any transfer of resources, services or obligations between related parties, regardless of whether a price is charged.”<sup>39</sup> From the above definition, it can be said that related party transaction is a broad concept. Hence, in so far as there is a transfer of resources, services or obligations from one related party to other related party, the transaction is considered related party transaction. The fact that there was or no consideration (price) in such transaction makes no difference. Besides, for a transaction to be called related party transaction, the transfer of one or more of resources or services or obligations is sufficient. Hence, no cumulative requirement is provided here. Further more, it should be clear that the definition contains many transactions which are considered to be related party transaction. On the other hand, the United States Financial Accounting Standards Board’s Statement No. 5740 provides that related party transactions involve “transactions between a parent company and subsidiary, subsidiaries of a common parent, an enterprise and trusts for the benefit

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<sup>36</sup> . Ibid, p.20

<sup>37</sup> . Financial Institutions Commission of Republic of Palau: “Prudential Regulation FIC-PR-06: Transactions with Related Persons,” September 2008, p.2. Available@<http://www.ropfic.org/pdf/regulations/FIC%20PR06%20Transactions%20w%20Related%20Persons.pdf>

<sup>38</sup> . Nevertheless, it should be mentioned here that some scholars simply explain related party transaction as any transaction through which a company provides a financial benefit to a related party. It is also argued that “Almost by definition, related party transactions involve conflicts of interest because related parties are often in a position to influence the decision of whether the benefit is provided to them, and the terms of its provision.”

<sup>39</sup> . Statement of Standard Accounting Practice 20: “Related Party Disclosures,” Issued August 1997, p.2. Available@[http://www.hkicpa.org.hk/file/media/section6\\_standards/standards/ssap2^--14](http://www.hkicpa.org.hk/file/media/section6_standards/standards/ssap2^--14)

of employees, an enterprise and its principal owners, management, or members of their immediate families and affiliates.”<sup>40</sup>

Even if attempt is made above to shed some light on the concept of related party transaction, it should be clear that there can be no simple definition that is sufficient for identifying all the transactions with related parties.<sup>41</sup> Besides, some people believe that the nature of related party transactions can be best understood and identified by general principles such as those of the IFASB Statement No. 57 rather than listing categories of people and entities.<sup>42</sup> Another issue in the definition of related party transaction is with terminology. This is because there is overlap between the term “related party transaction” and other terms including: “self-dealing,” “insider trading,” and “tunneling.”<sup>43</sup> Finally, it should be noted that, if we strictly adhere to the definition of related party transaction, what is important is not the spirit of the transaction, but whether or not the transaction falls under the legal definition of related party transactions. If it does not, then the accounting standards do not apply and the other issues such as disclosure, approval or ratification may not arise at all.<sup>44</sup> But, the majority of the provisions regulating related party transactions provide that the legal spirit and substance and not the legal letter and form should be adhered to.

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<sup>40</sup> . Supra note 16, p.16

<sup>41</sup> . Ibid

<sup>42</sup> . Ibid

<sup>43</sup> . Elaine Henry, Elizabeth A. Gordon, Brad Reed and Tim Louwers: “The Role of Related Party Transactions in Fraudulent Financial Reporting,” December 2006, p.6. Available @ [http://aaahq.org/audit/midyear/07midyear/papers/Henry\\_TheRoleOfRelatedPartyTransactions.pdf](http://aaahq.org/audit/midyear/07midyear/papers/Henry_TheRoleOfRelatedPartyTransactions.pdf). Self-dealing, as defined in Shapiro, is “the exploitation of insider positions for personal benefit” where personal benefit is defined to include embezzlement or expropriation of funds, allocation of corporate contracts to businesses in which the insider has an interest, and the use of corporate resources for personal gain. Here insider trading is included in self-dealing. The relationship between self-dealing and related party transaction should be clear. The former is narrower than the latter and is included in the latter. This is because self-dealing mainly deals with the transaction between a company and its director(s), whereas related party transactions includes the transactions between a company and other related parties in addition to the transaction between a company and its director(s). On the other hand, Johnson et al. use the term “tunneling” to refer to the “transfer of resources out of a company to its controlling shareholder...” using theft or fraud or “asset sales and contracts such as transfer pricing advantageous to the controlling shareholder, excessive executive compensation, loan guarantees, expropriation of corporate opportunities, and so on.”

<sup>44</sup> . Lee Kha Loon: “Related Party Transactions: key implementation impediments, case studies,” October 2010, p.16.

Available @ <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciple-146425415-36>

### 2.3. Historical Background of Related Party Transactions<sup>45</sup>

It is generally stated that the history of related party transactions began from/after the speech of Lord Cranworth in the case between “Aberdeen Railway Co. vs. Blaikie Bros” around 1854 in United Kingdom.<sup>46</sup> But, before dealing specifically with the case between Aberdeen Railway Co. vs. Blaikie Bros, it will be helpful to say some points on prior history and case. History showed us that from 1845 to 1847, there was railway boom in the United Kingdom. During these years and later on, some directors abused their powers and many frauds were committed. Such problems, including related party transactions in general and self-dealings of company directors in particular, occurred because they were not adequately regulated in the then existing laws.<sup>47</sup> For example, the case between “The York and North-Midland Railway Company vs. Hudson” can be mentioned here. In this case, George Hudson, a high profile promoter of railway companies, was involved in abusive related party transaction. One of the abuses that he committed was the sale of iron rails [at profit to himself] to a railway company of which he was a director. During this time, section 85 of the Companies Clauses Consolidation Act provides disqualification from office as the only sanction. Accordingly, he was disqualified from office.<sup>48</sup> The above case shows the courts prior to Aberdeen Railway equating the office of director to a trustee character; tendency to equate trustee and fiduciary.<sup>49</sup> Generally, the idea of fiduciary duty then was that it was illegal for the director to conclude any contract with the company especially without the knowledge of the other directors. This was raised both in the case between the York and North-Midland Railway Company vs. Hudson and Benson vs. Heathorn.<sup>50</sup> In the latter case, Heathorn, a director of a joint stock company, purchased a vessel and then on-sold it to the company at a profit.<sup>51</sup>

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<sup>45</sup> . In the first place, note should be made that the discussion on the historical background of related party transactions focuses on United Kingdom, where it is believed to have pioneered the regulation of related party transactions.

<sup>46</sup> . John H. Farrar and Susan Watson: “Self Dealing, Fair Dealing and Related Party Transactions –History, Policy and Reform,” March, 11 2012, Journal of Corporate Law Studies, Vol. 11, No. 2, 2011, p.5. Available @ [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2020075&download=yes](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2020075&download=yes)

<sup>47</sup> . Ibid

<sup>48</sup> . Ibid, p.6

<sup>49</sup> . Ibid

<sup>50</sup> . Ibid, p.p.7-8

<sup>51</sup> . Ibid, p.8

Coming back to the discussion of Aberdeen Railway Company case, one can see that it involved a railway company. Blaikie was the director of the Aberdeen Railway Company. He bought iron chairs (from the Blakie Brothers partnership which he was the chairperson) and sold them to Aberdeen Railway Company at profit. Generally, this act caused for the institution of court action. The case was Scots appeal to the House of Lords and it is generally taken as the leading case on the fiduciary obligations of directors of companies who find themselves in a position of conflict. In this case, Lord Cranworth raised general question, whether or not a director of a railway company is prevented from dealing on behalf of the company with himself or with a firm in which he is a partner. He then said that:

The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents, and it is, of course, the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such an agent has duties to discharge of a fiduciary character towards his principal, and it is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into. It obviously is, or may be, impossible to demonstrate how far in any particular case the terms of such a contract have been the best for the *cestui que trust* [that is, beneficiary] which it was impossible to obtain. It may sometimes happen that the terms on which a trustee has dealt or attempted to deal with the estate or interests of those for whom he is a trustee have been as good as could have been obtained from any other person; they may even at the time have been better. But still so inflexible is the rule that no inquiry on that subject is permitted.<sup>52</sup>

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<sup>52</sup> . Ibid, p.9.

In the above case, Lord Cranworth said of Blaikie: “His duty to the company imposed on him the obligation of obtaining these iron chairs at the lowest possible price. His personal interest would lead him in an entirely opposite direction – would induce him to fix the price as high as possible. This is the very evil against which the rule in question is directed.”<sup>53</sup> Note however, that the disqualification of director provision was generally considered too harsh.<sup>54</sup> After 1856, one of the developments was that a director was allowed to contract with the company but subject to disclosure of such transaction and provided that he does not vote on the transaction.<sup>55</sup>

### **Progresses after the Aberdeen Railway Company Case**

Generally, one can see that there were some developments after the Aberdeen Railways case. This is because laws in latter days do not totally prohibit directors to transact with their companies and were not disqualified but not permitted to vote or otherwise act as a director in respect of the transaction in which they were interested. Besides, the transaction was not enforceable until confirmed by the majority votes of shareholders present in the meeting. The approach thus reflects later approaches to conflicts by directors. After the 1856 Stock Companies Act, a related party transaction remains voidable until approved in the general meeting of shareholders. On the other hand, there were several developments in the 20<sup>th</sup> century in general. For example, the strictness of the rule that had developed by the end of the Nineteenth Century was quickly regarded as impracticable with directors “unwilling to suffer delay, embarrassment and possible frustration entailed by having to submit all such contracts to the company in general meeting.”<sup>56</sup> Besides, such developments can be reflected in the fact that related party transaction in general and between a company and its director in particular is voidable until it is approved by the company’s majority of disinterested board of directors.<sup>57</sup> The UK has developed an approach based on disclosure to and approval by disinterested body. However, there is another approach called the North American approach, followed

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<sup>53</sup> . Ibid, p.10

<sup>54</sup> . Ibid, p.15

<sup>55</sup> . Ibid

<sup>56</sup> . Ibid, p.20.

<sup>57</sup> . Ibid, p.21

in the North American countries, which combines disclosure and ‘fair value’ for the validity of a related party transaction. Its unique nature is that it emphasizes on the requirement of fair value<sup>58</sup> in addition to disclosure. But, in the 21<sup>st</sup> century, the concept of related party and related party transaction is expanded and the requirements for its validity are several. For example, in addition to the requirements of disclosure, review, reporting and approval and/or ratification are necessary in many countries. Further, the concept of related party extends far beyond company directors and the details of the requirements of disclosure are numerous. Besides, there are different requirements of disclosure and procedures for material and immaterial transactions. On the other hand, the approval of related party transaction is in the majority of cases by independent board of directors. Some exceptions such as the arms length are also recognized these days. Further more, it can be safely said that despite its long history, the regulation of related party transactions got better attention since the beginning of the 21<sup>st</sup> century. This is mainly due to the prevalence of many scandals caused by abusive related party transactions in many parts of the world.

## **2.4. Types, Nature, Indicators and Concerns of Related Party Transactions**

### **2.4.1. Types of Related Party Transactions**

Related party transaction is a broad concept in general. Thus, there are many transactions that fall under its definition so that there are several types of related party transactions. The following transactions show the different types of related party transactions: loans to related party, borrowings, guarantees, consulting arrangements, legal or investment services, leases, related business activities, unrelated business activities, overhead reimbursement and stock transactions.<sup>59</sup> It also includes: sharing of assets and resources, group procurement to take advantage of economies of scale, shared-service arrangements

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<sup>58</sup> . Ibid, p.23. It is believed that fair value has both a procedural and a substantive character. This is due to the fact that it is the value arrived at by a process which is regarded as fair, and which is substantively fair as being within an appropriate range. It also depends on the kind of transaction at issue and the context of that transaction.

<sup>59</sup> . Mark Kohlbeck and Brian Mayhew: “Agency Costs, Contracting, and Related Party Transactions,” University of Wisconsin, Madison, December 2004, p.30.  
Available @ [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=592582](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=592582)

for back-office functions, inter-company financing, other treasury management techniques<sup>60</sup>, the top management remuneration, and compensation and indemnification arrangements<sup>61</sup>. But, note that the above types are not the only types of related party transactions. Besides, each type of such transaction contains different subtypes within itself. Generally, all the above types of related party transactions can be grouped into the following two broad categories: simple and complex transactions. Simple transactions refer to those straight forward transactions which involve relatively few financial statement accounts and related parties and the disclosures are typically very clear. Such transactions include loans, guarantees, borrowings, consulting, legal services and leases. In contrast, complex transactions mainly refers to those transactions which contain many financial statement accounts and related parties, often include a number of conditions, and impact the financial statements in less obvious ways. These transactions include related business, unrelated business, overhead, and stock transactions.<sup>62</sup>

#### **2.4.2. Nature of Related Party Transactions**

Generally, related party transactions are of two broad kinds: normal related party transactions and abusive related party transactions.<sup>63</sup> But, it should be made clear that most related party transactions are not abusive. Transactions may be abusive when they benefit the related party to the detriment of mainly the company, its shareholders, creditors, investors and other stakeholders. This will be so when the related party transaction allows controlling shareholders or executives of a company or other related parties to benefit personally at the expense of non-controlling shareholders of the company. It should be mentioned here that the costs of abusive transactions are high. This may imply the need to effectively regulate related party transactions.<sup>64</sup> In addition, abusive related party transactions can affect a company in different ways such as by: a

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<sup>60</sup> . Supra note 34, p.9

<sup>61</sup> . Supra note 28, p.31.

<sup>62</sup> .Supra note 59, p.20.

<sup>63</sup> . Supra note 44, p.3. The following transactions are recognized as some types of abusive related party transactions: Injection of assets, Cross guarantees and loans to associates, Privatization and sale of assets, Transfer of wealth schemes and Recurring related party Transactions – Revenue rather than capital/ Asset transactions.

<sup>64</sup> . supra note 34, p.11

loss of business opportunity for the company, overpayment of an asset, or simply making use of financial services in a way that places the company at risk.<sup>65</sup> Moreover, some abusive related party transactions result in private benefits by a controlling shareholder, such as extracting wealth from the company at the expense of public shareholders. Other abusive related party transactions indicate management misrepresenting their financial statements, including by means of related party transactions, to meet market expectations under strong pressure from shareholders. But, what is common to many abusive related party transactions is that there is misappropriation or misrepresentation of the financial condition of the company. Besides, in any form, abusive related party transactions damage market integrity greatly.<sup>66</sup> It is also argued that the impact of abusive related party transactions on the whole financial sector and thus, on the economy is great. In fact, even though not all related party transactions are abusive, there is the perception that related party transactions are the first concerns to investors in their decision to invest. In this regard, some scholars forward their observation that even the announcement of related party transactions negatively affects companies.<sup>67</sup> At the end, some persons conclude that abusive related party transaction was one of the main reasons for the failure of many companies in many parts of the world generally.<sup>68</sup>

### 2.4.3. Indicators of Related Party Transactions

The identification of the existence of a related party transaction is a difficult job.<sup>69</sup> Even if identification of related party transaction is a difficult task, some events or transactions can give a clue to the existence of such transactions. For example, Australian Section 334

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<sup>65</sup> . Ibid,p.12

<sup>66</sup> . Ibid

<sup>67</sup> . Ibid

<sup>68</sup> . Supra note 59, p.9.

<sup>69</sup> . Jacqueline Lam: “Potential Risks of Related Party Transactions (“RPTs”) and Its Impact on Audit,” July 2006, p.p.1-2.

Available@<http://www.pkfhk.com/pdf/Audit/060720%20JL%20%20Potential%20Risks%20of%20RPT.pdf>. Normally, the management organ has the responsibility for the identification and disclosure of related parties and transactions with such parties. Such responsibility imposes on the management organ to enforce adequate internal controls to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements.

lists the following as transactions that because of their nature may indicate the existence of related party transactions. These are:

- borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- selling real estate at a price that differs significantly from its appraised value
- exchanging property for similar property in a non monetary transaction
- making loans with no scheduled terms for when or how the funds will be repaid.
- sales without substance, including funding the other party to the transaction so that the sales price is fully remitted and sales with a commitment to repurchase that, if known, would preclude recognition of all or part of the revenue.
- loans to parties that do not possess the ability to repay and loans advanced superficially for a valid business purpose and later written off as uncollectible.
- advancing company funds that are subsequently transferred to a debtor and used to repay what would otherwise be an uncollectible loan or receivable.
- services or goods purchased from a party at little or no cost to the entity and payments for services never rendered or at inflated prices.
- sales at below market rates to an unnecessary middle man related party, who in turn sells to the ultimate customer at a higher price with the related party and ultimately its principals retaining the difference and purchases of assets at prices in excess of fair market value.<sup>70</sup> In this regard, the discussion on whistleblowers will be relevant.

### **Whistleblower in Identifying Abusive Related Party Transactions**

The help of whistleblowers in detecting and disclosing abusive related party transactions and illegal acts is important because they can play a significant role in informing scandals and protect company participants, such as shareholders, investors, and creditors, from harm resulting in abusive related party transactions.<sup>71</sup> But, some non-management employees do not report some wrong doings they observe for the following two major

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68. supra note 29

<sup>71</sup> . Supra note 14, p.28

reasons: they do not believe it would stop the wrong practice and they fear that their report would not be kept confidential so that they may be dismissed by their employer.<sup>72</sup> The experience of America shall be mentioned here. This is because the United States Sarbanes- Oxley Act of 2002 contains clear provisions dealing with the importance of whistleblowers, their protection against any kind of retaliation by their employer and the sanctions against the employer in case of retaliation in general. Specifically, section 806 of the United States Sarbanes Oxley Act provides the remedy of administrative and civil action to the whistleblower and imposes criminal sanctions against the employer in case of retaliation by his employer for disclosing illegal activities. There is also clear procedure for the whistle blower to institute his complaint in such case.<sup>73</sup>

### **Why Companies engage in Related Party Transactions?**

Despite the fact that the law and accounting standards provide strong requirements on related party transactions, such transactions are still frequent in many countries and companies in general and in some cases, they are abusive. Thus, it will be important to briefly look at and ask, why companies engage in related party transactions or why they do not comply with the laws on regulation of related party transactions in general and requirements of disclosure, reporting and approval in particular. To understand the reasons, it is important to understand the related party transactions from the perspective of the companies. Some of the reasons include:

- most companies and boards believe that related party transactions, even if they are justified, and disclosed, would generally have a negative connotation because there is a presumption that the transaction will not necessarily be reported or concluded on an arm's length basis and hence not strictly commercial.
- there is a perception of nepotism about related party transactions and even if the transaction is genuine and done only on commercial terms there is a hesitation to disclose this transaction.

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<sup>72</sup> . Kim R. Sawyer, Jackie Johnson and Mark Holub: "The Necessary Illegitimacy of the Whistleblower," Australia, p.2. Available @ <http://www.bmartin.cc/dissent/documents/Sawyeretal05.pdf>

<sup>73</sup> . Guy P. Lander: "What is Sarbanes-Oxley," McGraw-Hill, 2004, p.p.97.98. For other details on whistleblowers, please see pages 99-97 of this book.

- due to the accounting effect in that the consolidated results of a company having subsidiaries are bound to be different from the stand alone results
- restrictions on the maximum lending exposure limits of banks to a single entity or aggregate limits of bank to a business group this is because the non banking finance companies also such restrictions exist so that companies and non banking finance companies structure entities and transactions to avoid these restrictions.
- avoidance of restrictions imposed by respective laws for inter-company loans by setting up entities which will be outside the scope of the legal classification of related parties and for companies with international subsidiaries.
- transfer pricing is another reason why they resort to “covering the tracks” by setting up apparently unconnected entities and
- companies often set up a web of companies often with the same address in international jurisdictions which are tax havens and which have relaxed or little regulations on capital market to avoid detection of money trail and to facilitate money laundering.<sup>74</sup>

More specifically, some researchers allege that related party transactions can be part of management or director compensation arrangements. Thus, companies that involve in related party transactions can provide lower cash compensation to reflect the benefits to officers and directors of the related party transactions, or firms may use the related party transactions to increase compensation to officers and directors to offset relatively lower direct compensation. Alternatively, low relative cash compensation levels can motivate managers and directors to enter into related party transactions to supplement their cash compensation and higher levels of stock option compensation create incentives for related party transactions in that Stock options are a less liquid form of compensation. Similar to cash compensation, related party transactions can be used to supplement the illiquid cash flows associated with stock options or the illiquid cash flows may motivate managers and directors to enter into

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<sup>74</sup> . Supra note 27, p.p.11-13.

related party transactions.<sup>75</sup> Finally, firm ownership can create incentives to enter into related party transactions. This is because, as ownership increases, manager wealth is more dependent on share appreciation, so firms might avoid potentially wealth decreasing related party transactions. However, increased ownership increases the ability of insiders to enter into related party transactions with less oversight.<sup>76</sup>

#### **2.4.4. Concerns of Related Party Transactions**

Concern here is generally used to mean the competing interests in regulating related party transactions. Thus, the regulator of related party transactions may face two competing regulatory interests. The first interest is the need to protect the interests of the company, its shareholders and to distribute social wealth. This view may cause the regulator to prohibit all or certain types of related party transactions in that they are regarded as detrimental to company, shareholders and other investors. The second interest is the need to enhance the efficiency of transactions and thereby maximize the firm value.<sup>77</sup> Thus, the law's concern about related party transactions is that "the terms and conditions on which that transaction takes place may be less favorable to the company than terms and conditions that would otherwise be achieved via arm's length negotiations with unrelated parties." However, there is also another concern that related party transactions may create efficiency of transactions so that related party transactions are generally permitted for commercial practicality reasons.<sup>78</sup> In this regard, some argue that there is currently pervasive consensus on the significance and legitimate role that related party transactions can play in everyday business life. These persons further argue that these transactions are authorized in many jurisdictions to permit flexibility and to make room for private contractual arrangements and entrepreneurship that are consistent with corporate objectives, and are subject to appropriate checks and balances. They also allege that, in some of these cases, the company's financial situation might prevent it from negotiating

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<sup>75</sup> . Supra note 59 , p.8

<sup>76</sup> . Ibid, p.9

<sup>77</sup> . Supra note 14, p.15

<sup>78</sup> . Supra note 26,p.4

on arm's length basis with third parties.<sup>79</sup> On the other hand, one of the concerns of regulators and investors in related party transactions is that the interests of a related party may influence the decision-making of directors to the detriment of the interests of the company and the members of the company as a whole when a company intends to enter into a transaction with a related party.<sup>80</sup> That is, they can be unduly influenced by the relationship between the two sides of a transaction and will not be undertaken according to market prices. For both controlling shareholders and insiders such as managers, related party transactions can be the mechanism for extracting private benefits at the cost of other shareholders. Further more, the limited ability of investors to protect themselves against wrongdoings by insiders and the high cost of regulating such transactions has influenced regulators' strategies around the world to deal with related party transactions.<sup>81</sup> In conclusion, it can be provided that monitoring related party transactions will be important in two ways. First, monitoring can actively discourage or prevent related parties from extracting wealth from the company or misreporting financial statement impacts. Second, companies that engage in related party transactions can imply to investors the transaction's benefits by adopting monitoring mechanisms designed to prevent wealth extraction or financial misreporting by the related party.<sup>82</sup>

## **2. 5. Major Theories on Related Party Transactions**

Generally, there is no good attitude towards related party transactions by many people. Particularly, regulators, market participants, shareholders and other company stakeholders often regard such transactions as potential source of conflicts of interest. But, such attitude is not agreed by all scholars in that others view related party transactions can enhance the efficiency of company transactions as advocated by the supporters of the efficiency theory. Thus, we can see that there is no an entire consensus

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<sup>79</sup> . Russian Corporate Governance Roundtable's Task Force Report: "Related Party Transactions," 2004, p.12. Available @ <http://www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/34946539.pdf>

<sup>80</sup> . Australian Securities and Investments Commission: "Regulatory Guide 76: Related party transactions," March 2011, p.4. Available @ [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg76-300311.pdf/\\$file/rg76-300311.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg76-300311.pdf/$file/rg76-300311.pdf)

<sup>81</sup> . Supra note 79.

<sup>82</sup> . Supra note 59, p.5

on the nature and effect of related party transactions on the company and its shareholders and that is why different theories of related party transactions are developed. But, the majority of the available literatures on related party transactions provide that there are mainly two alternative or contrasting<sup>83</sup> law and economics theories which try to explain the underlying nature of related party transactions. These theories are the conflict of interest theory and the efficient transactions theory. From these two theories, the predominant is the conflict of interest theory. Their brief discussion is provided below.

The conflict of interest theory considers all related party transactions as undermining directors' and officers' fiduciary responsibility to the company and the monitoring function of the board on behalf of the shareholders as a whole. Hence, related party transactions are regarded as potentially detrimental to the economic interests of the shareholders.<sup>84</sup> In addition, the proponents of this theory argue that related party transactions inherently involve agency costs and suggest the importance of monitoring mechanisms in such case.<sup>85</sup> Besides, according to the conflict of interest theory, related party transactions may involve moral hazard and such transactions may be concluded in the interest of directors in order to expropriate wealth from shareholders.<sup>86</sup> Generally, the implication behind conflict of interest theory is that such transactions should be prohibited. Similarly, scholars who support this theory provide with the negative effects of related party transactions. Such effects include that related party transaction: weakens corporate governance, results in earnings management<sup>87</sup>, promotes tunneling, encourages employment of relatives in family firms and may cause misleading financial statement.<sup>88</sup>

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<sup>83</sup>. Wen-Yi Lin, Y. Angela Liu and I Keng “Related Party Transactions, Firm Performance and Control Mechanisms: Evidence from Taiwan,” Taiwan, International Research Journal of Finance and Economics - Issue 35, 2010, p.1. Available @ [http://www.eurojournals.com/irjfe\\_35\\_06.pdf](http://www.eurojournals.com/irjfe_35_06.pdf).

<sup>84</sup>. Supra note 26, p.5

<sup>85</sup>. Supra note 59, p.9

<sup>86</sup>. Michele Pizzo: “Related party transactions under a contingency Perspective,” Springer, June 2011, p.4. Available @ <http://link.springer.com/article/10.1007/s10997-011-9178-1>

<sup>87</sup>. Ibid, p.5. Here earnings management is defined as “a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain.”

<sup>88</sup>. Ibid

On the other hand, the efficient transactions theory considers related party transactions as simply instruments fulfilling the economic needs of the company. This is because both parties have the ability to share confidential information freely and have a relationship built on trust. Thus, this theory does not view related party transactions as harmful to shareholders. It rather considers such transactions as beneficial.<sup>89</sup> Hence, the efficient transaction theory argues that related party transactions are efficient transactions that rationally fulfill economic demands of a company, such as securing in-depth skills and expertise or providing alternative forms of compensation. More importantly, some persons argue that the prohibition of related party transactions could deprive a company of talented employees or beneficial business arrangements”.<sup>90</sup>

Generally, there were some researches conducted on the effect of related party transactions with conclusions supporting each theory. For example, the research by Gordon, Henry and Palia in 2004 concluded in support of the conflict of interest theory.<sup>91</sup> On the other hand, a study conducted by Ryngaert and Thomas in 2007, concluded in support of the efficient transactions theory.<sup>92</sup> Despite the above and other researches, some scholars conclude that “there is little rigorous academic research to confirm or refute the views of them.”<sup>93</sup> Here, while the majority of scholars concluded that the conflict of interest and the efficiency theory are contrasting theories, only some scholars argue that the two theories are reconcilable. The latter scholars are in favor of another theory called contingent theory. According to this theory, related party transactions may be either beneficial or harmful to company based on some conditions such as whether or not the transaction was concluded on arms length basis. Thus, in contrast to the other two theories, this theory does not automatically side to one of the nature and effect of the related party transaction as being either beneficial or harmful. It simply recognizes the possibility of such transactions to be beneficial or harmful to the interests of the

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<sup>89</sup> .Supra note 26, p.5.

<sup>90</sup> . Elizabeth A. Gordon, Elaine Henry and Darius Palia: “Related Party Transactions: Associations with Corporate Governance and Firm Value,” August 2004, p.8-9.  
Available@ [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=558983](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=558983)

<sup>91</sup> . Ibid

<sup>92</sup> . Ibid

<sup>93</sup> . Supra note 90

company. Few researchers in support of contingency theory currently argue that both the conflict of interest theory and the efficient transaction theory are “affected by inconsistencies or deficiencies and in providing almost diametrically opposite interpretations, they are unable to cope with different kinds of possible cases.”<sup>94</sup>

Conversely, there is an argument that the adoption of a contingency theory implies an overlap between the conflict of interests and the efficient transactions theories and this theory suggests examining related party transactions from the perspective of contingent factors concerning specific organizational contexts and institutional environments.<sup>95</sup> Finally, from the perspective of the contingency theory, related party transactions should be understood as transactions which: fulfill sound business needs as well as be intended for deceptive or fraudulent purposes and interact with and be influenced by other contextual factors such as” geographical and cultural differences, corporations’ industry and size, and governance mechanisms like board approval, independent directors’ involvement and external appraisal.<sup>96</sup>

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<sup>94</sup> . Ibid, p.10

<sup>95</sup> . Ibid, p.18

<sup>96</sup> . Ibid, p.11.

## **Chapter Three- Methods of Regulation of Related Party Transactions in the Financial Sector in General**

The discussion in this chapter is mainly concerned with the issue of methods of regulating related party transactions in the financial sector in general. Thus, this chapter will specifically cover the available methods of regulation of related party transactions such as self-regulation or state regulation, on the one hand, and the prohibition of specific related party transactions and the requirements of disclosure and approval, on the other hand. It also attempts to specifically discuss on the regulation of related party transactions in banks, insurance and microfinance institutions and on derivative and class actions in the Ethiopian financial sector.

### **3.1. Purpose and Methods of Regulating Related Party Transactions in the Financial Sector**

Though there is no agreement on the rationale for regulation of related party transactions, one of the main purposes of regulating related party transactions is to ensure the correct operation of the market, to protect shareholders especially minority shareholders, creditors, investors and other stakeholders against possible abuses arising from transactions carried out by companies with persons in a potential conflict of interest position, such as controlling shareholders, directors and senior managers or their close relatives.<sup>97</sup> Thus, regulators of the financial sector should give due regard to the regulation of related party transactions to prevent abuses and to take the proper sanctions and provide with relevant measures or remedies in the occurrence of abuses.<sup>98</sup> But, it must be noted that all related party transactions do not lead necessarily to conflicts of interest. However, based on whether or not the related party transaction was conducted on arms length basis, it may result in conflict of interest.<sup>99</sup> Hence, it is in the abusive

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<sup>97</sup> . Nicola Asti and Luigi Verga: “The Italian market regulator approves the regulation on related party transactions,” Freshfields Bruckhaus Deringer, April 2010, p.1.

Available @ [www.freshfields.com/Knowledge.aspx?&language=en&regi - 346k -](http://www.freshfields.com/Knowledge.aspx?&language=en&regi - 346k -)

<sup>98</sup> . Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny: “Investor protection and corporate Governance,” Journal of Financial Economics 58, 2000, p.4.

Available @ [http://works.bepress.com/florencio\\_lopez\\_de\\_silanes/12/](http://works.bepress.com/florencio_lopez_de_silanes/12/)

<sup>99</sup> . Laura Luputi, David and Baias Scpa: “Reporting Related Party Transactions and Conflicts Of Interest,” Romania, 2004, p.4.

related party transactions that conflict of interest arises and not in all related party transactions. Conversely, conflict of interest is not confined to related party transaction because such conflict can also occur in other similar transactions such as self-dealing, tunneling and transfer pricing.<sup>100</sup> As stated above, there is confusion on the relationship between related party transaction and conflict of interest. This confusion again makes unclear as to why related party transactions, such as those concluded on arms length, that do not cause conflict of interest are prohibited.<sup>101</sup> Hence, making clear distinction between related party transactions and conflicts of interest is important for reporting purpose. This is because disclosure of related party transactions may be made before or after being performed but information on conflicts of interest should be disclosed as soon as they started to exist.<sup>102</sup>

Coming to the methods of regulation, it must be noted that there are several mechanisms in the regulation of related party transactions in general. But, here the main concern will be between self-regulation and state regulation mechanisms, on the one hand, and between prohibition and the disclosure and approval requirements of related party transactions, on the other hand. Thus, the regulation of related party transactions should consider and answer the following issues and questions. Should all related party transactions be prohibited? Or should there be self-regulation of related party transactions? Or rather than prohibiting such transactions, should there be strong legal rules on related party transactions? Another option will be prohibiting only abusive related party transactions but regulating legally the normal related party transactions. There is also an argument that there shall be no government involvement in related party transactions. But, note that in an empirical study it was concluded that a strategy of no public involvement at all does not lead to more developed finance markets and that the most effective regulation combines public disclosure of actual and potential conflicts

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Available@<http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/32387391.pdf>

<sup>100</sup> . Ibid

<sup>101</sup> . Ibid

<sup>102</sup> . Ibid

with a requirement that transactions be approved by disinterested shareholders.<sup>103</sup> Thus, this last option will not be discussed in this paper.

In some countries, the law presumes that transactions between the company and related parties involve conflicts of interests. However, where there is no general prohibition of related party transactions, most countries have developed monitoring instruments to ensure that the potential agency issues are reduced when related party transactions happen.<sup>104</sup> Even if there are several approaches in the regulation of related party transactions, we mention here three different approaches generally. The first approach is prohibition of some related party transactions. We can cite here the United Kingdom. The second approach is the fairness of related party transactions which tries to change the prohibition approach and develop more substantive criteria of fairness where transactions with conflicting interests should always be subject to challenge on the basis of unfairness, or at least on the ground of gross unfairness. This approach is frequently found in United States law, and in the United Kingdom to some extent. On the other hand, the third approach is to require specific disclosure and approval procedures for related party transactions. Russia can be mentioned specifically here.<sup>105</sup> But, the discussion here will be concerned with the first and third approaches. Finally, note should be made that the effectiveness of the regulation of related party transactions may depend on other several factors such as social factors, business models, corporate governance mechanisms.<sup>106</sup>

### **3.1. 1. Self-Regulation vs. State Regulation**

Generally, the regulation of related party transactions may be achieved through self-regulation or state regulation or both. Even if there are several definitions for self-regulation, for the purpose of this paper, it is generally defined “a regulatory process

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<sup>103</sup> . Supra note 26, p.9

<sup>104</sup> . Ibid

<sup>105</sup> . The Russia Corporate Governance Manual “Chapter 12: Material Corporate Transactions,” 2004, p.26. Available@[http://www.ita.doc.gov/goodgovernance/adobe/CGMEnPart\\_3/p3\\_c12\\_corporate\\_transactions.pdf](http://www.ita.doc.gov/goodgovernance/adobe/CGMEnPart_3/p3_c12_corporate_transactions.pdf)

<sup>106</sup> . Supra note 86, p.15

whereby an industry-level organization (such as a trade association or a professional society), as opposed to a governmental- or firm-level, organization sets and enforces rules and standards relating to the conduct of firms in the industry.”<sup>107</sup> From this definition, one can infer that in this regulation the state does not directly intervene. On the other hand, state regulation is generally defined as regulation whereby government organs monitor the actions and behaviors of firms in the private sector.<sup>108</sup> Thus, some points will be made below with respect to each method of regulation.

### 3.1.1.1. Self- Regulation

Self -regulation can have several forms such as internal reporting systems, ethical codes of conduct and market mechanisms such as reputation and publicity of information.<sup>109</sup> This method presumes that companies will comply with their own internal reporting systems and ethical codes governing related party transactions. But, if the director or managers of the given company do not disclose such transactions, they should be held liable in general and be dismissed and requested to pay compensation to their company, in particular.<sup>110</sup> Here some persons argue that codes of conduct principles tend to have the same effect as state law provisions. The regulator should also consider that market mechanisms could be used because they take into consideration the role of reputation and bad publicity in preventing and monitoring abusive related party transactions.<sup>111</sup> Besides, some persons believe that the market mechanisms, such as trust and loss of reputation, naming and shaming via media such as internet, will also be helpful in protecting abusive related party transactions.<sup>112</sup> However, it is stated that when private benefits from such transactions are high, such non-legal mechanisms will be less effective in preventing fraud and abuse by related parties.<sup>113</sup>

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<sup>107</sup> . Daniel Castro: “Benefits and Limitations of Industry Self-Regulation for Online Behavioral Advertising,” The Information Technology and Innovation Foundation, December 2011, p.3. Available@ <http://www.ntia.doc.gov/files/ntia/2011-self-regulation-online-behavioral-advertising.pdf>

<sup>108</sup> . Ibid, p.2.

<sup>109</sup> . Supra note 79, p.16

<sup>110</sup> . Ibid

<sup>111</sup> . Supra note 14, p.17

<sup>112</sup> . Ibid, p.15

<sup>113</sup> . Ibid, p.p.30-31

### 3.1.1.2. State Regulation

Despite the fact that the self- regulation is considered as an important option or as a supplement to state regulation of related party transactions, yet some researchers currently argue that self-regulation was based on a flawed confidence in individual rationality and that individual rationality is proved to be wrong.<sup>114</sup> Thus, many countries use different state regulation instruments to prevent or punish abusive related party transactions. Such instruments include: fiduciary duties, disclosure provisions, shareholder approval requirements, liability suits, actions to have abusive related party transactions declared void, criminal sanctions and administrative measures. Such instruments are available, often jointly, to protect the interests of minority shareholders and other stakeholders against insiders' opportunism.<sup>115</sup> In short, the major state regulation instruments in the protection of the different stakeholders in the financial sector are judicially enforced law and government enforced regulation, supported by adequate levels of disclosure and transparency. Note, however, that in addition to the above state regulation mechanisms, auditors, directors, investors and regulatory bodies can play relevant roles in this regard.<sup>116</sup>

### 3.1.2. Prohibition vs. Disclosure and Approval

Generally, there were and still are to some extent, differences on how to control related party transactions. This is because some persons and countries argue that related party transactions should be totally prohibited. However, others argue that strong rules should be adopted without prohibiting them. In early years, related party transactions were prohibited totally. But, the modern day's regulation opts for putting strong rules on

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<sup>114</sup> . Supra note 2, p.18

<sup>115</sup> . Pierre-Henri Conac, Luca Enriques and Martin Gelter "Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy," Law Working Paper N° 88/2007, October 2007, p.5.

Available @<http://www.usc.es/cde/documentoswebsummer2006/07octsharegholders.pdf>

<sup>116</sup> . Rodney Lester and Oliver Reichert: "Insurance Governance and Risk Management," primer series on insurance issue 11, November 1, 2009, p.6.

Available@[http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/primer11\\_Insurance\\_governance\\_Risk\\_mangement.pdf](http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/primer11_Insurance_governance_Risk_mangement.pdf)

related party transactions. However, in between them, some types of related party transactions are prohibited without prohibiting all related party transactions.

### **3.1.2. 1. Prohibition**

As we can understand from the historical background of related party transactions, prohibition of related party transactions was one of the major methods of legal regulation in the earlier centuries. But currently, the prohibition as a legal method of regulation is applicable and limited only to some specific related party transactions. The legal prohibition approach has both advantages and disadvantages. Its advantage is that all practitioners know where the boundaries are and hence, there will be no need for fine analysis as to the possibilities to circumvent the prohibition. However, its disadvantage is its lack of flexibility because even efficient and economically useful transactions will be prevented when the law contains a flat prohibition. Additionally, parties may make great efforts to circumvent the rule.<sup>117</sup> Thus, taking into account the fact that some related party transactions make great economic sense, some countries such as Brazil, Chile, France, Hong Kong (China), Hungary, India, and the United States have prohibited certain related party transactions, especially loans to directors and shareholders while the majority of other countries leave significant related party transactions subject to disclosure and approval requirements, even if such requirements and details are not uniform among them.<sup>118</sup> Particularly, the reason behind prohibiting or limiting loans to related party may have some thing to do with insider lending<sup>119</sup> because it is argued that there is an inherent conflict of interest in insider lending and it is considered as a cause for a serious problem in many financial institutions in developing countries. Besides, such loans are prohibited or restricted because there is a belief that the loans are concluded on conditions and terms much more favorable than loans to unrelated persons.

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<sup>117</sup> . supra note 105, p.25

<sup>118</sup> . OECD: “Related Party Transactions and Minority Shareholder Rights,” OECD Publishing, 2012, p.35. Available@<http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/50089215.pdf>

<sup>119</sup> . Insider lending is defined as a “loan made to a person who is in a position of influence within the lending institution, or to someone else connected with such a person”.

Moreover, there is the perception that, in some cases, it will be much easier for the insider borrowers to have their loans rescheduled or remitted.<sup>120</sup>

### **3.1.2.2 Disclosure and Approval**

Many countries currently use the requirements of disclosure, review and approval or ratification requirements in the regulation of related party transactions.

#### **3.1.2.2.1. Disclosure**

Information about the concerned financial institution will be important for the creditors, minority share holders, investors, regulators and the general public. This is because it is based on such information that such persons can deposit their money and take measures on the persons who act fraudently to get personal benefit. In particular, the creditors, investors, regulators and other stakeholders will get information about financial conditions and status of the concerned financial institution via disclosure and reporting requirements. Here it must be clear that information about related party transactions is the information that investors reasonably should get to make informed decisions. Thus, the disclosure on related party transactions should be made in a way that ensures that investors understand how related party transactions can affect the whole company and the shareholders.<sup>121</sup> Accordingly, in deciding on what to disclose on related party transactions, companies should give regard to the context in which the related party transaction occurs. This is because, “a related party transaction may not be relevant to an investor’s decision when considered on its own, but when grouped together with other transactions... and their cumulative impact on the entity is considered, they may become relevant and should be disclosed.”<sup>122</sup> The central point here is that the law should not only require the disclosure of information on related party transactions but also consider that

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<sup>120</sup> . Stefan Staschen: “Regulatory Requirements for Microfinance: A Comparison of Legal Frameworks in 11 Countries Worldwide,” Deutsche Gesellschaft für, 2003, p.37.  
Available @ <http://www.bu.edu/bucflp/files/2012/08/Regulatory-Requirements-for-Microfinance.pdf>

<sup>121</sup> . Supra note 80, p.33

<sup>122</sup> . Ibid

the disclosure should be of high quality so that regulators and investors could make informed decisions. Particularly to investors, high quality information disclosure requirements give them confidence in the reliability of financial reporting. In turn, this is a great asset in conducting business because it is argued that “without investor confidence, markets cannot thrive.”<sup>123</sup> Conversely, there is a wide recognition that the absence of transparency in the transactions will enhance the occurrence and prevalence of the abusive related party transactions.<sup>124</sup> At this juncture, note should be made that the theoretical rationale behind disclosure is that “... knowledge of an entity’s transactions, outstanding balances, including commitments, and relationships with related parties may affect assessments of its operations by users of financial statements, including assessments of the risks and opportunities facing the entity.”<sup>125</sup>

Disclosure requirement may have different purposes for different stakeholders of the financial sector. For example, when considered from the market’s perspective, the aim is to ensure that users of financial reports are presented with the most reliable and accurate information possible that allows them to make well-informed decisions. On the other hand, when seen from the director’s perspective, the purpose is to influence the decision making process of a director who is considering engaging the company in a related party transaction. Thus, because of the required disclosure, directors may avoid engaging in certain transactions that they believe would raise questions of a conflict of interest, even when the transaction is what could be defined as efficient.<sup>126</sup> In addition, disclosure requirements may be used in many areas and activities such as disclosure of remuneration, relationship, transaction, amount of transaction and so on. Particularly, the justifications for the disclosure requirement include disclosure: of remuneration makes directors and executives more accountable to shareholders and the public at large, permits shareholders to effectively monitor management and remuneration practices and

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<sup>123</sup> . S. P. Kothari: “The Role of Financial Reporting in Reducing Financial Risks in the Market,” Sloan School of Management, Massachusetts Institute of Technology, p.3.

.Available @ [http://www.bostonfed.org/economic/conf/conf44/cf44\\_6.pdf](http://www.bostonfed.org/economic/conf/conf44/cf44_6.pdf)

<sup>124</sup> . Supra note 14, p.4

<sup>125</sup> . Supra note 26, p.12

<sup>126</sup> . Ibid, p.p.12-13

reduce costs of the agency relationship between shareholders and executives, increases transparency which in turn increases “outrage costs” and is accordingly a strong constraint against managerial abuse, encourages the development of norms regarding best company practices, is a cost effective and less intrusive method of preventing abuses than other methods that have been tried and in the case of state owned or controlled enterprises is an important part of ensuring proper corporate governance of such companies.<sup>127</sup> On the other hand, it is clear that many of the regulations on related party transactions in general and the requirement of disclosure in particular are applicable to listed companies. But, there are some proposals to extend such regulation and disclosure requirements to non-listed companies since recently. For example, the European Union proposed extending the disclosure of related party transactions for non-listed companies to restore public confidence in companies’ financial statements and contribute to integrated capital markets.<sup>128</sup> The European Union regulators justify the extension of the disclosure for non-listed companies on the following two grounds: related party transactions are very often material for non-listed companies and disclosure would not be too cumbersome, as these firms usually do not have complicated off-balance sheet arrangements.<sup>129</sup> But, others challenge the proposal arguing that despite the fact that increased financial statement transparency is necessary and should be encouraged, regulators must not ignore the higher costs of disclosure for those non-listed companies. They argue that if the purpose is to increase the accountability of non listed companies, the European Union may need to subject disclosure of related party transactions on an aggregate basis.<sup>130</sup> The requirement of disclosure could also be necessary for non-listed company in that a listed company could deposit its surplus cash to its unlisted parent for an indefinite period, denying itself and its minority shareholders the opportunity to generate higher returns through strategic investments. Or, it could buy assets from an unlisted affiliate at an inflated price.<sup>131</sup>

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<sup>127</sup> . Ibid, p.p.2-6

<sup>128</sup> . Supra note 14, p.18

<sup>129</sup> . Ibid, p.19

<sup>130</sup> . Ibid, p.p.20-21

<sup>131</sup> . Supra note 34, p.7

### **3.1.2.2.1. 1. Mandatory vs. Voluntary disclosure**

There is a debate on whether disclosure should be mandatory or voluntary.<sup>132</sup> Thus, while the majority and the practice of many countries support the mandatory disclosure, some are in favor of the voluntary disclosure. In mandatory disclosure, companies are required by law to disclose the necessary information specifically provided in the law and failure to disclose will be followed by sanctions and other measures. In voluntary disclosure, it is presumed that companies will have incentives to disclose relevant information without being required by law to do so. Hence, failure to disclose in this case will not result in legal sanctions. Those who argue in support of voluntary disclosure forward several reasons. Benston can be mentioned here. He argues that mandatory disclosure is not necessary and it can be hazardous and against the consumer interest. It is argued that ,especially efficient and competitive, companies have an interest in disclosing relevant information to consumers in an open manner: ‘Financial service providers have strong incentives to provide potential investors with the information they require, as do suppliers of other goods and services’. Benston also argues that regulatory agencies are not able to specify universally useful disclosure rules and ‘may design rules that keep financial product providers from communicating effectively with consumers’. He concluded that, mandatory disclosure is more harmful than beneficial. Particularly, he argues that mandatory disclosure requirement involves a huge cost so that this may discourage and bar new market entrants by raising the United Kingdom experience<sup>133</sup> and it presupposes effective enforcement and has a restricted effect because it does not affect all firms equally.<sup>134</sup>

### **3.1.2.2.1. 2. Disclosure of Material vs. Immaterial related party transactions**

Note that there is no the same requirement for the disclosure of material and immaterial related party transactions. However, determining materiality has been a challenge. Thus, countries use both quantitative and qualitative criteria to determine materiality. But, the

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<sup>132</sup> . David Llewellyn: “The Economic Rationale for Financial Regulation,” Occasional Paper Series1, Financial Services Authority, April 1999, p.34.

Available @<http://www.fsa.gov.uk/pubs/occpapers/op01.pdf>

<sup>133</sup> . Ibid, p.35

<sup>134</sup> . Joseph A. McCahery: “The Role of the Board in Related Party Transactions,” De Universiteit Van Amsterdam, February, 2006, p.19.

Available @ <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciple-127175419-16>

quantitative criteria are thought to be more effective in many countries.<sup>135</sup> Generally speaking, transactions are material if their disclosure could reasonably be expected to influence the economic decisions of users of financial statements. Besides, the materiality of related party transactions is to be determined based on their importance to the reporting enterprise. Note also that when determining materiality, regard should be taken to the fair value of the resources transferred. However, note that there is difference among countries in the materiality threshold.<sup>136</sup> Although some related party transactions may appear to be below a certain threshold, a materiality test may prove that they are material to one or more related counter-parties, and as such may be subject to the requirement of disclosure or shareholder approval. Thus, it is also common in many countries to provide two distinct thresholds: one threshold for ongoing/recurring transactions, and another threshold for non-recurring transactions.<sup>137</sup> The distinction between material and immaterial transactions is essential for the purpose of disclosure procedure because there is a general procedure for related party transactions which are below the materiality threshold and a special procedure for material transactions that must be disclosed promptly. It is obvious that disclosure of information involves costs. Such costs include direct costs, litigation costs, and proprietary costs. Thus, to reduce these disclosure costs, the requirement of disclosure should be optimal.<sup>138</sup>

#### **3.1.2.2.1. 3. Disclosure of Some related party transactions**

It is also helpful to say some points in relation to disclosure of some types of related party transactions. Generally, the following types of related party transactions may require disclosure: purchases or sales of goods, purchases or sales of property and other assets, rendering or receiving of services, agency arrangements, leasing arrangements, transfer of research and development, license agreements, finance including loans and equity contributions in cash or in kind, guarantees and collaterals, management contracts and provisions against or write off of amounts due from related parties and write back of such

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<sup>135</sup> . Supra note 118, p.11

<sup>136</sup> . Supra note 39, p.4

<sup>137</sup> . Supra note 32, p.32

<sup>138</sup> . Supra note 123, p.p.4-5

provisions.<sup>139</sup> More particularly, disclosure is required in the following loan transactions: the name of borrower and, where applicable, the name of director involved, the terms of loan, the amount of the loan outstanding at the beginning and end of the financial year and the maximum amount so outstanding during that financial year and the amount of interest due but unpaid and the amount of any provision made.<sup>140</sup> Besides, disclosure is required in the following loan guarantee/security provided by the company. Here the necessary particulars include: the name of borrower and, where appropriate, the name of director involved, the maximum liability of the company under the guarantee or in respect of the security at the beginning and end of the financial year and any amount paid or liability incurred by the company in fulfilling the guarantee or in discharging the security.<sup>141</sup> However, it must be noted that there are exceptions for disclosure requirement in general. One of such exceptions is the arms length. But, in order to qualify for exemption from disclosure, a reporting entity would have to demonstrate that it has undertaken a related party transaction on the same terms as current transactions with unrelated parties, with similar volumes, terms and conditions.<sup>142</sup>

#### **3.1.2.2.2. The Approval Process**

The approval process is regarded as one legal mechanism of monitoring related party transactions. The different mechanisms of approval can be generally classified into board of directors' approval and shareholder approvals. But, the board of directors, executive or non-executive, approval is more prevalent than the shareholders approval currently. In some cases, both board of directors and shareholders have the power to approve related party transactions.

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<sup>139</sup> . Supra note 39, p.p.4-5

<sup>140</sup> . Ibid, p.7

<sup>141</sup> . Ibid

<sup>142</sup> . Public Sector Accounting Board: "Related Party Transactions-Definition and Disclosure," The Canadian Institute of Chartered Accountants, October 2011, p.26.

Available@ <http://www.frascanada.ca/standards-for-public-sector-entities/documents-for-comment/item53040.pdf>

### **3.1.2.2.2.1. Approval by Board of Directors**

It is obvious that board of directors, both executive and non-executive, of a company can play an important role in the regulation of related party transactions such as through the oversight and approval requirements. This role will be helpful in preventing conflicts of interest and abuse. Specifically, independent directors can play a significant role in monitoring abusive related party transactions.<sup>143</sup> On the other hand, it should be mentioned here that the issue of monitoring related party transactions becomes more complicated when independent directors engage in related party transactions with the company.<sup>144</sup> If transactions occur, the concern is that not only could the transaction result in the misappropriation of firm resources, but it also threatens to undermine the monitoring function of the independent director.<sup>145</sup> Anyways, since recent times, most countries laws require board approval to regulate related party transactions and evaluate whether the transaction is at arms length or whether it is detrimental to the company. This mechanism is thought to promote greater transparency. Note again that, within the decision making process of the board, independent board members, the audit committee, and internal auditors and independent experts, if necessary, are required to play an important role in monitoring and approving related party transactions to prevent abuse.<sup>146</sup>

### **3.1.2.2.2.2. Approval by Shareholders**

The shareholders can in some countries and companies play a role in the approval of some related party transactions. However, it should be noted that shareholder approval is considered as an alternative or complement to the board of directors approval procedure but the practice is not widespread and often only applies to large transactions or those not on market terms. For example, in the United Kingdom prior shareholder approval is mandatory for non-routine transactions with directors and large shareholders of listed companies. Other countries such as Australia, Canada, Hong Kong, China, and Italy

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<sup>143</sup> . Supra note 32, p.p.37-38

<sup>144</sup> . Supra note 26, p.10. The problem here is that some countries laws in general and the definition of related party do not clearly prohibit independent directors from engaging in related party transactions. For example, in New Zealand, there are no rules that prevent independent directors from engaging in related party transactions.

<sup>145</sup> . Ibid, p.11

<sup>146</sup> . Supra note 118, p.32

require shareholder approval as an additional control over the potential abuse of related party transactions. Canada, France and Italy go even further and have adopted provisions for approval by non-interested shareholders sometimes called majority of the minority.<sup>147</sup> In contrast, requiring all related party transactions to be approved by shareholders may not be feasible in the case of ongoing transactions, or where multiple transactions are small in number and would require multiple approvals. In case of multiple transactions, the risk is that issuers will separate large transactions into multiple smaller transactions to avoid shareholder approval requirements.<sup>148</sup> For this reason, many countries recently limit the requirement of shareholders to material transactions. On the other hand, it is provided that related party transaction should be properly approved. However, in practice not all transactions follow such procedures. There are different reasons for this, including the fact that the board of directors and shareholders may not always know whether the transaction involves related parties, in particular when insiders concealed their affiliation and personal interest. In such cases, non-executive and independent directors need to play the crucial role in identifying and disclosing related party transactions. Creating the list of related parties and their position in the transaction is one solution but it is made difficult by the fact that most ownership structures remain opaque. The materiality of these transactions is another important issue. Indeed, while the nature of some related party transactions is easily identifiable, others are structured in an elaborate manner, involving complicated off-shore schemes.<sup>149</sup>

When we come to the decision whether to approve/disapprove or ratify or not ratify a related party transaction, the concerned organ should consider, among other things, the fact whether or not the said transaction is on arms length basis under the same or similar circumstances and the extent of the related party's interest in the transaction.<sup>150</sup> It should also include information on: the parties that are involved in the transaction, other beneficiaries of the transaction, if any, the value of the transaction, the assets and services

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<sup>147</sup> . Ibid

<sup>148</sup> . Supra note 32, p.26

<sup>149</sup> . Supra note 105, p.p. 29-30

<sup>150</sup> . Etoile: "Apple Related Party Transactions Policy," April 2011

Available @ <http://www.pdfcast.org/pdf/apple-related-party-transactions-policy> - 50<sup>1</sup>

involved in the transaction and any other significant terms and conditions related to the transaction.<sup>151</sup> Note again here that there are some exceptions to the requirement of approval. For example, some countries provide that no approval is required in the following transactions where: (a) the transactions are concluded on arm's length basis (b) the benefits are reasonable remuneration or reimbursement of officers' and employees' expenses and (c) certain other transactions or financial benefits given under a court order.<sup>152</sup> From the exceptions of approval mentioned above, some points should be raised on the arms length.

### **3.1.3. Exceptions/Exemptions/Exclusions to Disclosure and Approval**

As in other principles of legal provisions, there are some exceptions to the requirements of disclosure, review, approval and ratification of related party transactions generally. The most common and obvious exception here is the arm's length. Even if there may be different definitions for 'arms length', here we begin with what the case law defines the phrase "arms length" as referring to the relationship between parties where neither bears the other any special duty or obligation, they are unrelated, uninfluenced and each acts in its own interests."<sup>153</sup> Arm's length also refers to "the bargaining position of two parties that are unrelated to one another and whose mutual dealings are influenced only by the independent interest of each."<sup>154</sup> One can boldly say that the central idea and purpose of the arms length exception is to make sure that there are no different treatments when a company transacts with a related party, in one hand, and with unrelated party, on the other hand. Where there are no other exceptions, it is a general principle that all related party transactions requires approval and disclosure. Thus, unless it is proved<sup>155</sup> that the

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<sup>151</sup> . Supra note 105, p.29

<sup>152</sup> . Supra note 80, p.p.6-7

<sup>153</sup> . Jacinta Munro, et al: "Avoiding the perils of related party transactions: Risk and Compliance," KPMG, June 2011, p.2.  
Available@<http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Documents/Avoiding-the-perils-of-related-party-transactions.pdf>

<sup>154</sup> . Supra note 79

<sup>155</sup> . Supra note 14, p.20. Note that the party who claims that the related party transaction was concluded on arms length basis has the burden of proof. This can be inferred from IAS 24.21 which provides generally that "The firm must provide proof if it states that related party transactions were made on terms that are common in arm's length transactions."

transaction is concluded on arms length, the related party transaction is required to be disclosed and approved. Therefore, transactions involving related parties cannot be presumed to be carried out on an arm's length basis, as the requisite conditions of competitive, free-market dealings may not exist.<sup>156</sup> But, when it is proved that the related party transaction is concluded on arms length basis, the transaction will not be required to be disclosed and approved.<sup>157</sup> This signifies the importance of determining whether or not a given transaction is carried out on arms length. However, this is a difficult task because there will be difficulty in obtaining sufficient evidence of all the circumstances of the transaction and providing some independent evaluation of the transaction.<sup>158</sup> It is especially more difficult for the ordinary investors to detect the true nature of the transaction. This is particularly true when there is a disclosure that the transactions were concluded on arms length, and/ or approved by independent board of directors.<sup>159</sup>

### **3.2. Regulation of Related Party Transactions on Banks, Insurance and Microfinance Institutions**

The argument for regulating and supervising any financial institution rests on the need to protect depositors from loss of their savings and the need to maintain confidence in, and stability of, the financial system.<sup>160</sup> On the other hand, one of the main objectives of financial institutions is mobilizing resources, in particular domestic saving and channeling them to the would-be investors.<sup>161</sup> Coming to the discussion of related party transactions in the financial sector, recent research suggests that corporate governance reforms in the non-financial sector may not be appropriate for banks and other financial

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<sup>156</sup> . Supra note 29, p.8

<sup>157</sup> . Supra note 153, p.3

<sup>158</sup> . Janine Pascoe: "Regulation and Disclosure of Financial Benefits to Directors and Related Parties: A Comparative Analysis of the Malaysian and Australian Approaches," Singapore Journal of International & Comparative Law, 1999, p.19.

Available@ <http://law.nus.edu.sg/sybil/downloads/articles/SJICL-1999-1/SJICL-1999-108.pdf>

<sup>159</sup> . Supra note 27, p.13

<sup>160</sup> . -----:"Regulation of Non-bank Microfinance Institutions," p.3.

Available @ <http://www.bwtp.org/publications/pub/Chapter6.pdf>

<sup>161</sup> . Alemayehu Geda: "The Structure and Performance of Ethiopia's Financial Sector in the Pre and Post Reform Period: With Special Focus on Banking," Draft, p.1.

Available@[http://www.alemayehu.com/On%20Going%20Research/BookChapter\\_EthBank\\_George2004.pdf](http://www.alemayehu.com/On%20Going%20Research/BookChapter_EthBank_George2004.pdf)

sectors. This is based on the view that no single corporate governance structure is appropriate for all sectors, and that the application of governance models to a particular sector should consider the institutional dynamics of the specific sector. Thus, corporate governance in the banking and financial sector differs from non-financial sectors because of the broader risk that banks and financial companies pose to the entire economy. As a result, the regulator is supposed to play a more active role in establishing standards and rules to make management practices in the financial sector in general and banks more accountable and efficient in particular. This is because, unlike other firms in the non-financial sector, a mismanaged bank may lead to a bank run or collapse, which can cause the bank to fail on its various counterparty obligations to other financial institutions and in providing liquidity to other sectors of the economy.<sup>162</sup>

### **3.2.1. Regulation of Related Party Transactions on Banking Companies<sup>163</sup>**

The role of banks is very important to the economy of a country because banks provide financing for commercial enterprises, access to payment systems, and a variety of retail financial services for the economy at large. But, some banks have a greater effect on the macro economy, facilitating the transmission of monetary policy by making credit and liquidity available in difficult market conditions. Thus, financial regulation is necessary because of the multiplier effect that banking activities have on the rest of the economy. The large number of stakeholders such as employees, customers, suppliers, whose economic well-being depends on the health of the banking industry, depends on appropriate regulatory practices and supervision. Thus, it is imperative that financial regulators ensure that banking and other financial institutions have strong governance structures, especially in light of the pervasive changes in the nature and structure of both the banking industry and the regulation which governs its activities.<sup>164</sup> The bank regulator plays an important role in ensuring that the bank's governance practices do not undermine the broader goals of macroeconomic growth and financial stability.

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<sup>162</sup>. Supra note 17

<sup>163</sup>. The specific discussions here are mainly made based on the Palau, Israel and Georgian bank regulations on related party transactions.

<sup>164</sup>. Ibid, p.6.

We shall now go to the definition of related party from the context of banks. For example, the Israel bank regulation defines related party to a banking corporation as:

- (a) Anyone who controls the banking corporation;
- (b) A potential buyer or someone who holds more than 10% of any means of control in the banking corporation or in a banking corporation that controls the banking corporation (henceforth - party at interest);
- (c) A family member of the parties mentioned in paragraphs (a) and (b);
- (d) A director or senior officer of the banking corporation, or of a corporation that controls the banking corporation, or of a corporation that is a party at interest in the banking corporation;
- (e) The spouse of a director or senior officer, as defined in paragraph (d);
- (f) A corporation in which the parties mentioned in paragraphs (a), (b), or (c) control or hold more than 10% of the means of control, and a corporation in which a corporation as specified above holds more than 50% of any means of control;
- (g) A corporation in which the parties mentioned in paragraphs (d) or (e) hold more than 50% of any means of control, and a corporation in which the corporation mentioned above holds more than 50% of any means of control;
- (h) A corporation in which the banking corporation controls or holds more than 10% of any means of control, and a corporation in which the corporation mentioned above holds more than 50% of any means of control.<sup>165</sup>

After the definition of related party seen from the context of bank, it will be important to briefly discuss on the purposes of bank regulation on related party transactions. For example, in Palau Banks Regulation, the purposes of regulation of related party transaction include ensuring that related party transactions: are concluded on arms length basis, there is no transfer of wealth such as capital or income to a related person in a manner that gives unwarranted preference to a related person, are not used as a means of

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<sup>165</sup> . Supervisor of Banks of Israel: "Proper Conduct of Banking Business: Banking Corporation's Business with Related Parties," 2010, p.p.1-2.  
Available@[http://www.boi.org.il/en/BankingSupervision/SupervisorsDirectives/ProperConductOfBankingBusinessRegulations/312\\_et.pdf](http://www.boi.org.il/en/BankingSupervision/SupervisorsDirectives/ProperConductOfBankingBusinessRegulations/312_et.pdf)

evading capital or other regulatory requirements and do not adversely affect the solvency, liquidity or profitability of a bank.<sup>166</sup> Similarly, the purpose of Israel bank regulation on related party transactions is to “restrict the extent of indebtedness of related parties to the banking corporation, and to ensure that transactions between a banking corporation and related parties are undertaken on an arm's-length basis, in accordance with commercial terms, that are not preferential to similar transactions with unrelated parties.”<sup>167</sup>

When we come to discuss the regulation of related party transactions in banks, we see that some scholars suggest that all related party transactions with a bank should be reviewed and monitored by a sufficient number of directors capable of exercising objective and independent judgment. In addition, they say that the review process should require approval of individual transactions. It is also obvious that the disclosure of related party transactions between a bank and its related parties is important. Particularly, appropriate disclosure of material related party transactions is deemed helpful in reducing the burden for banking supervisors who may have limited human resources.<sup>168</sup> But, a study conducted by Ahmad and Yousuf in Bangladesh in 2005 indicated that inadequate disclosure is one of the most important obstacles to ensure good corporate governance. This shows that the banking sector is not free from financial abuses and crimes. But, the problem lies in the weak governance of the bank company, which gives the opportunity of illegal related party transactions.<sup>169</sup> Yet, it is important for the regulator to specifically provide on who has the obligation to establish the policy, procedures and monitoring and implementation of compliance with the policy, regulations and acts on related party transactions. In this regard, the Palau Regulation clearly provides that the board of directors of each bank has the responsibilities in relation to related party transactions. In particular, their responsibility is to: establish an appropriate policy with regard to

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<sup>166</sup> . Supra note 37, p.3

<sup>167</sup> . Supra note 165, p.1

<sup>168</sup> . OECD: “Policy Brief on Improving Corporate Governance of Banks in the Middle East and North Africa,” November 2009, p.12.

Available @ <http://www.oecd.org/mena/44372710.pdf>.

<sup>169</sup> . Mohammad Zakir Hossain Sharkar and Md. Abdus Sobhan: “Association between Corporate Governance and Related Party Transactions: A Case Study of Banking Sector of Bangladesh,” BRAC University Journal, Vol. IV, No. 1, 2007, p.5. Available @ <http://dspace.bracu.ac.bd/>

transactions with and loans to related parties, make sure that the appropriate procedures are provided to enforce the policy and monitor and ensure compliance to the policy, this regulation and the Act.<sup>170</sup>

In Palau, there are generally some minimum requirements in relation to transactions between a bank and its related parties. These are the requirements of compliance to policy and non-preferential terms/arms length. The compliance to policy requires that “All transactions between a bank and a related person and all loans to a related person shall conform to a written policy that has been approved and adopted by a majority of the entire board of directors and such policy must be adequate to ensure compliance with this regulation, the Act and prudent banking practices.”<sup>171</sup> On the other hand, the non-preferential terms requires that “All transactions between (i) a bank and a related person... and (ii) all loans by a bank to a related person... shall be at "arm’s length"...in respect of charges, fees, interest rate, liability, maturity, price, repayments, risk, security, etc. as the same or similar transactions between a bank and an unrelated person.”<sup>172</sup>

More particularly, as in many countries, the Palau Bank regulation on related party transaction puts some limits on loans to related parties, both to a single person and on aggregate. In a loan to a single related person, the limit is that the total amount outstanding at any time for all loans shall not exceed 20% of a bank’s capital. On the other hand, in aggregate the limit is that the total amount outstanding at any time for all loans to all related persons shall not exceed 100%[?] of a bank’s capital.<sup>173</sup> Besides, the Palau bank regulation on related party transactions prohibits the following transactions: purchase a low quality asset from a related person or become obligated to a related person in respect of a low quality asset, sell or otherwise transfer an asset to a related person at a price that is below the current fair

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<sup>170</sup> . Supra note 37, p.3

<sup>171</sup> . Ibid

<sup>172</sup> . Ibid, p.p. 3-4

<sup>173</sup> . Ibid, p.4

market value of that asset and purchase an asset from a related person at a price that is above the current fair market value of that asset.<sup>174</sup> Article 3 of the Georgian bank regulation also provides many prohibitions and limitations<sup>175</sup> on related party transactions. But here some of them will be mentioned. Thus, a bank is hereby prohibited to: lend or provide any financial service to any of its administrators, affiliates or any of their related interests on preferential terms irrespective of the type, interest rate, maturity of credit, collateral value or other factors, extend a loan or other commitments at any time to any of its administrators, affiliates or their related interest, if the total amount of loans and other commitments extended to this person exceeds 5% of the bank's total capital, extend a loan or other commitments at any time to any of its administrators, affiliates or their related interests, if the total amount of the loans and other commitments extended to these persons exceeds 25% of the bank's total capital, extend any loan to any of its administrators, affiliates or any of their related interests, if each such loan is supported by collateral, the market value of which is less than 110% of the total amount of the loan to be extended, purchase from any of its administrators, affiliates or related interests, any asset whose quality, as of the date of such purchase, is clearly destined to be, subject to a classification, of less than "Standard" and an administrator of a bank is hereby prohibited to receive (draw) compensation from (to) that bank or any of its affiliates, which is in excess of services actually rendered or of the market price for similar services provided by banks with similar earnings figures and asset composition.<sup>176</sup> Finally, the Israel bank regulation provides that banking corporation shall not enter into a transaction with a related party on terms that are preferential to those it provides to others in similar transactions. Besides, it is stated that securities issued by the banking corporation shall not be accepted as collateral for the indebtedness of a related party, and if that related party has control or is a party at

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<sup>174</sup> . Ibid

<sup>175</sup> . Martin Brownbridge, Colin Kirkpatrick and Samuel Munzele Maimbo: "Prudential Regulation," Finance and Development Briefing Papers, September 2002, p.2.

Available@<http://www.sed.manchester.ac.uk/idpm/research/publications/archive/fd/fdbrief3.pdf>

<sup>176</sup> . National Bank of Georgia: "Regulation on Conflict of Interests and Transactions between Bank Administrators and Related Parties," May 2001, p.p.2-4.

Available@[http://lexbox.am/uploads/PDF/Georgia%20Laws/regulations/nbg1.4.5.1conflict\\_of\\_interestsen g.pdf](http://lexbox.am/uploads/PDF/Georgia%20Laws/regulations/nbg1.4.5.1conflict_of_interestsen g.pdf)

interest - securities issued by that controlling party or party at interest, or by a corporation they control, shall not be accepted.<sup>177</sup> The Israel bank regulation also provides some limitations on indebtedness of related parties. Such limitations include: the aggregate of all indebtedness to the banking corporation of all related parties shall not at any time exceed 10% of the banking corporation's capital, the indebtedness of all the components of the group to the banking corporation shall not at any time exceed 10% of the banking corporation's capital and when the indebtedness of a component in the group is mainly to the same banking corporation, the indebtedness of that component shall not exceed the amount obtained by multiplying its relative share in the core holding by 10% of the banking corporation's capital.<sup>178</sup> On the other hand, article 3 of the Georgian bank regulation requires the approval of the bank's Supervisory Council meeting if there is a transaction between a bank and any of its administrators, affiliates or with any related party. In addition, the regulation provides that "Any administrator or any person, who is a related party of a bank or of an administrator, shall not take part in any discussions of any such transaction if he is to benefit directly or indirectly from it, nor shall any such administrator or person 'attempt to influence the decision of the Supervisory Council', in any manner with respect to such transaction." What is interesting here is that the beneficiary administrator or related party is prohibited from making any attempt to influence the decision of the Supervisory Council, in addition to being excluded himself from the meeting/decision."<sup>179</sup> It is also relevant to mention that Article 4 of the Georgian regulation gives the following wide rights to the National Bank of Georgia. This bank has the right to enforce each of the prohibitions and limitations set forth in Article 3 of this Regulation through sanctions and civil money penalties against banks who have violated the requirements of this Regulation and compel the immediate removal from the Supervisory Council, or the Board of Directors, of the employee or any administrator who, in the documented judgment of the National Bank, has violated

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<sup>177</sup> . Supra note 165, p. 3

<sup>178</sup> . Ibid

<sup>179</sup> . Supra note 176, p.3

this Regulation.<sup>180</sup> At the end, when the National Bank of Georgia thinks that the above requirements of the regulation are not satisfied or due to time and circumstances will not be satisfied in the future, the bank may take the following administrative and corrective measures: revocation of the license of the violator bank, or, when needed, filing of the case with relevant bodies in order to commence a criminal case.<sup>181</sup>

### **3. 2.2.Regulation of Related Party Transactions on Insurance Companies**

Generally, some persons consider the insurance sector as a highly fragile business and show the need to closely supervise that it is mandatory and essential practice all over the world.<sup>182</sup> Thus, like any other financial sectors, insurance is highly regulated and supervised business. This is primarily due to the need to protect the interests of the policy holders and to ensure that the trust and confidence the public has on the insurance business remains intact ongoing basis. Similarly, supervision is carried out to ensure that insurance operators are able to fulfill their promises towards the policyholders and with the view to maintain safe, sound and stable insurance sector.<sup>183</sup> For this reason, even if there may be differences among countries, one of the major objectives of insurance regulation is to correct market failures that would otherwise cause insurers to incur an excessive risk of insolvency or engage in market abuses that hurt consumers.<sup>184</sup> Basically, the wider purpose of insurance is supporting the economy. Conversely, as the economy grows, it supports the growth of insurance as well. Therefore, it can be clearly seen that insurance and the economy go hand in hand. For this reason, it will be sometimes difficult to think the success of the one without the involvement of the other. In specific

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<sup>180</sup> . Ibid, p.4

<sup>181</sup> .Ibid

<sup>182</sup> . Mesfin Zegeye (Ed.): “The Landscape of Micro-Insurance in Ethiopia: Exploring Opportunities and Challenges,” Birritu, Bulletin of the National Bank of Ethiopia No.112, November 2012,p.30.

<sup>183</sup> . Ibid, p.p.29-30

<sup>184</sup> . Report of the National Association of Insurance Commissioners (NAIC) and the Federal Reserve System Joint Troubled Company Subgroup: “A Comparison of the Insurance and Banking Regulatory Frameworks for Identifying and Supervising Companies in Weakened Financial Condition,” April 19, 2005, p.8.Available @ <http://www.federalreserve.gov/boarddocs/staffreports/naicfrs/>

terms, insurance encourages investment by taking care of insurable risks.<sup>185</sup> In particular, Malaysian Insurance Act and Regulations 1996 and the Companies Act 1965, contain provisions that aim to ensure that related party transactions are conducted in an independent manner and do not result in a compromise of the fiduciary duty owed by insurers to their policy owners. The above Malaysian laws also provide disclosure by directors of circumstances and transactions that may give rise to conflicts of interest, proper conduct of directors, chief executive officers and managers in performing their duties, the grant of credit facilities to directors and the acquisition of shares in related companies.<sup>186</sup> In addition to the laws mentioned above, there is a guideline on the regulation of related party transactions in insurance sector in Malaysia whose purpose is to complement, not to replace, the existing legal framework towards promoting good corporate governance in the conduct of insurance business. In the guideline a related party is defined as “a person, including a body corporate, that directly or indirectly through one or more intermediaries, controls, is controlled by or is under common control with the insurer and includes persons connected with the related party.” Particularly, the persons which fall in the above definition as related party include: relatives of a related party who is an individual, directors and shareholders of a related party which is a body corporate, and their relatives, bodies corporate controlled by persons connected with a related party, trustees of a trust under which a related party or persons connected with the related party are beneficiaries and partners of a related party.<sup>187</sup> On the other hand, the guideline defines related party transaction as “the transfer of assets or liabilities, or the performance of services, by, to or for a related party irrespective of whether a consideration is given.” Especially in the context of insurance companies, related party transactions include: “extensions of credit facilities, purchases, sales or exchange of shares or assets, guarantees or undertakings, property rentals, management and service agreements, including arrangements for the sharing of resources, agency agreements, reinsurance arrangements and settlement of inter-company balances including payments

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<sup>185</sup> . Supra note 182,p.28

<sup>186</sup> . Malaysian Prudential Financial Policy Department: “Guidelines on Related Party Transactions,” p.2. Available@[http://www.bnm.gov.my/guidelines/02\\_insurance\\_takaful/03\\_prudential\\_stds/05\\_related\\_party\\_transaction.pdf](http://www.bnm.gov.my/guidelines/02_insurance_takaful/03_prudential_stds/05_related_party_transaction.pdf)

<sup>187</sup> . Ibid , p.p.2-3

in kind for insurance coverage.”<sup>188</sup> The guideline also provides some minimum standards with respect to related party transactions concluded by insurers. For example, it requires that: the transaction must not be prejudicial to the interests of the insurer, its policy owners, claimants or creditors, the terms and conduct of the transactions should conform to other relevant laws of the country, the transaction must not result in an impairment of the insurer's financial condition, terms of the transaction must be fair and reasonable and full disclosure of the nature and extent of all related party transactions shall be made to the board of directors of the insurer.<sup>189</sup> Specifically, the guideline provides that the purchase and /or sale of property between the insurer and the related party shall be approved by the Central Bank. In this regard, the purchase price or the sale price shall be similar to the fair value or price prevalent in the same transaction with unrelated parties.<sup>190</sup>

It can be generally provided that the need for regulation and the standard of the regulation varies according to the stages of development in the insurance sector. This is because, in the early stages of development, the insurance sector is often seen purely as a commercial enterprise. The primary insured parties here are industrial firms and entrepreneurs.<sup>191</sup> At this stage, relatively light regulation and oversight of the insurance companies is all that is needed. However, the situation changes once compulsory classes of insurance are introduced. When motor third party liability insurance is required for all automobile drivers and major liability classes of business have been introduced, the public at large starts to rely on insurers for significant sums of money in the event of an accident or tort. At this stage, high standards of governance of insurance become necessary. The stakes rise further when life insurance and pensions become common and the public invests its long-term savings, including retirement incomes funds. At this latest stage, the government has an obligation to ensure that insurers and pension providers follow high

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<sup>188</sup> . Ibid, p.3

<sup>189</sup> . Ibid, p.4

<sup>190</sup> . Ibid, p.6

<sup>191</sup> . Supra note 116

standards of corporate governance, and risk management in particular.<sup>192</sup> It is obvious that currently the insurance sector is in its latest stage so that there is a need for high and strong standards of regulation in general and in the regulation of related party transactions in the insurance sector in particular. For a strong regulation of the insurance institutions in related party transactions, both the internal and external organs and measures are important. The internal bodies include: the management, the systems of risk management, internal audit and internal controls, the company's actuary and the supervisory board that should have oversight of them all. On the other hand, the external organs include both the supervising authority that oversees the insurance companies and market mechanisms that monitor and influence the sector. Besides, it should be recognized that the burden on the supervisory authority will be much less if the companies' internal governance mechanisms are strong, or where the market provides an effective form of monitoring through enhanced levels of transparency.<sup>193</sup>

But, note that, as in other business areas, the insurance sector has some weaknesses in the area of corporate governance in general and related party transactions in particular. For example, a 2006 World Bank survey of European Union accession countries identified four key weaknesses in insurance governance. One of such weaknesses is mainly with respect to related parties. The survey reads "External reporting by insurers was generally confined to financial results and operating reports. Additional data which would cover corporate governance issues, such as disclosure of salary levels by individual board member, detailed disclosure of related party transactions or statements of independence by supervisory board members were not disclosed."<sup>194</sup> On the other hand, good corporate governance practices on financial reporting recommend that, among other things, irrespective of the fact that the insurer is listed or not, the annual reports should be publicly available. In addition, it is suggested that the annual report should include: the full financial statements, including comprehensive notes covering such issues

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<sup>192</sup> . Ibid, p.7

<sup>193</sup> . Ibid, p.8

<sup>194</sup> . Ibid, p.9

as all related party transactions and the auditor's opinion.<sup>195</sup> Though there are some improvements generally, it is suggested that "All developing and transition countries should move as quickly as possible to the adoption of International Financial Regulation Standard for insurance company annual reports once the insurance contracts and financial instruments valuation rules are finally agreed. Regulations should specify that financial statements should be available on the internet."<sup>196</sup> It is also suggested that supervisory agencies should, among other things, "issue regulations defining related party transactions and limits on such transactions, and the regulations should: include a precise definition of related parties, require that insurers maintain reliable systems and controls for identifying, monitoring, and managing exposures and dealings with related parties including upstream parent entities or other controlling or significant shareholders and downstream subsidiaries and affiliates." Besides, it is alleged that "All business dealings with related parties should be on arm's length terms and be in the interests of all shareholders, creditors and policyholders. Any significant related party transactions involving cash transfers from the insurer should be subject to prior supervisory authority approval or notification."<sup>197</sup> It should be noted here that the insufficient regulation and control of related party transactions are also considered as a common source of insurer impairment. Thus, regulation of related party transactions in insurance institutions should require that all significant transactions take place between owners and other related parties of insurance companies on "an arm's length basis", that is, on terms and conditions prevailing in a well functioning market.<sup>198</sup> Finally, note here that some scholars argue that one major weakness of the insurance supervisory agencies in many developing and transition countries is the conflicted role created when the state is both the supervisor of the sector and the owner of insurance companies operating in the sector. Thus, it is clear that such conflicts may make it difficult for the supervisory agency to supervise the entity and enforce the legal framework in an impartial manner. Hence, it is

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<sup>195</sup> . Ibid, p.18

<sup>196</sup> . Ibid, p.19

<sup>197</sup> . Ibid, p.20

<sup>198</sup> . Ibid

suggested that privatization is an important step once the necessary regulatory and supervisory oversight capacity is in place.<sup>199</sup>

### **3. 2.3. Regulation of Related Party Transactions on Microfinance Institutions**

In the first place, it should be noted that there are arguments for and against the regulation of microfinance institutions. Nevertheless, the main idea of such arguments is that not all microfinance institutions should be subject to regulation and supervision. It is mainly those microfinance institutions which collect deposits from the public which should be regulated and supervised.<sup>200</sup> On the other hand, there is an argument that credit only microfinance institutions should generally be free from prudential regulation and supervision. But, note again that there may be a need for prudential regulation and supervision of credit-only microfinance institutions which are large enough to threaten the viability of the financial systems in which they operate.<sup>201</sup> Generally speaking, prudential regulation is considered to be essential in ensuring the sustainability and viability of microfinance institutions and in ensuring effective governance. Specifically, it is stated by some scholars that prudential regulation of microfinance institutions has three main objectives: to ensure the solvency and financial soundness of all intermediaries and to protect the stability of the country's payments system, to provide consumer protection against undue risks of losses that may arise from failure, fraud, or opportunist behavior of the suppliers of financial services and finally, to promote the efficient performance of institutions and markets and the proper working of competitive market forces.<sup>202</sup> However, there are different views on the need for having special laws for microfinance institutions. Thus, some argue that separate regulation is necessary because licensed financial institutions are unwilling to engage in microfinance and because banking regulations are unfavorable to it. Others argue that such laws will result in regulatory fragmentation, and that it is better to reform banking laws discouraging of microfinance.

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<sup>199</sup> . Ibid, p.21

<sup>200</sup> . Supra note 160, p.3.

<sup>201</sup> . Ibid.

<sup>202</sup> . Wolday Amha: "Corporate Governance of the Deposit Taking Microfinance Institutions (MFIs) in Ethiopia (Draft)," The Association of Ethiopian Microfinance Institutions (AEMFI), Addis Ababa, Ethiopia, p.7. Available @ <https://pipl.com/directory/name/Amha/Wolday/> - 54k -

Nevertheless, where it proves impossible to reform banking legislation, special laws may be the “second best” option.<sup>203</sup> The delivery of efficient and effective microfinance services to the poor required conducive macro economic policies and the establishment and enforcement of legal and regulatory frameworks of a country. An effective financial system is a basis for an effective poverty reduction program.<sup>204</sup> The traditional banks provide financial services to the business community with relatively high income.<sup>205</sup> Thus, microfinance institutions will be important in providing some financial services to the rural and urban poor and those who have difficulty of access to the commercial banks. In many ways, the microfinance sector provides social protection for the vulnerable by enabling them to access finance, create assets and prevent people from sliding back into poverty traps.<sup>206</sup> On the other hand, others argue that most of these concerns and problems in the microfinance institutions are due to lack of adequate regulatory practices in the sector. The industry is largely either unregulated or self-regulated. In many countries, the governments had followed a laissez-faire approach in regulating microfinance institutions. However, recently the issues of regulatory concerns of microfinance sector attract larger than usual interest from the policy makers and many countries, particularly in Africa.<sup>207</sup> The aim of regulating microfinance is two fold: to secure the interest of the vulnerable and uneducated consumers and to ensure smooth operations of the industry and thus safeguarding the financial system as a whole. But there is also a danger of hampering the growth of microfinance.<sup>208</sup> Generally, the problems and concerns in the microfinance institutions imply the need for specific regulations in the sector and more closer involvement between government and industry in developing regulations. This is due to the fact that the lack of specific microfinance institutions regulations affects the viability of the business model, undermines depositor

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<sup>203</sup> . Supra note 160, p.5. Note here that most stakeholders in the microfinance sector consider there is a need to enact a separate law for microfinance.

<sup>204</sup> . Wolday Amha: “Review of Microfinance Industry in Ethiopia: Regulatory Frameworks and Performance,” AEMFI Occasional Paper No.2, August, 2000, p.8.

Available @ <http://www.microfinancegateway.org/p/site/m/template.rc/1.9.24726/>

<sup>205</sup> . Ibid, p.p.36-37

<sup>206</sup> . Thankom Arun and Victor Murinde: “Microfinance Regulation and Social Protection,” European Report on Development, 2010, p.2.

Available @ <http://erd.eui.eu/media/2010/Arun-Murinde.pdf>

<sup>207</sup> . Ibid, p.8

<sup>208</sup> . Ibid, p.12

and investor confidence, and exposes microfinance institutions to political interference.<sup>209</sup> Broadly, microfinance regulation seems to be a public intervention measure to assist and protect individuals to better manage risks and deposits, and supports the arguments on access to finance and development.<sup>210</sup> These days, despite the costs of regulation and its implementation, there is generally positive perception in the regulation of microfinance institutions. Thus, a regulated microfinance institution is perceived as more secure and trustworthy than a non-regulated one. Besides, a regulated microfinance institution attracts more funders. Generally, microfinance is considered as one of the most efficient instruments to promote economic development and to fight poverty in poorer countries.

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<sup>209</sup>. Ibid, p.16

<sup>210</sup>.Ibid.

## **Chapter Four-Enforcement Mechanisms, Remedies and Sanctions in Abusive Related Party Transactions in the Financial Sector in General**

The discussion in this chapter will be made into two subunits. The first subunit will try to generally deal with the enforcement mechanisms. It will attempt to discuss briefly the private and public enforcement mechanisms. The second subunit will, however, specifically discuss the available remedies and sanctions in case of violations of provisions of related party transactions and their abuse. Some points with regard to derivative suits and class actions will also be dealt with here. Generally, the discussion in this chapter implies that no matter what the type and quality of the legal framework on related party transactions, the enforcement mechanisms remain crucial. This is because the legal provisions against abusive related party transactions are meaningless without appropriate remedies, sanctions and implementation methods. Hence, the regulation on related party transactions should give proper focus to both the contents of the law and its implementation.

### **4.1. Enforcement Mechanisms in General**

Generally, shareholders and other investors can be protected in two general ways: the ex-ante protection and the ex-post protection. The ex-ante protection tries to prevent in advance the occurrence of abusive related party transactions via, for instance, the requirements of disclosure and approval. On the other hand, the ex-post protection provides the remedy after the occurrence of the abusive related party transactions. This may include the administrative, civil and criminal sanctions and remedies in general. Thus, when we come to the issue of enforcement in the regulation of related party transactions, it should be clear that enforcement actions to control abusive related party transactions can be both ex-ante and ex-post. On one hand, ex-ante actions aim at preventing abusive related party transactions. On the other hand, ex-post actions aim at ensuring effective ways for shareholders to obtain legal redress and they can play an important function in monitoring abusive related party transactions.<sup>211</sup>

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<sup>211</sup> . Supra note 32, p.33

Similarly, there are two major mechanisms of enforcement of related party transactions. These are the mechanisms of private enforcement and the public enforcement. The private enforcement mechanisms in related party transactions include: market mechanism such as publicity, reputation and trust, extensive disclosure, approval procedures for transactions, and facilitation of private litigation. On the other hand, the public enforcement mechanisms consist of administrative, civil and criminal remedies and sanctions in case of violations of provisions on related party transactions.<sup>212</sup> Besides, it can be said that if the private enforcement mechanisms are found to be inadequate, the public enforcement mechanisms come/should come in to effect in case of related party transactions.<sup>213</sup> However, it must be noted that several prior studies generally concluded that in many countries, the public enforcement of the regulation on related party transactions appears to be weak. They indicated that in many ways reliance is on market mechanisms that are based on extensive disclosure obligations about related party transactions. They specifically mention that in some countries such as Belgium and France, bad publicity is said to be an enforcement mechanism in itself, but the basis rests on the tight social structure among elites. Reputations might also be important in some countries such as in India.<sup>214</sup> Note that, even if both private and public enforcement mechanisms involve costs, the cost of the former is higher than the latter.<sup>215</sup> Particularly, the cost of private enforcement increases with the obstacles faced by minority shareholders to sue derivatively. Besides, courts can void the transaction when approval is fraudulent, or in bad faith, or negligent, or when the transaction is merely unfair or involves a conflict of interest and damages the company. Nevertheless, it should be considered here that private enforcement is more costly when plaintiffs face more obstacles to invalidate the transaction.<sup>216</sup> On the other hand, in public enforcement mechanism, the law tries to prevent abusive related party transactions through the

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<sup>212</sup> . Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer: “The law and economics of self-dealing,” *Journal of Financial Economics* 88, 2008, p.2.

Available @ [http://www.economics.harvard.edu/faculty/shleifer/files/self\\_dealing.pdf](http://www.economics.harvard.edu/faculty/shleifer/files/self_dealing.pdf)

<sup>213</sup> . Ibid

<sup>214</sup> . Supra note 118, p.27. In short, it is stated that “The damage is not confined to any fines or other regulatory sanctions that might be imposed in respect of related party breaches. Indeed the most lasting consequence of contentious related party transactions is often the long-term damage to the reputation of the companies and individuals involved.” See Supra note 153, p.1

<sup>215</sup> . Supra note 79, p.18

<sup>216</sup> . Supra note 212, p.8

provisions of sanctions against the controlling shareholder and those who approved the transaction in violation of the law.<sup>217</sup> Besides, the public enforcement mechanisms are supposed to enable the victim of abusive related party transaction with some remedies. In particular, the role of courts here is important in several ways. For instance, in many countries laws, courts can review related party transactions.<sup>218</sup> Besides, improving the use of courts by companies and shareholders to solve disputes promotes better protection of shareholder rights.<sup>219</sup> However, they are in practice less willing to review decisions approved by independent board of director.<sup>220</sup> Therefore, though there are different mechanisms of enforcement of the regulation in related party transactions, court may be preferred in many countries mainly because it has wider enforcement powers and discretions. Particularly, court can impose civil and criminal sanctions, request evidence from different sources, summon witnesses, and enforce decisions. In addition, some countries such as France have established specialized courts with magistrates that got training in this area. The implication here is that some lessons should be taken from France. Yet, it is provided that in countries with a weak legal system, this will not properly work. This is because there will be serious limitations in the latter case due to slow and unspecialized courts.<sup>221</sup>

#### 4.2. Remedies and Sanctions<sup>222</sup>

Some points should first be said in relation to sanctions and corrective measures in general. Thus, it is stated that sanctions and corrective actions have two main functions: they should prevent/deter individuals or institutions from violating regulatory provisions

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<sup>217</sup> . Ibid

<sup>218</sup> . Supra note 134, p.14

<sup>219</sup> . Supra note 79, p.18

<sup>220</sup> . Supra note 134, p.14

<sup>221</sup> . Suzanne Smith: "Self-Dealing: Sneaking Corporate Value through the Back door," Note Number 312, September 2006, p3.

Available @ [http://rru.worldbank.org/documents/publicpolicyjournal/312Nenova\\_Hickey.pdf](http://rru.worldbank.org/documents/publicpolicyjournal/312Nenova_Hickey.pdf)

<sup>222</sup> . Note here first that the remedies and sanctions in case of abusive related party transactions are the two sides of a coin. This is because while the remedy tries to discuss abusive related party transactions from the context/side of the victim of such transactions, the sanctions considers such transactions from the context/side of the wrong doer. Thus, the discussion on the remedies and sanctions are not mutually exclusive of each other. They are rather inclusive of each other in that one cannot be meaningful without the other.

and they should help to cure/remedy the problem which has been created by the violation of regulations. However, the serious problem with both sanctions and corrective actions is regulatory forbearance. This is because as soon as prevention has not properly worked, in some cases, the regulator might prefer not to make the problems public; it may rather prefer to “sweep them under the carpet.” But, this problem can be solved, for instance, by clearly providing the appropriate corrective actions which should be taken as a reaction to such violations.<sup>223</sup> Generally, when there is/are violation(s) of a regulation on related party transactions, in many countries, some sanctions will be taken against the violator and some remedies will be available to the victim of such violation in general. For example, the measures include: administrative, civil and criminal sanctions and remedies. Similarly, in many countries such as Croatia, Serbia and Bulgaria, the violation of existing provisions and prohibitions to related party transactions result in severe sanctions. For instance, from the perspective of criminal sanction, the violations constitute criminal offence and carry fines or imprisonment, and from the standpoint of civil law, the transactions are considered null and void. Thus, the applicable sanctions may be: civil sanctions, administrative sanctions and criminal sanctions.<sup>224</sup> One or more of the above sanctions are applicable in violation of the requirements of: disclosure, reporting, approval of related party relationship, related party transaction and existence of conflict of interest.<sup>225</sup> However, mention should be made that the applicability of a sanction for breaching related party transactions provisions does not depend on whether the transaction caused any damage to the company.<sup>226</sup>

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<sup>223</sup> . Supra note 120, p.41

<sup>224</sup> . Supra note 99, p.5

<sup>225</sup> . Ibid, 16

<sup>226</sup> . Ibid, p.17

#### **4.2.1. Remedies**

Even if there may be several remedies with regard to abusive related party transactions, specific discussion will be made below on administrative, civil and criminal remedies.

##### **4.2.1.1. Administrative remedies**

The administrative remedies are considered from the side of the victim of abusive related party transactions. Thus, the remedies are the rights of the victim to request the concerned organ to take one or more of the following measures: suspension or removal of individual directors or the whole board, issuing of warnings and, as a next step, policy directives with specific instructions, taking over of management, putting the institution under receivership, revoking the license and liquidation of the institution.<sup>227</sup>

##### **4.2.1.2. Civil remedies**

Shareholders should be given some rights to monitor the abuse of related party transactions in general. But, more importantly, shareholders should have some of the following rights. They include the right to request a court to: prohibit an abusive related party transaction from occurring, that is, obtain an injunction, instruct directors to cease undertaking an abusive related party transaction and ensure that profits derived from an abusive related party transaction are repaid to the company.<sup>228</sup> On the other hand, it will be important to briefly discuss on the issue of the remedy available to claimants when there is no approval or no proper approval of related party transactions. Generally, the available remedy may be either to nullify the transaction or to request for damages.<sup>229</sup> Specifically, the threat of nullification serves to protect investors by encouraging ex ante disclosure of conflicted transactions to shareholders and this can increase their ability to take action against these transactions through, for example, an injunction. Nonetheless,

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<sup>227</sup> . Supra note 120, p.41

<sup>228</sup> . Supra note 32, p.35. In general, it can be said that the following remedies are available in abusive related party transactions, tunneling and/or self-dealing: liability suits, nullification of shareholder and board meeting resolutions (nullification suits), appointment of a special auditor and nullification of conflict of interest transactions. But, liability suit is the most common remedy here. Besides, the remedies in liability suits include class suits, derivative suits and individual suits.

<sup>229</sup> . Supra note 79, p.17

the strength of the ex post damages remedy is that it directly benefits the party that has suffered damage. But note here that there are several differences among countries in their choice of damages remedies for unapproved related party transactions.<sup>230</sup> On the contrary, the practice in several countries such as in Russia shows that most related party transaction cases involve plaintiffs seeking to reverse transactions. Thus, it is suggested that when choosing between the threat of nullification and damages, governments need to balance the potential benefits in order to move toward an optimal policy. On the one hand, nullification can be costly to both the conflicted internal party who failed to obtain bona fide prior approval and to third parties who perhaps were involved in the transaction in good faith. In contrast, other countries rely on the ex post damages remedy depending on the willingness of shareholders to undergo reasonable costs to bring actions and the quality of the courts to enforce the law.<sup>231</sup> Finally, it is important to mention here what the Russian regulation on the related party transaction provides in relation to the cost of enforcement of claims of victims of unapproved or not properly approved related party transactions. It is provided that “Whatever the means chosen to challenge unapproved or inappropriately approved related party transactions, the Russian government needs to ensure that the transaction costs are not too high for injured parties to enforce their claims.”<sup>232</sup>

#### **4.2.1.3. Criminal remedies**

The criminal remedies generally here are in relation to the right of the victim to see that the violator of the regulation in related party transaction is held liable criminally. Particularly, the remedy to the victim is to file a criminal charge against the violator in such case. For example, in Italy, public prosecutors can only start prosecutions for this crime if the victim files a charge against the directors. But, note here that, until recently, the common view was that shareholders were not considered as victims of the crime. This

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<sup>230</sup> . Ibid, p.16

<sup>231</sup> .Ibid, p.17. However, it should be noted that in some countries such as Russia, there is a tendency of courts to refuse shareholders' claims because the shareholders cannot prove that the resulting damages were directly caused by the related party transaction.

<sup>232</sup> . Ibid

was because there was the presumption that an abuse of corporate assets only harms directly the corporation so that shareholders' indirect damage was regarded as irrelevant for criminal law purposes. However, a recent Supreme Court case included shareholders among crime victims, so that now they may file a charge and also petition the criminal court for a conviction to damages suffered *qua* shareholders from the disloyalty i.e. their pro rata share of the total damage caused by the related party transaction to the corporation.<sup>233</sup>

#### 4.2.2. Sanctions

Generally, sanctions will be followed when there is violation of the regulation in general and related party transactions in particular. In this regard, it will be important to look at some of following lists of sanctions that are used in some countries: fines, imprisonment, suspension or removal of individual directors or the whole board, issuing of warnings and, as a next step, policy directives with specific instructions, taking over of management, putting the institution under receivership, revoking the license and liquidation of the institution.<sup>234</sup> On the other hand, it should be made clear that in case of violation of regulations on related party transactions, the person to be sanctioned will be either the institution, by paying a fine, or individuals via imprisonment or both. It is important to specifically mention here that in Indonesia, it is common practice for owners of companies to require management and/or staff to reimburse the company for some or all of any penalties imposed by the supervisor. But, in some countries such as Honduras, for some offences such as concealing the real financial condition of a company, managers or directors are held liable personally.<sup>235</sup>

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<sup>233</sup> . Supra note 115, p.35

<sup>234</sup> . Supra note 120, p.41. However, it should also be noted that, in some countries, the supervisory authority cannot impose all sanctions on its own, but needs an order from a court. For instance, it is mentioned that In Ghana, a petition to the High Court is required in order to liquidate a bank.

<sup>235</sup> .Ibid, p.42.

#### 4.2.2.1. Administrative sanctions

Administrative sanctions normally apply to cases in which the related party acting in breach of the rules governing related party transactions is a supervised company. It can extend to withdrawal of the authorization.<sup>236</sup> Besides, in some states, one or more of the following administrative sanctions can be taken: suspension or removal of individual directors or the whole board, issuing of warnings and, as a next step, policy directives with specific instructions, taking over of management, putting the institution under receivership, revoking the license and liquidation of the institution.<sup>237</sup> On the other hand, regulators in some countries are given the discretion to impose administrative measures, such as fines and other more severe sanctions, to ensure compliance. The importance of enforcement mechanisms to meet regulatory goals is confirmed by recent cross-country studies that show how the quality and effectiveness of disclosure regulation depends on the willingness of regulators to establish procedures and undertake enforcement actions against parties that are in breach of the law.<sup>238</sup>

#### 4.2.2.2. Civil sanctions

Generally, related parties can be held liable for losses caused to the company because of a transaction that was concluded in violation of procedural requirements and other substantive provisions. Similarly, if several persons are responsible for losses, they are jointly and severally liable.<sup>239</sup> On the other hand, some states provide that a “related party transaction for which approval has not been obtained or for which approval has been denied shall be voided, terminated or amended, or such other actions shall be taken, in each case as determined by the relevant law or organ, in order to avoid or otherwise address any resulting conflict of interest.”<sup>240</sup> Specifically, civil sanctions consist mainly in the cancellation of the transaction or the possibility to claim in court the cancellation of

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<sup>236</sup> . Ibid, p.17

<sup>237</sup> . Ibid, p.41

<sup>238</sup> . Supra note 79, p.p. 15-16

<sup>239</sup> . Supra note 105, p.32

<sup>240</sup> . NYSE EURONEXT: “Related Party Transactions Policy,” p.4.

Available @ [http://www.nyse.com/pdfs/Related\\_Party\\_Policy\\_v3.pdf](http://www.nyse.com/pdfs/Related_Party_Policy_v3.pdf)

the transaction performed in violation of the relevant legal provisions.<sup>241</sup> There are cases when the civil sanctions are applicable by virtue of the law, for example, when there is a specific provision to the effect that the transactions performed in breach of the provisions regarding the reporting of related party transactions are considered null and void. In other cases, the interested persons are entitled to file a court action for the cancellation of a transaction performed in breach of the reporting rules.<sup>242</sup> In addition, a court may nullify a related party transaction in a legal action filed by the company or a shareholder if procedural requirements were violated. But, note here that some countries, especially western countries, also try to protect the interest of the company's counterparts in related party transactions. That is, when the company wants to invalidate a transaction that was not concluded in arms length basis, then this may create undue problems for the counterpart in some cases. Thus, in such countries, in order to invalidate the transaction, the company needs to prove that the counterpart in the transaction knew or must have known of the irregularity of its approval.<sup>243</sup>

#### **4.2.2.3. Criminal Sanctions**

Criminal sanctions apply mainly to violations of clear prohibitions against the conclusion of related party transactions. However, in certain cases, criminal sanctions apply to violations of rules governing reporting of related party transactions.<sup>244</sup> In abusive related party transactions, they include penalty, both prison and fine. It is obvious that the length of prison and the amount of fine will be different in different countries. For example, in France the penalty is a prison term of up to five years.<sup>245</sup>

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<sup>241</sup> . Supra note 99, p. 17

<sup>242</sup> . Ibid

<sup>243</sup> . Supra note 105, p.32

<sup>244</sup> . Supra note 99, p. 17

<sup>245</sup> . Supra note 115, p.p. 30-31. In France, the minority shareholder, acting derivatively in the name of the company, can initiate a criminal prosecution by filing a criminal complaint with the Dean of the Examining magistrates of the civil first degree court.

### 4.3. Shareholders Direct, Derivative and Class Actions

In this subunit, attempts will be made to discuss the specific means of enforcement of related party transactions through shareholders direct, derivative and class actions/ suits. It is generally stated that shareholders can sue the corporations in which they are shareholders in two different ways: direct shareholder suits and derivative shareholder suits.<sup>246</sup> Similarly, it is also provided that there are mainly two legal means of shareholder redress in relation to abusive related party transactions: class actions or derivative suits.<sup>247</sup> It should be noted here that class actions are shareholders direct actions. But, the idea here is there is plurality of the shareholders in the action so that there is a representative litigation.

#### 4.3.1. Shareholders Direct and Derivative Actions

Shareholder(s) direct action refers to a claim or suit instituted by a shareholder(s) to remedy a personal injury suffered by that shareholder(s). The purpose of a direct shareholder suit is to compensate a shareholder for suffering a harm that the corporation itself has not suffered. Thus, because of the exclusivity of the harm to the shareholder(s), courts allow shareholder(s) to sue the corporation directly on his or their own right and name(s).<sup>248</sup> Thus, in such case, the court awards all compensation directly to the shareholder(s) participating in the action. However, derivative suits refer to those suits instituted by shareholders in the name and on behalf of a company. It can also be defined as a lawsuit initiated by a shareholder to enforce a corporate cause of action against officers, directors and third parties when the corporation has failed or refused to assert its rights in this regard.<sup>249</sup> The shareholders here allege that the company's directors or

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<sup>246</sup> . Elizabeth J. Thompson: “Direct Harm, Special Injury, or Duty Owed: Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigation?” Journal of Corporation Law, Vol. 35:1, 11/16/2009, P.3. Available@[http://www.ilep.info/pdf/univ\\_of\\_iowa/2009/%28A12%29%20Thompson.pdf](http://www.ilep.info/pdf/univ_of_iowa/2009/%28A12%29%20Thompson.pdf)

<sup>247</sup> . Supra note 32, p.34

<sup>248</sup> . Supra note 246, p. 5.

<sup>249</sup> . Edward T. Kole and M. Matthew Mannion: “Complex Litigation: Fighting Claims of Corporate Wrongdoing,” New Jersey Law Journal, Vol. CLXXII – No. 4 – Index 299, April 28, 2003, p.1. Available@<http://www.wilentz.com/Files/ArticlesandPublicationsFileFiles/27/ArticlePublicationFile/ComplexLitigation-FightingClaimsOfCorporateWrongdoing.pdf>

officers violated one or more of their fiduciary<sup>250</sup> duties to the company and its shareholders. In such actions, the plaintiff shareholders do not claim monetary damages, but rather they want to protect their long-term interest in the company by imposing corporate governance and management changes. Thus, if they win the case and if there is a monetary compensation, this compensation goes to the company, not to the individual plaintiffs.<sup>251</sup> Hence, this concept and practice was developed by courts to enable shareholders' to protect their investments. In general, derivative action began and developed in both United States and English courts. In particular, the first United States derivative action "where [a court permitted] a shareholder . . . to sue to compel the directors to restore corporate assets taken in violation of their fiduciary duty" was *Taylor v. Miami Exporting Co.*, an Ohio case in 1831.<sup>252</sup> After this case, there developed famous English case between Foss and Harbottle in 1843, which is regarded as a leading English precedent in corporate law.<sup>253</sup> This latter case developed the rule or principle that "In any action in which a wrong is alleged to have been done to a company, the proper claimant is the company itself," and this principle is termed as the 'rule in Foss and Harbottle' and the several important exceptions that have been developed are often described as "exceptions to the rule in *Foss vs. Harbottle*". Derivative action is one of such exceptions.<sup>254</sup> Thus, we can see that the derivative action is an exception to the right of the company to institute an action on its own right, name and behalf and that the case between Foss and Harbottle is not a derivative action by itself but it laid down the foundation for the development of derivative action. In general, it should be noted that

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<sup>250</sup> . Dave Bradford (Ed.): "Shareholder Derivative Suits: A Growing Concern for Corporate Directors and Officers," *Insight for Insurance Professionals*, July 2005, p.1.

Available@[http://www.cnapro.com/pdf/ShareholderDerivativeSuits\\_Advisen.pdf](http://www.cnapro.com/pdf/ShareholderDerivativeSuits_Advisen.pdf)

It should be mentioned here that there exist two wider categories of breach of fiduciary duty that underlie derivative actions: duty of loyalty and duty of care. Duty of loyalty means that a director or officer may not profit at the expense of the company, rather, he/she must put the company's interests first. But, suits seeking relief under the duty of care allege that a company's directors or officers failed to manage corporate affairs honestly and in good faith. In either case, the burden is on the plaintiff to demonstrate a violation has occurred. Breach of duty of loyalty is relatively easier to prove in general.

<sup>251</sup> . Ibid

<sup>252</sup> . Amy M. Koopmann: "A Necessary Gatekeeper: The Fiduciary Duties of the Lead Plaintiff in Shareholder Derivative Litigation," *Journal of Corporation Law*, Vol. 34:3, 3/31/2009, P.4.

Available@ <http://www.uiowa.edu/~lawjcl/articles/volume%2034-3/%28A7%29%20Koopmann.pdf>

<sup>253</sup> . Case opinions by Wigram VC: "Foss vs. Harbottle," (1843) 67 ER 189, (1843) 2 Hare 461, Wikipedia, the Free Encyclopedia. Available@ [http://en.wikipedia.org/wiki/Foss\\_v\\_Harbottle](http://en.wikipedia.org/wiki/Foss_v_Harbottle)

<sup>254</sup> . Ibid

the distinction between shareholder derivative and direct suit is related to the existence of the separation of the personality of the entity from that of its shareholders.<sup>255</sup> One of the major effects of not making a distinction between the derivative and direct action is that the risk of dismissal of the action by preliminary objection.<sup>256</sup>

#### **4.3.2. Shareholders Derivative vs. Class Actions**

Class actions refer to “Those suits which are instituted by shareholders when there is an alleged negligence or fraud committed by company directors or officers which may cause a loss to shareholder value. For example, the suits against Enron and World.Com can be mentioned here.<sup>257</sup> It should also be mentioned that the plaintiffs in class actions represent both their own interests and the interests of the other class members. Hence, like shareholder derivative actions, class actions are representative litigation. Besides, the members of the class action receive the compensation if the suit is successful or the parties reach a settlement.<sup>258</sup> Normally, derivative actions and class actions are different. Such differences include who is injured, who receives the recovery, and who is involved in the decision to bring the action. Yet, they are similar in that both involve representative litigation. And, in representative litigation “the named parties represent others similarly situated.’ In such cases, it is stated that the lead plaintiff plays an important role because this plaintiff in “a class or derivative action has undertaken to act on behalf of the class or the corporation and is treated as a fiduciary, but is not subject to the control of the class or corporation.”<sup>259</sup> Note should be made that some consider “a derivative action is actually two causes of action<sup>260</sup> it is an action to compel the corporation to sue and it is an action brought by a shareholder on behalf of the corporation to redress harm to the

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<sup>255</sup> . Daniel S. Kleinberger: “Direct Versus Derivative and the Law of Limited Liability Companies,” Faculty Scholarship, Paper 233, 2006, p.8.

Available@<http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1038&context=wmlr>

<sup>256</sup> .Ibid

<sup>257</sup> . Supra note 250

<sup>258</sup> . Supra note 252, p.p.8-9

<sup>259</sup> . Ibid, p.5

<sup>260</sup> .Supra note 249. It is also described as “double suits” or “two suits in one”

corporation.” Derivative actions stand in contrast to class actions, which are direct actions.”<sup>261</sup>

But, it should be regarded that in many countries, derivative suits are provided, but not class action suits. This is, for example, the case in both China and Hong Kong. Even though a derivative suit provides some redress for shareholders, it has some constraints. One of its constraints is that monetary awards resulting from a successful litigation would belong to the company and not shareholders directly and this discourages shareholders generally. The other constraint is the risk of the free-rider problem, that is, that a lead claimant’s compensation awards would be shared equally by all shareholders.<sup>262</sup> Besides, there are some problems to an effective class action/derivative suit mechanism. Such problems include: access to proper information, shareholder sophistication, and cost. Moreover, others observe that the wording of the law with regard to the burden of proof is of important concern because the focus on the burden of proof will determine whether minority shareholders make effective use of the mechanism judiciously, or are discouraged from effectively using it based on the legal wording.<sup>263</sup> The implication here is that the legal provision should be drafted in a way that enables shareholders to effectively use these legal remedies in case of violation of the regulation of related party transactions. Thus, there shall be some measures that enable the use of such suits or remedies easy. The practice of Israel shall be briefly discussed in this regard. This is because Israel has devised some instruments which enable the regulator to financially support derivative suits in addition to class actions by individuals for breaches of duty by directors and damages arising from related party transactions .With respect to derivative suits, the support concerns the main issue that there is no financial incentive for shareholders to initiate a court process, the costs of which they invariably bear alone if the case is lost. More importantly, the resolution of such suits has been facilitated by the establishment of a special department of one of the courts which will hear, amongst

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<sup>261</sup> . Supra note 252. But, note that shareholder derivative suits are increasingly instituted together with class action suits.

<sup>262</sup> . Supra note 32, p.34

<sup>263</sup> .Ibid

others, such cases. For instance, in its first decision in May 2011, the court ruled that despite passing the approval process related party transactions still needed to pass a fairness test: the minority shareholders were entitled to the best possible price.<sup>264</sup> In conclusion, due attention should be given to enforcement in general and enforcement of shareholder rights in particular. But, the fact shows that such enforcement appears to be inadequate in the world. However, there are some attempts in several countries to establish specialised courts and in a few countries the regulators are now trying to offset legal fees for derivative shareholder actions.<sup>265</sup> Stated in other words, all rights need enforcement which may be public or private. But, the practice of enforcement is weak generally. This is because very few cases are brought each year in some countries. In particular, derivative law suits are rare since financial incentives are lacking in that litigants might have to cover all the costs of the action but awards are paid to the company. However both Israel and India have taken or proposed to take steps to improve the situation. For example, in Israel a specialised court has been established and the regulator can and does support derivative and other actions financially. On the other hand, in India the security regulator established a fund to support derivative suits financially. Finally, France has some limited powers of discovery in which a judge can require the release of documents to litigants.<sup>266</sup> Thus, it is generally suggested that these attempts be followed by other countries.

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<sup>264</sup> . Supra note 118, p.p.28-29

<sup>265</sup> . Ibid, p.11

<sup>266</sup> . Ibid, p.16

## **Chapter Five- Regulation of Related Party Transactions in the Financial Sector in Ethiopia: with special focus on Banks**

In the present chapter, the discussion is specific to Ethiopia and it will be mainly on the regulation of related party and related party transactions in the financial sector in Ethiopia, especially on banks<sup>267</sup>, insurance and microfinance institutions. The emphasis here will be to deal with the relevant laws with regard to the concepts and regulation of related party transactions. Thus, in this chapter, efforts will be made to deal particularly with: What constitutes related party in Ethiopia, whether or not there is a definition for related party transactions in Ethiopia, whether or not there is a requirement of disclosure, reporting and approval or ratification of related party transactions, whether or not the arms length exception is available in Ethiopia, the specific organ that has the power or duty to identify the existence of related party transactions in the financial sector in general and in banks in particular, the enforcement methods and the remedies and sanctions in case of abusive related party transactions in the financial sector in Ethiopia, the concepts of derivative and class actions and finally, whether or not regulation of related party transactions in Ethiopian financial sector is adequate.

### **5.1. Introductory Remarks**

Here it should be clear first that the notion of ‘financial sector’ in general and in Ethiopia in particular is a broad concept. Besides, even if there is no direct definition for the phrase ‘financial sector’ in Ethiopia, the definition for ‘financial institution’ can be used here as having similar meaning. Thus, article 2(6) of the Micro-Financing Business Proclamation No. 626/2009(hereinafter called Proclamation No. 626/2009) defines ‘financial institution’ as referring to “insurance company, bank, micro-financing institution, postal savings, money transfer institution or such other similar institution as determined by the National Bank.”<sup>268</sup> Despite the above broad definition for the financial

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<sup>267</sup> . Nevertheless the discussion will focus on banks for two main reasons. First, clear attempt is made in the regulation of related party in banks in Ethiopia. Second, the banking sector is more important and risky than the other two financial sectors in Ethiopia.

<sup>268</sup> . The same definition is also available in article 2.4 of Requirements for Persons with Significant Influence in a Bank Directives No.SBB/54/2012. However, the Amendment for New Bank Licensing and Approval of Directors and CEO Directive No.SBB/39/2006 defines financial institution as referring to

institution and thus, financial sector, the discussion in this paper, especially in this chapter, is limited to banks, insurance and microfinance institutions.<sup>269</sup>

### The Licensing and Supervision of Banking Business Proclamation

No.84/1994<sup>270</sup>(hereinafter called Proclamation No.84/1994) allows the private sector (but, all owners should be Ethiopian nationals only) to engage in the banking and insurance businesses and it marks the beginning of a new era in Ethiopia's financial sector. Thus, after its enactment, there were increases in the number of private banking and insurance companies in Ethiopia in general.<sup>271</sup> In particular, there are currently more than 17 banks operating in Ethiopia including the Development Bank of Ethiopia.<sup>272</sup> Besides, there are 14 insurance companies operating in Ethiopia currently.<sup>273</sup> There are some relevant laws in Ethiopia which deal with the issue of related party and related party transactions. The main laws include the Commercial code of Ethiopia, the Income Tax Proclamation No.286/2002( hereinafter called Proclamation No.286/2002) and the Credit Exposures to Single and Related Counterparties Directives No.SBB/53/2012 (hereinafter called Directives No.SBB/53/2012). Their discussion is presented in different subunits below. But, before going to discuss other specific issues, it will be important to mention first that a study conducted on the “Reports on the Observance of Standards and Codes in Ethiopia” in 2007 concluded the following: enforcement mechanisms of financial reporting requirements are non-existent because of lack of capacity in regulatory institutions and the absence of penalties in the regulations in Ethiopia,<sup>274</sup> there

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insurance companies, banks, microfinance institutions and such other institutions as determined by the Bank.

<sup>269</sup> . In Ethiopia it is only share companies that can engage in banking and insurance and microfinance institutions. This is clearly provided in article 513 of the commercial code of Ethiopia, article 4(b) of licensing and supervision of microfinance institutions proclamation no. 40/1996 and article 2(3) of Proclamation No. 626/2009) activities.

<sup>270</sup> . But this Proclamation is now repealed and replaced by the Banking Business Proclamation No.592/2008

<sup>271</sup> . Supra note 161, p.10

<sup>272</sup> . Supra note 32, p.1. Generally, it is stated that the public banks, especially the Commercial Bank of Ethiopia, are more dominant than the private banks. However since recently there is general tendency that private banks are catching up quickly with the public banks in Ethiopia. See Supra note 59, p.11

<sup>273</sup> . Supra note 182, p.2

<sup>274</sup> . Reports on Observance of Standards and Codes in Ethiopia: “Accounting and Auditing,” November 2007, p.1. Available @ [http://www.worldbank.org/ifa/rosc\\_aa\\_ethiopia.pdf](http://www.worldbank.org/ifa/rosc_aa_ethiopia.pdf)

are no extra requirements for banks and insurance companies for preparation of their annual financial statements in Ethiopia<sup>275</sup>, auditors for insurance companies are not subjected to any additional requirements other than the provisions of the Ethiopian Commercial Code<sup>276</sup>, Ethiopia has not yet experienced litigation on financial reporting<sup>277</sup>, there are no penalties for non-compliance with the requirements on accounting and financial reporting<sup>278</sup> and the accounting practices in Ethiopia vary among institutions and differ from International Financial Reporting Standards.<sup>279</sup>

## 5.2. The Legal Framework

Before discussing on the Directive No.SBB/53/2012, it will be important to deal briefly with the Amendment of Single Borrower Loan Limit Directive No.SBB/29/2002 (hereinafter called Directive No.SBB/29/2002) and the Amendment of Limitation on Loans to Related Parties Directive No.SBB/30/2002 (hereinafter called Directive No.SBB/30/2002). This is because, the latter two Directives are the basis for the former Directive, even if they are now repealed and replaced by the former Directive. In general, Directive No.SBB/29/2002 has some relevance in the discussion of related party transactions in Ethiopia in that it contains several provisions similar to the Directives No.SBB/30/2002 and SBB/53/2012. Thus, this Directive served as a basis for the latter two Directives. Particularly, the following provisions should be mentioned here. For instance, article 3 of the above Directive talks about the combination of loans. The presumption behind combining the loans may be due to the possibility that the persons mentioned above will be related parties so that they will be considered as one borrower for the purpose of loan limit. Besides, article 4 of the Directive talks about single borrower loan limit and it specifically provides that the aggregate loan or extension of credit by a bank to any one borrower shall at no time exceed 25% of the total capital of the bank. However article 5 of the same Directive makes it clear that the above limit will

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<sup>275</sup> . Ibid, p.7

<sup>276</sup> . Ibid

<sup>277</sup> . Ibid, p.10

<sup>278</sup> . Ibid, p.12

<sup>279</sup> . Ibid, p.13. Note however, that there are some developments in Ethiopia after this study.

not be applicable in case where the loans are fully secured by cash collateral and[or] the loans are fully secured by cash substitutes. Finally, article 6 of the above Directive deals with reporting requirement. From this provision, it could be inferred that not all loans to single borrower are required to be reported; it is only those loans to a single borrower which is greater than 10% of the total capital of the lending bank. In general, it can be safely said that, except for minor changes, the ideas in the above provisions of Directive No.SBB/29/2002 are also contained in Directive No.SBB/30/2002 and Directive No.SBB/53/2012.

On the other hand, Directive No.SBB/30/2002 contains several provisions the same with Directives No.SBB/53/2012 on related party transactions in banks in Ethiopia. For example, article 3 of Directive No. SBB/30/2002 deals with the threshold of a shareholder to be considered as related party, article 4 with limitations of loans in general, article 5 with exclusion of the loan limitations provided in article 4 above, article 6 with the duty of identifying related party transactions in banks and finally, article 7 with the reporting requirement of related party transactions in banks. Generally, it could be concluded here that the provisions of this Directive are almost exactly available in Directives No.SBB/53/2012. Their differences is mainly while Directive No.SBB/30/2002 talks about ‘banks in Ethiopia in general’, Directives No.SBB/53/2012 is confined to ‘commercial banks’ in particular. Besides, they are different in the threshold in considering a shareholder as a related party in that the threshold in the first Directive is a share holding of 5% or more of the subscribed capital of a bank whereas in the latter Directive the threshold is a share holding of 2% or more of the subscribed capital of a commercial bank. Otherwise, these two provisions are almost the same. On the other hand, Directives No.SBB/53/2012 is one of the most relevant laws in force in the regulation of related party transactions in the Ethiopian banking sector. Thus, more or less the provisions provides in the above two Directives are also contained in it. Having the above discussions in mind, there is a wider consensus in many countries currently that all related party transactions should be tightly regulated and transparently reported in general. Thus, some attempts will be made to examine how related party transaction is

regulated in the Ethiopian financial sector by looking at the laws that have relevance to the discussion.

## **5.2.1. Definitions of Related Party and Related Party Transaction in Ethiopia**

### **5.2.1.1. Definition of Related Party**

Though Proclamation No.286/2002 is directly relevant for income purposes, the definition provided in this Proclamation may be relevant to some extent in the definition of related party in the financial sector discussed in this subunit. It contains some provisions about related party. In particular, article 2(4) reads: “Related person” means:

- (i) A natural person and, (a) Any relative of that natural person or (b) a trust in respect of which such relative is or may be a beneficiary or
- (ii) A trust and a person who is or may be a beneficiary in respect of that trust; or
- (iii) A partnership, joint venture, or an incorporated association or body or private company and (a) any member thereof; or (b) any other person where that person and a member of such partnership, joint venture, or an incorporated association or body, or private company as the case may be, are related persons in terms of this definition; or
- (iv) An incorporated company, other than a closed
  - (a) a person, other than an incorporated company, where that person and a person related to the first mentioned person in terms of this definition controls 10 percent or more of
    - (i) the right to vote in the first mentioned company or (ii) the rights to distributions capital or profits of the first-mentioned company, either directly or through one or more interposed companies, partnerships, or trusts; or
    - (b) any other incorporated company in which the first mentioned person referred to in (a) or that person and a person related to that first mentioned person in terms of this definition controls 10 percent or more of
      - (i) The right to vote in the first mentioned company, or (ii) The rights to distributions of capital or profits of the first-mentioned company, either directly or through one or more interposed companies, partnerships, or trusts; or

- (c) Any person where that person and the person referred to in (a) or the other incorporated company referred to in (b) are related persons in terms of this definition; or
- (d) Any person related to the person referred to in (c) in terms of this definition.

Besides, article 4(5) of the same proclamation defines relative as follows: “Relative” in relation to a natural person means:

- (i) the spouse of the person or (ii) an ancestor, lineal descendant, brother, sister, uncle, aunt, nephew, niece, stepfather, stepmother, stepchild, or adopted child of that person or of the spouse, and in the case of an adopted child the adoptive parent; or (iii) the spouse of any person referred to in paragraph (ii) and for the purposes of this definition, an adopted child is treated as related to her adoptive parent within the first degree of consanguinity.

Generally, it can be inferred that the definition of related party in Proclamation No. 286/2002 is broader than Directives No.SBB/53/2012.

Similarly, Directives No.SBB/53/2012 provides the definition of related party in banks. Particularly, article 3.7 of this Directive defines a related party to a commercial<sup>280</sup>, bank in two ways. Thus, in one hand, a related party to a commercial bank shall mean “A shareholder, a director, a chief executive officer or a senior officer of that commercial bank<sup>281</sup> and/or the spouse or relation in the first degree of consanguinity or affinity of such shareholder, director, chief executive officer or senior officer,” and on the other hand, “A partnership, a common enterprise, a private limited company, a share company, a joint venture, a corporation or any other business in which the shareholder, the director, chief executive officer or senior officer of the commercial bank and/or the spouse or relation in the first degree of consanguinity or affinity of such shareholder, director, chief executive officer or senior officer has a business interest as shareholder, director, chief

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<sup>280</sup> . Article 3.4 of this Directive defines commercial bank as “a bank licensed by the National Bank which is engaged mainly in deposit mobilization, short term commercial lending and international banking. The term excludes institutions established mainly to engage in medium and long term project financing, with the purpose of promoting in the industrial, agricultural, construction, services, commercial or other economic sectors.”

<sup>281</sup> . All these persons are called ‘ persons with significant influence’ as can be seen from article 2.10 of Requirements for Persons with Significant Influence in a Bank Directives No.SBB/54/2012 which provides that ‘persons with significant influence’ are influential shareholders, directors, chief executive officers and senior executive officers of a bank.

executive officer or senior officer, owner or partner.” Similarly, article 2.6 of Directive No.SBB/30/2002 defines related party. In this regard, there is no difference between the above two Directives except for the use of ‘chief executive officer or senior officer’ in the former Directive and ‘principal officer’ (and its omission in the last paragraph) in the latter Directive.<sup>282</sup> From the above definitions, the following points can be made. While the first part of the definition refers to the individual related parties, the second part of the definitions refers to legal entities. But, the definition of related party provided above is very narrow in general and in the first part of the definition in particular. This is especially true in that the wording of the definition does not look illustrative. The definition tried to make exhaustive lists of related parties. In this regard, some persons suggest that it is better to provide the principle of related parties, as in IAS 24, than listing the persons considered related parties. In Ethiopia, related party is defined narrowly. Even though, the reason for this is not really clear, the implication could be that the legislature does not want to limit the financial transactions between related parties on the guise of related party transactions.

Generally it can also be said that while IAS 24 sets the principle of related party, the Ethiopian laws, income tax proclamation, banking business directive and insurance business directive, make lists of related parties. Each has its own advantage and disadvantages. For example, the advantage of IAS 24 is it will better enable to fight abusive related party transactions by taking into account the spirit of the law regulating related party transaction. But, its disadvantage is that it may sometimes create a confusion on determining whether a given party or entity is a related party or not. However, the Ethiopian laws on the definition of related party have the advantage in terms of clarity. Yet their disadvantage will be that they are narrow so that they may not cover parties or entities which do not exactly fall in the definitions. This in turn may limit to fight abusive related party transactions.

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<sup>282</sup> . The Amendment for New Bank Licensing and Approval of Directors and CEO Directive No.SBB/39/2006 also contains the same definition of related party as in the latter Directive

### **5.2.1.2. Definition of Related Party Transaction**

Generally, the existing laws in Ethiopia do not clearly contain definition of related party transactions. In particular, there is no such definition in Directives No.SBB/53/2012. However, there are some laws which contain some concepts of related party transaction: Commercial Code of Ethiopia and Amendment for New Bank Licensing and Approval of Directors and CEO Directive No.SBB/39/2006 (hereinafter called Directive No.SBB/39/2006) can be mentioned and their brief discussion is presented below.

#### **A. Related Party Transaction in the Commercial Code**

Even if the titles do not clearly say related party and related party transactions, the Commercial Code contains some relevant provisions on these issues, under articles 356 and 357. Article 356 is about dealings between a company and its directors. The relevant sub-articles here read: (1) Any dealings made directly or indirectly between a company and a director shall receive the prior approval of the board of directors and notice shall be given to the auditors. (2) Approval and notice under sub-art.1) shall be required in respect of any dealings made between a company and another concern where one of the directors of the company is owner, partner, agent, director or manager of such concern.

The following points can be made with regard to the above article. In the first place, the term “any dealings....” shall be interpreted as equivalent to any transactions. Thus, we can easily understand that this article is concerned with the issue of related party transaction in general. This is because the company and its director are related parties to each other and any transaction between them is a self-dealing and hence, a related party transaction. Besides, where there is a transaction between a company and another entity where a director of the company is also owner, partner, agent, director or manager of the entity, the transaction is considered as related party transaction in that the company and the entity are related. Further, in so far as there is a transaction between them, the fact that the transaction was direct or indirect brings no any difference so that advance board of directors’ approval, excluding the interested director, is necessary. This article broadly deals with the issue of related party transactions. This is because the wording of “any dealings or transactions...” between the related parties signifies that this article is not

limited to one type of related party transaction. Thus, this provision should be understood to include several types of transactions. On the other hand, article 357 of the Commercial Code is particularly concerned with prohibition of loans to company directors. This provision reads: (1) Directors of a company other than bodies corporate may not borrow money from the company, obtain an overdraft in current account or have any obligation guaranteed in respect of business transacted with third parties. (2) The provisions of sub-article (1) shall not apply in respect of day to day business of a company which carries on banking business. It should be remembered that loan is one type of related party transaction. Thus, the relevant point in this provision here is that loan transaction between a company and its directors is recognized as one type of related party transaction in Ethiopia. But, note that the other provisions and comments on articles 356 and 357 of the Commercial Code are made in 5.2.2. This is because the attempt here is only to show that articles 356 and 357 of the commercial code of Ethiopia deal with some concept of related party transaction.

#### **B. Related Party Transaction in Directive No.SBB/39/2006**

Directive No.SBB/39/2006 requires the “Descriptions of actual purchases made or proposed purchases of goods and services, or lease of real estate by the bank from related parties.” From the above provision it could be safely said that this Directive has recognized some types of related party transactions such as: actual or proposed purchase of goods, actual or proposed purchase of services, or lease of real estate by the bank from related parties. Generally, even if the above laws and provisions are helpful, they still do not make clear the whole concept of related party transaction. So, it is the opinion of the author that we should take the definition provided in IFASB Statement No. 57. This is because it is an international standard definition and that the definitions provided by different national accounting standards adopt more or less this standard’s definition. Hence, if we accept this idea, related party transaction is defined as “a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.” This is the broadest definition so far for related party transactions in general. The author also comes up with another alternative. Thus, it would be possible to define related party transactions in Ethiopia, as any dealings made

between a company or institution and its related parties irrespective of whether a consideration is charged, related parties as defined in different laws of the country.

### **5.2.2. Regulation of Related Party Transaction on Banks in Ethiopia**

Let us begin the discussion with the role of banks and their proper regulation in Ethiopia. In this regard, the preamble of the Banking Business Proclamation No.592/2008(hereinafter called Proclamation No.592/2008) provides the importance of banks and their proper regulation as follows. “...banks play an important role in economic development through mobilization of funds from within and outside the country and channeling such funds to various sectors of the economy, banks occupy a central place in the payment and settlement system of the country’s economy, the business of banking has a number of attributes which, if not managed properly, has the potential to generate financial system and macroeconomic instability, the cost of financial system and macroeconomic instability to the general public and the Government is significant and it is essential to ensure safety, soundness and stability of the banking system by having a comprehensive law for the licensing and supervision of the banking business.” Thus, it should be clear that the regulation of related party and related party transactions in the banking sector in Ethiopia will be important. But, before going to the main discussion of the major laws, it will be important to raise the question: What is the purpose of regulation of related party transactions in the Ethiopian financial sector? With regard to banks, article 2 of Directives No.SBB/53/2012 provide that the main purpose of these Directives is to ensure that commercial banks have sufficiently diversified their credit risks so as to minimize loses because of failure of single or related counterparty to repay loans. Moreover, it will be significant here to ask the question: Why do we regulate related party transactions in the Ethiopian financial sector now? The same question was raised to my questionnaire participants and 22 out of 27 participants replied that related party transactions exist. 16 out of 27 respondents also gave their opinion that related party transaction is prevalent in the country in general. but, 6 respondents said they are not prevalent. But, while 8 respondents stated that they are abusive, 12 of them replied that they are not abusive transactions. Thus, no matter how small and valid the

above replies are, there is an indication that there are related party transactions in banks in Ethiopia currently. Particularly, the author has the opinion that there will be more related party transactions and their abuse in the Ethiopian financial sector when the request of Ethiopia for accession to the World Trade Organization is accepted. This may be because Ethiopia's membership will require further liberalization of the Ethiopian financial sector. This in turn, may enable many foreign companies to invest in Ethiopia and compete with the Ethiopian financial companies in general. Again, it is likely that the foreign financial companies will have parent, subsidiaries, or affiliate companies in their countries and/ or in Ethiopia. Thus, there may be transactions between the related parties and the need for the regulation of related party transactions will arise. This may be mainly due to the fact that abusive related party transactions may have a negative impact on the financial sector in Ethiopia in general. Therefore, it is good for the regulators to prepare themselves in advance in coming up with the detailed and proper regulation of related party transactions in the Ethiopian financial sector in general and the banking and the insurance companies in particular.

The next discussion will try to look at some relevant laws on regulation of related party transactions in banks in Ethiopia. The major laws include Directives No.SBB/53/2012 and Proclamation No. 592/2008. But, where appropriate, other laws such as: Directive No.SBB/39/2006, Directive No.SBB/29/2002, Directive No.SBB/30/2002 and the Commercial Code of Ethiopia will also be used. The major discussions are provided next briefly.

#### **A. Proclamation No.592/2008**

Though Proclamation No. 592/2008 is not directly concerned with related parties and transactions between them, there are some provisions implying the regulation of related party transactions. For example, we can see article 15(1) and (3) of this proclamation. Article 15 generally talks about prohibitions on the appointment of certain persons as officers, directors or employees of a bank. The relevant sub-articles of this provision are provided and discussed below as follows. Article 15(1) states that “No person who has

been convicted of any offence involving a breach of trust or a fraud, whether in Ethiopia or elsewhere may be a director or an employee of a bank.” On the other hand, article 15(3) provides “A director or chief executive officer of a financial institution may not, at the same time, serve as a director of a bank. Moreover, a business entity or a company in which such director or chief executive officer has ten percent or more equity interest may not serve as a director of a bank.” Article 15(1) is concerned with discouraging the acts of breach of trust and fraud. Thus, a person who has been convicted of breach of trust and/or fraud cannot be appointed as a director or an employee of a bank. This sub article makes it clear that there will be no difference whether such offence was committed in Ethiopia or elsewhere in so far as that person is convicted of such offence(s). Conversely, abusive related party transactions involve breach of trust or fraud when such act is committed by the insiders of the company such as a director or employee of the bank. This is because when the director does not act in accordance with his fiduciary duty or in due diligence and in the best interest of the company or when he commits fraudulent acts, there will be a breach of his duty or fraud. But, the conviction of such breach of trust or fraud is not a mandatory requirement in case of abusive related party transaction if related party is involved in such acts. The justification behind the prohibitions in article 15(3) could be because there will be conflict of interest between the bank and the concerned financial institution or because such director cannot serve best the interests of both the bank and the financial institution at the same time. Besides, if the director has greater than or equal to ten percent equity interest in another company, he cannot be a director in a bank, may be because the bank and the company will be related parties and conflict of interest will arise. The other relevant provision of Proclamation No.592/2008 with regard to related parties may be article 17(2) (b) which deals about the suspension or removal of a director, a chief executive officer or a senior executive officer of a bank. Thus, as per this sub-article, there will be a sufficient cause for the suspension or removal, by the National Bank of Ethiopia, of a director, a chief executive or a senior executive officer where there is “any action detrimental, in the opinion of the National Bank, to the stability or soundness of the financial sector, the economy or the general public interest carried out by a director, a chief executive officer or a senior executive officer a bank.” In this regard, it should be mentioned that abusive related party transactions are generally

detrimental to the financial sector in general and the banks and its shareholders in particular. Here one can easily infer that the engagement of a director, a chief executive officer or a senior executive officer in an abusive related party transaction in a bank will be at least against the interest of the bank and its minority shareholders. Article 26 of Proclamation No. 592/2008 which generally deals with the duties of auditors also incidentally recognized the arms length exception. This is particularly provided in article 26(3) which reads “A person appointed as an auditor of a bank may not operate an account with, or be granted any type of loan, advance or facility from that bank except in the normal course of business and at an ‘arm’s length’ basis.” This provision is relevant in the prevention of abusive related party transaction in the Ethiopian banking sector because the auditor of a bank should not be given a loan or other facility on preferential terms. But, this does not mean that the auditor is a related party as discussed in the definition of related parties. It can also be mentioned here that even if it is not clearly provided, article 54 of Proclamation No.592/2008 has recognized the arms length exception in the banking sector in Ethiopia as reflected in the phrase that the transactions between the bank and insurance companies “...shall be undertaken on the same terms and conditions as provided to any other person.” This is clearly the very concept of the arms length. Besides, article 54(1) of the above Proclamation has attempted to deal partly with some types of related party transactions as reflected in the expression “Transactions, including the provision of loans and advances, the acceptance of deposits and the provision of banking and insurance services, between banks and insurance companies....” This is because provisions of loans and advances, the acceptance of deposits and the provision of banking and insurance services represent some types of related party transactions particularly loan and the purchase or sale of service transaction. In addition, it should be mentioned here that these are not the only types of related party transactions but illustrative examples as can be inferred from the wording “...including...” At the end, article 54(2) of the proclamation makes it clear that it is the power of the National Bank of Ethiopia to issue directives to regulate the relationship between banks and insurance companies [and other related parties] and that it has the discretion to issue such directives as it deems appropriate.

## **B. Directives No.SBB/53/2012**

Here, it should be noted that this Directive is one of the main legal provisions which has direct relevance in the regulation of related party in the banking sector in Ethiopia. Thus, relatively detailed discussions will be made here. However, note that it has several limitations mainly because it is concerned with the provisions of loans to related parties and only with commercial banks.

### **Threshold for a shareholder to be considered as related party**

The definition in this Directive indicates that a shareholder can be one source of being related party, but, the same Directive makes it clear that there is a threshold for shareholders to be considered as related party. Specifically, article 8 of Directives No.SBB/53/2012 provides that only those shareholders of a commercial bank with holdings<sup>283</sup> of 2% or more of the commercial bank's subscribed capital shall be treated as related party and shall be subject to the provisions of this Directive. In this regard, it should be mentioned that such shareholders are considered as influential shareholders. This is because article 2.6 of Requirements for Persons with Significant Influence in a Bank Directives No.SBB/54/2012 (hereinafter called Directives No.SBB/54) defines an influential shareholder as "a person who directly or indirectly holds two percent or more of the total subscribed capital of a bank." The implication of the above threshold is that not all shareholders can be considered as related party and that the scope of the directive with regard to shareholders is limited to those shareholders with holdings of 2% or more of the commercial bank's subscribed capital. Conversely, shareholders of a commercial bank with holdings less than 2% of the subscribed capital will not be regarded as related party and will not be subject to the provisions of this Directive.

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<sup>283</sup> .As per article 3 of Directive No.SBB/30/2002, the threshold was holdings of 5% or more of the subscribed capital of the bank.

## **Limitation and Prohibition of Loans**<sup>284</sup>

The other concern of the discussion with regard to the above Directive is on the limitations and prohibitions of loans. For example, article 6.4 of the Directive provides that “Commercial banks shall not extend loans to related parties on preferential terms with respect to conditions, interest rates and repayment periods other than the terms and conditions normally applied to other borrowers.”<sup>285</sup> The following comments shall be made in relation to the above limitation and prohibition in the Directive. In the first place, the limitation and prohibition is confined to loan transactions of commercial banks with related parties<sup>286</sup> and thus, it does not apply to other transactions, such as purchase or sale of goods, purchase or sale of assets, lease, receiving and rendering of services, with related parties. Even within the loan transaction, the limitation is restricted to “...preferential terms with respect to ‘conditions, interest rates and repayment’ ....” The implication here again will be that the restriction will not include preferential terms with respect to other things not specifically mentioned above. But, this should not be so. There shall not be such restrictions if the purpose is to prevent abusive related party transactions. On the other hand, the above limitation impliedly recognized the “arms length” exception. This is reflected in the expression “...other than the terms and conditions normally applied to other borrowers.” But, even here the arms length exception is recognized narrowly.

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<sup>284</sup> . Bank Supervision Directorate: “Bank Risk Management Guidelines (Revised),” National Bank of Ethiopia, May 2010, p.2. Credit Exposures to Single and Related Counterparties Directive No.SBB/53/2012 limited itself with the regulation of loans to related parties. This may be because the major risk in banks is credit risk as witnessed in many countries in the world. This may be particularly due to the fact that failure to collect loans granted to customers has been the major factor behind the collapse of many banks around the world.

<sup>285</sup> . The same provision is also found in article 4.1 of Directive No.SBB/30/2002.

<sup>286</sup> . In this regard I raised to my interviewees from National Bank of Ethiopia this question: Why the regulation of related party transactions is limited to **loans** and commercial banks in Ethiopia? Three of the interview participants, namely, Ato Zeray G/wahid and Semir Teka and Ato Semere W/eyesus, told me that this is because the loan is the most sensitive banking business in practice. That is, there is a great risk in extension of loan. Besides, Ato Zeray G/wahid told me that the National Bank of Ethiopia did not give due attention to the other types of related party transactions.

On the other hand, article 357 of the commercial code is particularly concerned with the prohibition of loans to company directors. This provision reads:

- 1) Directors of a company other than bodies corporate may not borrow money from the company, obtain an overdraft in current account or have any obligation guaranteed in respect of business transacted with third parties.
- 2) The provisions of sub-article (1) shall not apply in respect of day to day business of a company which carries on banking business.

The following comments shall be made under article 357 of the commercial code. Though the title of this article looks prohibition of loans to company directors, it should be noted that the prohibition is not specific to loan because, it also applies to getting an overdraft in current account and to guaranteeing any obligation in relation to business transactions with unrelated third parties. In addition, the above prohibitions are limited to natural person company directors so that it does not apply to body corporate directors of a company. Finally, the above prohibitions, be it natural person or body corporate director, will not be applicable where the company is a banking business company in so far as the above transactions, loan, giving overdraft in current account or guaranteeing the obligation, is in the normal course of business.

Note also that article 6(1-3) of the Directives No.SBB/53/2012 provides some limits on extending loans to one unrelated and one related party and to all related parties at a time. Thus, article 6.1 states that “The aggregate sum of loans or advances extended or permitted to be outstanding directly or indirectly by a commercial bank to any one person, who is not related to the commercial bank, shall at no time exceed 25% of the total capital of the commercial bank.” On the other hand, article 6.2 states that “The aggregate sum of loans or advances extended or permitted to be outstanding directly or indirectly to one related party at any one time shall not exceed 15% of the total capital of the commercial bank.” Besides, article 6.3 provides that “The aggregate sum of loans extended or permitted to be outstanding directly or indirectly to all related parties at any

one time shall not exceed 35% of the total capital of the bank.” Article 4.2 and 4.3 of Directive No.SBB/30/2002 is respectively the exact copy of article 6.2 and 6.3 of the Directive No.SBB/53/2012. In the above article, the phrase” ...at any one time....” is not clear. But, it is the opinion of the author that it should be understood to mean the aggregate sum of loan granted to the related party or related parties within one year period because the author believes that this way of interpretation appears sound. But, note that the limitations provided in article 6 of the above Directive do not apply in the following cases. This is when the loans are fully secured by cash collateral and [or] the loans are fully secured by cash substitutes.<sup>287</sup> This is provided in article 7 of the same Directive. This exclusion is also exactly found in article 5 of Directive No.SBB/30/2002.

### **Identification of Related Party and Related Party Transactions**

It is clear that the identification of related party and related party transactions is an important but a difficult task.<sup>288</sup> Thus, it will be essential to raise here the question “who has the duty to identify related party and/ or related party transaction in banks in Ethiopia?” In this respect, article 9 of Directives No.SBB/53/2012 clearly provides that it is the responsibility of each individual commercial bank to identify related party. The same provision is also found in article 6 of Directive No.SBB/30/2002. But, this provision is general in that it does not specifically address which organ of the individual commercial bank has the duty to identify the existence of related party and/or related party transaction. However, the general tendency is to give this power or impose the duty to the board of directors. This can be inferred from the literature which simply provides that it should be the board of directors of each bank that should approve and review loans

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<sup>287</sup> . Besides, note should be made here that article 3 of the Limitation on Accommodation Directive No.SBB/10/95 talks about limitation on accommodation. It reads: “No bank shall, directly or indirectly, except with the prior written approval of the Bank, grant or permit to be outstanding unsecured loans, advances or credit facilities of an aggregated amount in excess of birr 30,000: (1) to its directors, or any of them, whether severally or jointly with any other person (2) to any person of whom or of which it or any one or more of its directors is guarantor. Besides, for the purpose of this Directive, Article 2 of this directive defines a person to refer only to physical or natural person.

<sup>288</sup> . At this juncture, the issue of whistleblower should also be raised here. Despite its importance in the identification and prevention of abusive related party transactions, it is not provided in the existing Ethiopian laws.

to related parties to the concerned commercial bank.<sup>289</sup> Note again that, in other countries with similar problems to Ethiopia, two suggestions are provided. The first solution is to address such issue by internal company regulation. The other solution is to share this obligation among different organs such as directors, auditors and shareholders.<sup>290</sup> Anyways, the researcher hopes and suggests that amendments to the existing laws on or new legislations on related party transactions will specifically address this issue.

### **Disclosure of Related Party Transactions**

As repeatedly discussed in the previous units, disclosure of related party transactions is one of the main instruments of regulation and enforcement of related party transactions in general. Particularly, it has been discussed that transparency through effective disclosure of related party transactions is necessary to build and enhance trust and confidence in business and to protect important public interests in general.<sup>291</sup> But, it should be also raised here that some investors have sometimes argued that there is a significant gap between disclosure and transparency.<sup>292</sup> However, there is no requirement of disclosure in Directives No.SBB/53/2012 in banks in Ethiopia. Yet note should be taken that as a requirement of information for the applicant to get license to work in the banking business, Directive No.SBB/39/2006 demands the “disclosure of the identity of shareholders who have acquired five or more percent of the capital stock, indicating their names, nationality, number and value of shares held.” Nevertheless, article 10 of Directives No.SBB/53/2012 provides “reporting” requirement. But, the requirements of disclosure and reporting are not strictly the same. Anyways, this article provides that “Reports showing month-end exposures to every single borrower exceeding 10% of total capital of the commercial bank and all related parties shall be submitted to the Bank Supervision Directorate of the National Bank of Ethiopia within twenty days after the end of the period for which the data are reported. The reported data shall be submitted in accordance with the table attached herewith which shall be a part hereof.” Similarly,

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<sup>289</sup> .Supra note 284, p.p.2-3.

<sup>290</sup> . Supra note 99, p.5

<sup>291</sup> . Supra note 79, p. 5

<sup>292</sup> . Supra note 118, p. 23

article 7 of Directive No.SBB/30/2002 also provides that “Reports showing month-end exposures to each related party shall be submitted to the Supervision Department of the National Bank of Ethiopia with in twenty days after the end of the period for which the data are reported. The report shall be submitted in accordance with the table attached herewith which shall be a part thereof.” Thus, the difference between the above Directives is while the former includes the threshold of lending to a single borrower to more than 10% of the total capital of the commercial bank, the latter does not provide any limit for the reporting requirement. Despite the reporting requirement, none of my interviewees in the National Bank of Ethiopia could tell me that they have a record of how many related party related party transactions occurred each month/year and they told me that they have no information on such record. Furthermore, they honestly told me that related party transactions occur hidden and that such reports will come to the National Bank of Ethiopia if and only if there is a conflict within the company that is involved in related party transactions. They also told me openly that even if such documents are available they will not give me copies because they believe that such documents are confidential. On the other hand, a study conducted on the “Reports on the Observance of Standards and Codes in Ethiopia” in 2007 states the following in relation to this issue. It states first that the accounting practices in Ethiopia vary among institutions and differ from International Financial Reporting Standards.<sup>293</sup> It then, particularly, provides that “Contrary to the requirements in IAS 24, 33 financial statements, including all financial institutions, did not have disclosures such as the relationship and transactions, pricing policies, the volumes of related party transactions, and the corresponding amounts.” The study further provides that “All entities did not disclose information such as retirement benefits and compensation paid to key management personnel. Adequate disclosure of material related party relationships and transactions is essential to users’ understanding of entities’ financial position and results, and for minority investors’ confidence that they will receive a fair treatment.”<sup>294</sup> In addition, the above study indicated that there is a lack of understanding on the role of quality financial reporting by the business community. This is because many people in

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<sup>293</sup> . Supra note 274, p.13.

<sup>294</sup> . Ibid, p.14

the business community are not aware of the importance of good quality financial reporting and the purpose it would serve. Finally, the study mentioned that banks in Ethiopia do not rely on financial statements for lending. This is mainly because the lending culture is largely based on collateral security. If anything, financial statements play a small secondary role.<sup>295</sup>

### **Auditing Related Party Transactions**

Auditing is internationally recognized as one means of identifying related party transactions. But, Directives No.SBB/53/2012 does not contain provisions dealing with auditing with regard to related party transactions in banks in Ethiopia. But, auditing requirement is generally provided in the commercial code and other laws of the country.<sup>296</sup> However, these general provisions may not address specifically the concerns of related party transaction.<sup>297</sup>

### **Approval and/or Ratification of Related Party Transactions**

It is clearly provided in the previous units that the requirement of approval procedure is one legal instrument in the regulation of related (esp. abusive) party transactions in general. However, there is no such requirement in the regulation of related party transactions in the Ethiopian financial sector in general and banks in particular in the Directives. Here we are concerned with the approval by shareholders and/or the board of directors, not the prior approval required by the National Bank of Ethiopia.<sup>298</sup> However,

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<sup>295</sup> . Ibid, p.15

<sup>296</sup> . Articles 12 and 13 of Proclamation No.626/2009 and articles 368-387 of the commercial code of Ethiopia talk about the different issues of auditors. Particularly, art 356(3) of the Commercial Code may be relevant here.

<sup>297</sup> . In this regard, it should be mentioned that some respondents Ato Zeray G/wahid and Ato Semir Teka told me the existence of prevalent problems with the external auditors. This is particularly with the appointment, independence and integrity of external auditors. For this reason, the works of the external auditors in the majority of cases in practice is simply confirming the works of the board of directors. That is why the National Bank of Ethiopia is planning to issue a directive on external auditors.

<sup>298</sup> . For instance, article 4 of Requirements for Persons with Significant Influence in a Bank Directives No.SBB/54/2012 is concerned with the National Bank of Ethiopia's approval of the appointment and shareholding of the influential persons in general. In particular, sub-articles 4(2)and 4(4) of the above Directive are concerned with the 'appointment of directors, chief executive officer and senior management

the commercial code of Ethiopia contains relevant provisions in this area. Here article 356 provides that:

- 1) Any dealings made directly or indirectly between a company and a director shall receive the prior approval of the board of directors and notice shall be given to the auditors.
- 2) Approval and notice under sub-article (1) shall be required in respect of any dealings made between a company and another concern where one of the directors of the company is owner, partner, agent, director or manager of such concern.
- 3) The auditors shall submit a special report to the general meeting relating to dealings approved by board of directors. The meeting may take any action it thinks fit.
- 4) Dealings approved by the meeting may only be set aside on the ground of fraud.
- 5) Dealings not approved shall remain in force but the director concerned shall be liable for damages arising from fraud and if he fails to meet his liability, the board of directors shall be liable.

The following points can be made in relation to the approval requirement provided in the above article. In the first place, it should be clear that this article is concerned with the issue of related party transaction in general. Besides, this provision has recognized the importance of approval of related party transactions by board of directors. From this, we can see that, a related party transaction is not prohibited at all. It simply is subject to the prior approval of the board of directors. In particular, any transaction made directly or indirectly between a company and a director will be considered as related party transaction because the company and its director are regarded as related parties. Further, if there is a transaction between a company and another entity where a director of the company is also owner, partner, agent, director or manager of the entity, the transaction is considered as related party transaction because the company and the entity are related. Thus, in both cases, where there is any transaction between them, the prior approval of the board of directors is mandatory for the validity of such transaction. In addition, the

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officers' and 'any shareholding that makes a person an influential shareholder' to be approved by the National Bank of Ethiopia.

approval of the related party transaction by board of directors shall be notified to the auditors and the latter shall submit this special report to the general meeting of the company. The general meeting has the power to take any measure it considers appropriate. Thus, it can either ratify or not ratify a related party transaction which was approved by board of directors. Where the general meeting approves (properly speaking, it is ratification or confirmation), the approval of board of directors, this approval can be challenged only when there is fraud. Otherwise, the approval or ratification of the general meeting becomes final and binding. But, where the general meeting does not approve (confirm) the approval of the board of directors, the transaction still remains in force and hence binding on the contracting parties. However, the transacting director will be held liable for damages arising from his fraud. In this case, where the concerned director is not able to satisfy his liabilities, the board of directors will be held liable jointly. Thus, in so far as the board of directors has approved the related party transaction, the transaction or contract remains binding whether or not the general meeting has confirmed it. Generally, the above provision is very important in the discussion of related party transaction in Ethiopia. This is because it contained several issues of related party transaction, such as a partial definition of related party and related party transactions, approval by board of directors, the role of auditors, the general meeting's power of ratification of related party transactions approved by board of directors, the fate of related party transaction approved by board of directors but not ratified by the general meeting and the liability of the concerned director and board of directors in such a case. In short, the above provision provides that related party transactions should be approved by board of directors and their review or ratification should be made by the general meeting of the concerned company. However, the above article does not clearly provide as to the fate of a related party transaction not approved by the board of directors. In this case, one possibility could be that such transaction should be invalidated upon the request of interested party including shareholders on behalf of the company. Further, there is an allegation that the board of directors is responsible for reviewing and approving a bank's credit risk strategy and policies. According to them, each bank should develop a strategy that sets the objectives of its credit-granting activities and adopts the necessary policies and procedures for

conducting such activities.<sup>299</sup> Besides, it is stated that the board shall approve loans in line with National Bank of Ethiopia Directives. Particularly, it is argued that the board of directors shall review exposures and policies regarding credit to related parties as defined by the National Bank of Ethiopia Directives.<sup>300</sup>

### **5.2.3. Regulation of Related Party Transaction on Insurance Companies in Ethiopia**

In this subunit, attempts will be made to look at some of the relevant laws in relation to the regulation of related party transactions in the Ethiopian insurance sector. But, before going to discuss the issues of regulation of related party and related party transactions, some general points with regard to issues of insurance sector in Ethiopia should be raised first. To begin with, it should be noted that “trust and promise” is the main philosophy for insurance.<sup>301</sup> Thus, the regulation of the insurance sector mainly revolves around it. On the other hand, the mission of the insurance sector in Ethiopia is “To maintain safe, sound and stable insurance sector with the main focus of policy holders’ interest protection.”<sup>302</sup> In addition, insurance has several functions such as facilitating credit transactions and providing with financial compensation. For example, in the recent past 10 years, the Ethiopian insurance sector paid around Birr 4 billion for compensation.<sup>303</sup> Besides, insurance gives both direct and indirect employment opportunity. At present, around 3,000 people work in the insurance sector. Many persons also work as insurance intermediaries and as employees of corporate offices to deal in insurance matters.<sup>304</sup> Currently, there are 14 insurance companies, one state owned insurance corporation, Ethiopian Insurance Corporation (EIC), and 13 privately owned insurance<sup>305</sup> companies

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<sup>299</sup> . Supra note 284

<sup>300</sup> . Ibid,p.3. Generally speaking, a potential area of abuse arises from granting credit to related parties, whether companies or individuals. Consequently, it is important that banks grant credit to such parties on an arm’s-length basis and that the amount of credit granted is suitably monitored.

<sup>301</sup> . Supra note 182, p.29

<sup>302</sup> . Ibid, p.p.30-31. In this regard, it is generally stated that this mission is implemented through the following four supervisory pillars: regulation, licensing, supervision and enforcements. On the other hand, it is mentioned here generally that “No insurance company is left unsupervised irrespective of the degree of risks.”

<sup>303</sup> . Ibid, p.28

<sup>304</sup> . Ibid, p.29

<sup>305</sup> . \_\_\_\_\_: “Building an Inclusive Insurance Market in Ethiopia,” 21 October 2008, p.1.

Available@[http://cenfri.org/documents/microinsurance/2008/Ethiopia\\_Regulator%20report%20110208.pdf](http://cenfri.org/documents/microinsurance/2008/Ethiopia_Regulator%20report%20110208.pdf)

operating in Ethiopia. There are also a number of insurance auxiliaries operating in the Country. For example, more than 50 brokers, around 55 loss assessors, two surveyors, more than 1,000 active insurance sales agents are operating in the sector. On the other hand, the total assets and total capital of the sector as of June 30, 2011 were Birr 4.288 billion and Birr 946.3 million, respectively.<sup>306</sup>In general, the future of the insurance sector in Ethiopia is very promising. This is because the country has good potential and opportunities such as population size, natural resources, economic growth, and the country's vision to bring the people to the middle income category and all these, in turn, will have good effect on insurance.<sup>307</sup> Despite the above progresses and the good potential of the insurance sector in Ethiopia, due attention is still not given to the regulation of related party transaction in the insurance companies in Ethiopia.<sup>308</sup> However, note that the Licensing and Supervision of Insurance Business Directive No. Sib/1/1994(hereinafter called Directive No. Sib/1/1994) contains some issues of related party and related party transactions in the Ethiopian insurance sector. Thus, efforts are made below to discuss the available relevant provisions of the above Directive.

Directive No.Sib/1/1994 has some relevant provisions such as on the definition of related parties. This Directive simply defines related parties as referring to “directors, founders, principal officers, employees and other businesses in which they have direct interest.” It is not clear whether or not the relatives of related parties are included in the above definition of related party. On the other hand, as one requirement to give license to the applicant insurer, this Directive provides that the applicant should “Describe any

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It is stated by some writers that the Ethiopian insurance market had been opened for private investors after the enactment of Proclamation No. 86/1994 which effectively ended almost 17 years monopoly of a state insurance company.

<sup>306</sup> . Supra note 182, p.29

<sup>307</sup> . Ibid, p.32

<sup>308</sup> . For example, there is no specific Directive dealing on the regulation of related party transactions in the Ethiopian insurance companies so far. Besides, an interview held with w/ro Serkaddis Adugna indicates that related party transaction is identified as one risk among the eight risked identified so far in the Ethiopian insurance sector guideline. According to the risk based approach, what matters is not the occurrence of a single abusive related party transaction but on the effect of such transaction on the concerned insurance company. Thus, this approach does not deal with case by case (file by file) basis. However, there is a plan in the future to issue a directive on the regulation of related party transactions on the insurance sector in Ethiopia.

purchase or proposed purchase of goods and services, or lease of real estate by the insurer from related parties.” Some points should be raised to the above requirement. First, it should be noted that the requirements of descriptions of such transactions, purchase/proposed purchase of goods and services and lease, is in one direction. That is, the insurer is required to describe if it purchases or intends to purchase or leases from related parties, not when the insurer sales/proposes to sell its goods or services or leases its real estate to the related parties. This one is literal reading of this provision. However, the requirement of description here should be on both sides of the transaction. This is to mean that the insurer should be required to describe the purchase/proposed purchase/sale of goods and/or services, leases from and/or to related parties. Besides, the term “...describe...” should be understood to mean disclose. Furthermore, even if there is no definition for the phrase ‘related party transactions’ in this Directive, the above requirement provides some types of related party transactions, namely, purchase or proposed purchase of goods and services, or lease of real estate. However, it should also be noted that these are not the only types of related party transactions. Thus, the above transactions should be considered illustrative and not exhaustive. In all the above discussions, regard should be made to the spirit and the substance of the law in the regulation of related party transactions in general. In conclusion, it can be said generally that though only indirectly and narrowly, little attempt is made in the regulation of related parties and related party transactions in the insurance companies in Ethiopia. But, many issues with respect to the regulation of related party transactions in the insurance sector in Ethiopia are left unregulated. For example, no definition of related party transaction is provided. The issue of identification, disclosure, approval and ratification of related party transaction is not provided in Ethiopian insurance sector. But, one can also use articles 356 and 357 of the commercial code as discussed in the above subunit.

#### **5.2.4. Regulation of Related Party Transaction on Microfinance Institutions in Ethiopia**

Before going directly to the discussion of related party and related party transactions in the Ethiopian microfinance institutions, some points should be discussed. The objectives

of regulation and supervision of microfinance institutions include protecting small depositors, ensuring integrity and stability of the microfinance sector in particular and financial sector in general and promote efficient performance of the institutions.<sup>309</sup> Some scholars argue that the delivery of efficient and effective microfinance services to the poor demands proper macro economic policies and the establishment and enforcement of legal and regulatory framework. Besides, they allege that government has a great role in creating conducive and enabling environment for the development of microfinance and the conduct of small business.<sup>310</sup> It is obvious that the majority of the population in Ethiopia has no access to financial services in the formal banking and insurance sector, because such companies demand high collateral requirements. In addition, small and medium enterprises lack access to financial services in the formal banks due to the fact that formal banks are either unwilling or unable to serve small and medium enterprises.<sup>311</sup>

Generally, the microfinance institutions in Ethiopia have shown a remarkable qualitative and quantitative growth since the early 1990. The formal base has been laid by the issuance of Licensing and Supervision of Microfinance Institutions Proclamation No. 40/1996 (hereinafter called Proclamation No. 40/1996). Particularly, article 20 of this Proclamation provides that “Every micro financing institution shall devise and execute a policy whereby the low-income section of society, especially in rural areas, get access to credit and to this end it shall implement such means of substituting group guarantee for property collateral requirement.” It is also generally argued that, unlike many countries, the microfinance in Ethiopia is considered as part of the financial sector. In particular, the preamble of Proclamation No.40/1996 states that it needs to provide for a legal regime that brings the activities of micro financing' institutions within Ethiopia's monetary and

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<sup>309</sup> . Yigrem Kassa: “Regulation and Supervision of Microfinance Institutions in Ethiopia: Achievements, Challenges & Prospects,” National Bank of Ethiopia, 2010, p.13  
Available @ <http://www.mra.gov.bd/conference/images/speakers/ppt%20-%20yigrem%20kassa-%20ethiopia%20pp.pdf>

<sup>310</sup> . Wolday Amha: “Revisiting the Regulatory and Supervision Framework of the Microfinance Industry in Ethiopia,” Proceedings from a Seminar organized by the Relief Society of Tigray (REST), on behalf of the Drylands Coordination Group in Ethiopia and Sudan, Mekele, DCG Proceedings No. 3, August 25, 2001, p.6.

<sup>311</sup> . Hayder Al-Bagdadi and Michael Bruentrup: “Microfinance Associations: The case of the Association of Microfinance Institutions Ethiopia (AEMFI),” GTZ, 2002, p.16.

financial policies. However, it provides that the monetary and banking laws in force do not provide for micro financing institutions catering for the credit needs of peasant farmers and others engaged in small scale production and service activities. Thus, there arises the need to regulate it separately. Currently, there is some consensus among practitioners in Ethiopia that enabling prudential regulation and supervision of microfinance institutions has been effective in promoting and guiding the governance of microfinance institutions.<sup>312</sup> It is also mentioned that, as of September 30, 2011, thirty one microfinance institutions were serving about 2.7 million rural and urban low income people. During the same year, they mobilized savings around 3.9 billion and their total assets, total outstanding loan, and total capital were Birr 10.2 billion, 7.1 billion, and 3.1 billion, respectively.<sup>313</sup> On the other hand, compared to the banking and insurance institutions, the amount of money involved in microfinance institutions may be small in general. But, this may not be always true particularly in Ethiopia, in that it is argued that the assets of largest microfinance institutions are comparable to those of the smallest private banks<sup>314</sup> and the total assets, total outstanding loans and total capital of microfinance institutions are greater than the total assets, total outstanding loans and total capital of insurance companies in Ethiopia in general. This is because, in one hand, as of June 30, 2011, the total assets and total capital of the insurance companies were Birr 4.288 billion and 946.3 million, respectively.<sup>315</sup> On the other hand, as of September 30, 2011, the total assets, total outstanding loan, and total capital of the microfinance institutions in Ethiopia were Birr: 10.2 billion, 7.1 billion, and 3.1 billion, respectively. Besides, microfinance institutions mobilized savings of Birr 3.9 billion in the form of compulsory and voluntary savings.<sup>316</sup> In addition, even if the amount of money involved is small by comparison to banks and insurances, microfinance institutions play a major role in the society in providing some financial activities particularly to the poor and those who have no easy access to the banks and insurance institutions. Thus, the writer believes that related party transactions in the Ethiopian microfinance institutions shall be

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<sup>312</sup> . Supra note 202. It should be noted that although regulation contributes to stable and efficient performance of the microfinance institutions, regulation and supervision also has significant cost.

<sup>313</sup> . Supra note 182, p.32

<sup>314</sup> . Supra note 309, p.8

<sup>315</sup> . Supra note 182, p. 29

<sup>316</sup> . Ibid,p.32

regulated. But, the provisions should be flexible enough based on different factors such as the size of the microfinance institution, the financial activity of the microfinance institution( such as saving, credit), the entry period of the microfinance institution and so on, as the case may be. In this respect, I have raised to my interviewees from the National Bank of Ethiopia the question: Don't you believe that regulation of related party transactions is important in microfinance institutions? Generally, the answers of the persons interviewed vary. This is because Ato Zeray G/wahid and Ato Semir Teka said even if it is necessary, it is not at this time. On the other hand, Ato Semere W/eyesus replied that their regulation is necessary. Still Ato Abate Mitiku said that attempt is made to regulate them under Directive No.SSB/53/2012. Besides, he told me that they are drafting on corporate governance and they are intending to make the provisions of the microfinance institutions similar with that of banks in the majority of cases.

There is also an argument forwarded generally that cost is involved in regulation and regulation of related party transactions in microfinance institutions. But, it should be considered that this cost of regulation is not limited only to microfinance institutions. Both banks and insurance companies also incur costs because of regulation and regulation of related party transactions. Besides, the cost of failure of regulation will be much greater than the cost of regulation.

Bearing in mind the above discussions, let us come to the discussion of related party and related party transactions in the microfinance institutions in Ethiopia. Some efforts will be made below to look at the relevant provisions in the Proclamation No.626/2009 and Proclamation No.40/1996. Article 3 of Proclamation No.626/2009 deals with the purpose and activity of Micro-Financing Institutions. Particularly, article 3(1) provides the “main purpose of a micro-financing institution shall be to collect deposits and extend credit to rural and urban farmers and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs, the maximum amount of which may be determined by the National Bank.” Furthermore, article 3(2) states that “Subject to conditions set under this Proclamation, a micro-financing institution may engage in some or all of the following: a) accepting both voluntary and compulsory savings as well as

demand and time deposits, b) extending credit to rural and urban farmers and people engaged in other similar activities as well as micro and small-scale rural and urban entrepreneurs, c) drawing and accepting drafts payable within Ethiopia, d) micro-insurance business as prescribed by directive to be issued by the National Bank, e) purchasing income-generating financial instruments such as treasury bills and other short term instruments as the National Bank may determine as appropriate, f) acquiring, maintaining and transferring any movable and immovable property including premises for carrying out its business, g) supporting income generating projects of urban and rural micro and small scale operators, h) rendering managerial, marketing, technical and administrative advice to customers and assisting them to obtain services in those fields, i) managing funds for micro and small scale businesses, j) providing local money transfer services, k) providing financial leasing services to peasant farmers, micro and small-scale urban and rural entrepreneurs in accordance with the Capital Goods Leasing Business Proclamation No.103/1998; and l) engaging in other activities as specified by directives of the National Bank from time to time. Thus, taking in to account the fact that microfinance institutions carry out several financial activities as mentioned above, it is advisable to have a regulation on related party transactions in microfinance institutions in Ethiopia.

Moreover, article 12 of Proclamation No.626/2009 provides several issues about auditors for microfinance institutions. Even if the above article does not deal directly with the role of auditors in related party transactions, this provision can be helpful in the prevention of abusive related party transactions. In particular, article 13 of the above proclamation governs the duties and reports of external auditors in microfinance institutions. More particularly, article 13(4) states that “A person appointed as an external auditor of a micro-financing institution shall not operate an account with, or be granted any type of facility from, that institution except in ‘the normal course of business and at an arm’s length basis’”. This sub-article has recognized the exception of arms length. Article 13 of Proclamation No.626/2009 also provides about financial record and disclosure of information. This provision indicates the importance of preparing financial statements

and disclosure of financial information to the National Bank of Ethiopia, depositors, creditors, investors or other stakeholders in the microfinance institutions. But note that, according to article 15(4) of the same proclamation, such information will not be disclosed to any person except in the following justified reasons. Thus, the financial information may be disclosed to any person, other than the National Bank of Ethiopia, when the disclosure is: made for the purpose of fulfilling the requirements of this Proclamation, required to ensure the financial soundness of the institution, made to recipients who are legally authorized to obtain such information, made to the body to which the National Bank is accountable, ordered by a court or required for the purpose of meeting obligations which Ethiopia entered into under international agreement, However, note that the above provision does not deal with the requirement of disclosure in related party transactions. Besides, article 16 of this Proclamation deals with the provisions of loans. It states that “An authorized institution may extend loans to groups and to individuals. Loans may be made without collateral, secured by collateral or secured by group or individual guarantees as appropriate and at the discretion of the institution.” Even if the above article gives wide discretionary power to the specific microfinance institution, article 17 of the same proclamation provides some prohibitions, by stating, among other things, “Without the prior written approval of the National Bank, no micro-financing institution shall: 1. enter into an agreement for the amalgamation or disposal of its business.

2. transfer or otherwise dispose of the whole or any part of its property other than in the ordinary course of business.” The above two prohibitions have some relevance in the regulation of related party transactions. This is because they fall to some extent under the definition of related party transaction defined as transfer of resources, services or obligation between related parties regardless of whether a price has been charged. Besides, such prohibitions are important taking into account the fact that each specific microfinance institution has wide discretionary power in extending loans to individuals or groups with or without collaterals or guarantees.

However, it should be raised here that some researchers challenge that insider lending is a less problem in microfinance institutions than in traditional banks may be due to the fact that relatively the size of loans in microfinance institutions is small particularly the loan

limit is strict which in turn makes insider borrowing in the microfinance institutions less attractive.<sup>317</sup> The most relevant provision of Proclamation No.626/2009 is article 28(1) which generally states that “Banking business laws shall, mutatis mutandis, be applicable to micro financing business with respect to matters not covered by this Proclamation.” Though the interpretation of this article may be subjective, its relevance to the regulation of related party is provided below. There are many proclamations and directives that deal with the banking business. But, Directives No.SBB/53/2012 is the most relevant law with respect to the regulation of related party in the banking sector in Ethiopia. On the other hand, Proclamation No.626/2009 has no provisions clearly dealing with the regulation of related party and /or related party transactions in the microfinance institutions. Thus, it can be argued that Directives No.SBB/53/2012 shall be applicable to microfinance institutions with regard to the regulation of related party transactions, taking the necessary adjustments to microfinance institutions. Finally, Article 21 of Proclamation No.626/2009 deals with the transformation of a microfinance institution into a bank or other financial institution. Thus when the concerned microfinance institution satisfies the criteria provided by the National Bank of Ethiopia for the establishment of the desired financial institution and an application is made to the National Bank of Ethiopia for the transformation of the microfinance institution in to a bank, insurance company or other financial institution, the National Bank of Ethiopia can relicense it based on article (21(1).On the other hand, note that after the microfinance institution is transformed in to a bank or other financial institution, the National Bank of Ethiopia may require it to continue to provide micro-financing services as part of its financial operations, in accordance with article (21(2). Particularly, I argue that when the microfinance is transformed in to banks or insurance companies but continues to provide micro-financing services, the regulation of related party transactions becomes necessary.

On the other hand, some points will be raised below on Proclamation No. 40/1996 with regard to the regulation of related party and/or related party transactions in the microfinance institutions in Ethiopia. To begin with, article 12(2) of Proclamation No.

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<sup>317</sup> . Supra note 120

40/1996 contains provisions relevant to related party transactions. This article provides generally that the National Bank of Ethiopia has the power to issue directives on the following financial activities: (a) limits on the maximum credit extended by micro financing institutions to any individual or group, (b) the loan period and procedures (c) periodic reporting, the accounting system and the keeping of books of accounts (d) periodic surveys of loan and audits (e) standards regarding accountability, structure, savings system and financial performance and (f) setting of special interest rate applicable to micro financing institutions. Therefore, the regulation of such issues may be important in reducing abusive related party transactions in the microfinance institutions. Article 15 of Proclamation No.40/1996 also deals with provision of loans to members and non-members. This article reads “Micro financing institutions may extend loan to members as well as to non-members. However, such credit schemes as operating under group guarantee shall exert themselves to bring borrowers into membership of the institutions.” However, there shall not be a preferential loan treatment between members and non-members. That is, the granting of loan to members shall also be conducted on arms length basis. Similarly, article 17 of the proclamation provides some limitations and prohibitions. This article states the prior approval of the National Bank of Ethiopia is mandatory in the following activities. Thus, it is stated that without the prior approval of the Bank, no micro financing institution may: 1) enter into any arrangement or agreement for the sale or disposal by amalgamation or otherwise of its business or effect self restructuring, 2) transfer or otherwise dispose of the whole or any part of its property, whether inside or outside Ethiopia, other than in the ordinary course of its business. It is believed that such prior mandatory approval of the National Bank of Ethiopia may reduce the occurrence of abusive related party transactions in the Ethiopian microfinance institutions. At the end, article 18 of Proclamation No. 40/1996 requires a prior written approval of the National Bank of Ethiopia for the following persons to be appointed as managers of microfinance institutions: 1) persons declared bankrupt or who have made a compromise with their creditors, whether in Ethiopia or elsewhere, 2) persons convicted of offences of breach of trust or fraud, whether in Ethiopia or elsewhere. Admittedly abusive related party transaction is one of the financial frauds or breach of trust. Thus, the above written

approval requirement of potential managers will also play its own role in preventing abusive related party transactions in the microfinance institutions in Ethiopia.<sup>318</sup>

### **5.3. The Enforcement Mechanisms, Sanctions and Remedies in Ethiopia in Abusive Related Party Transactions**

Though legal and regulatory framework is an important thing in the regulation of related parties and their transaction, what is more important in this respect is found in the enforcement side. Thus, due attention should also be given to the enforcement issue if the legal and regulatory framework objectives are intended to be achieved. Discussion in this regard will be made on relevant laws in Ethiopia. Article 27 of Proclamation No.592/2008 talks about audit reports but this provision incidentally becomes relevant in that it impliedly recognizes the importance of the auditor in identifying and reporting the commission of financial fraud or dishonesty by a bank or its directors or employees. Particularly, article 27(4) (b) of this proclamation provides that the auditor should report that "...a criminal offence involving fraud or other dishonesty has been committed by the bank or any of its directors or employees."<sup>319</sup> The relevance of the above provision is that because abusive related party transaction is one type of financial fraud and dishonesty. In this regard, several Directives in general and Directives No.SBB/53/2012 in particular, are issued based on the banking, insurance and Microfinance proclamations and these Proclamations also contain the general provisions that any violation of these Proclamation or laws enacted based on this proclamation are punishable.

On the other hand, article 58 of Proclamation No. 592/2008 deals with the criminal sanctions in case of violation of this Proclamation. But, it makes different the penalties depending on which specific provision of this proclamation is violated. Thus, article 58 is reproduced directly as follows:

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<sup>318</sup> . Note that without making specific the standard of auditing to be in conformity with international auditing standards, article 22 of Proclamation No.40/1996 requires auditing in microfinance institutions.

<sup>319</sup> . Besides, article 5.2 of Directives No.SBB/54/2012 provides for the integrity of the persons with significant influence. It generally states that such persons should be honest, reputable and diligent. For particulars on their integrity, please refer articles 5.2.1-5.2.3 of the same Directive.

1. Any person who contravenes the provisions of Article 3(1)<sup>320</sup> of this Proclamation shall be punished with a fine of Birr 20,000 in respect of each day on which the contravention continues and with a rigorous imprisonment from 10 to 15 years.
2. Any person who, having been called upon by the National Bank under Article 3(4)<sup>321</sup> of this Proclamation, fails or refuses to submit the documents described therein shall be punished with a fine from Birr 50,000 to Birr 100,000 and with a rigorous imprisonment from 7 to 10 years.
3. Where the offence under sub-article (1) or (2) of this Article is committed by a legal entity, the penalty of imprisonment shall be imposed on the person in charge of the management of the entity.
4. Any person who contravenes the provisions of sub-article (1)<sup>322</sup> or (2)<sup>323</sup> of Article 15 Or Article 16<sup>324</sup> of this Proclamation shall be punished with a fine from Birr50, 000 to Birr100, 000 and with a rigorous imprisonment from 10 to 15 years.
5. Any director of a bank who contravenes the provisions of Article 28(5)<sup>325</sup> of this Proclamation shall be punished with a fine from Birr50, 000 to Birr100, 000 and with a rigorous imprisonment from 7 to 10 years.

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<sup>320</sup> . According to this provision, it is prohibited to transact banking business in Ethiopia without obtaining a banking business license from the National Bank.

<sup>321</sup> . This provision reads "Where the National Bank has a reason to believe that a person, in contravention of sub-article (1) of this Article, is advertising for or soliciting deposits of money or transacting banking business, it may, in order to ascertain the situation, require that all books, minutes, accounts, cash, securities, records, vouchers and other documents which are in the possession or custody of such person be submitted to it and inspect the same or cause the same to be inspected."

<sup>322</sup> . This sub article states that no person who has been convicted of any offence involving a breach of trust or a fraud, whether in Ethiopia or elsewhere may be a director or an employee of a bank.

<sup>323</sup> . This sub article, however, provides that "Without prior approval of the National Bank, no person who had been a director, chief executive officer or senior executive officer or otherwise directly or indirectly participated in the management of any bank that wind up, whether in Ethiopia or abroad, may act as a director, chief executive officer or senior executive officer or otherwise be directly or indirectly participate in the management of a bank."

<sup>324</sup> . On the other hand, this article provided that Any person who is a director or chief executive officer or senior executive officer or otherwise participate, directly or indirectly, in the management of a bank shall cease to exercise such function if: 1/he or the company in which he is a director or executive officer, has instituted bankruptcy proceedings or declared bankrupt, or his or the company's assets have been sequestered because of bankruptcy or been foreclosed by a bank because of failure to repay a loan granted by the bank; 2/he has been convicted of default on repayments of bank or other credits or tax payment; 3/he or the company in which he is a director or executive officer carries non-performing loans, as defined by directives of the National Bank, from any bank; or 4/he fails to fulfill any of the qualification of competency requirements set by the National Bank.

<sup>325</sup> . According to this provision, the Board of directors of a bank shall, jointly or severally, immediately report in writing to the National Bank where the following happened or likely to happen that the bank:

6. Any director or employee of a bank who: a) obstructs the proper performance by an auditor of his duties in accordance with the provisions of this Proclamation or inspection of a bank by an inspector duly authorized by the National Bank; or b) With intent to deceive, makes any false or misleading statement or entry or omits any statement or entry that should be made in any book, account, report or statement of a bank c) Knows or ought to know the insolvency of the bank and receives or authorizes or permits the acceptance of a deposit shall be punished with a fine from Birr 50,000 to Birr100,000 and with a rigorous imprisonment from 10 to 15 years.

7. Any person who contravenes or obstructs the provisions of this Proclamation or regulations or directives issued to implement this Proclamation shall be punished with a fine up to Birr10, 000 and with an imprisonment up to three years. Generally, except for sub-article 58(1) of the above proclamation, the other sub-articles have some relevance in the discussion of enforcement of related party transactions in the Ethiopian financial sector. Besides, it should be raised that the criminal punishment in the above provision is imprisonment and fine. The fines and rigorous imprisonments are imposed on the violator. The crimes stated above may be committed by a legal entity or a physical person. However, when the stated offence in article 3(1) or) 3(4) was committed by a legal entity, it is clearly provided in article 58(3) that the imprisonment shall be imposed on the person in charge of the management of the entity.

On the other hand, Article 18 of Proclamation No.626/2009 deals with the inspection of microfinance institutions and corrective measures. The inspection can be initiated in two ways. First, the National Bank of Ethiopia can periodically, or at anytime giving or without giving advance notice make or cause to be made the inspection of a given microfinance institution when the bank deems this necessary, as per article 18(1) of this proclamation. The second is when one-tenth of the total number of depositors or any number of depositors holding not less than one-sixth of the deposits of a micro-financing institution makes an application to the National Bank of Ethiopia for the inspection of the

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a)cannot meet its obligations to its depositors or other creditors; or b)possibly unable to made payments on time to depositors or other creditors.

concerned microfinance institution. Based on article 18(2) of this proclamation, the very purpose of such inspection is to ensure whether or not the microfinance institution is in a sound financial condition and to ensure whether or not the provisions of this Proclamation and regulations and directives issued hereunder have been complied with. When the inspection concludes that the microfinance institution did not comply with the relevant laws, directives, proclamations or with the terms and conditions of license or it has engaged in practices detrimental to the interests of depositors or it has serious weaknesses in its corporate governance, the National Bank of Ethiopia can take one or more corrective measures. Particularly, the National Bank of Ethiopia may: a) require the inspected micro-financing institution to call a meeting of its shareholders or board of directors for the purpose of considering any matter arising out of, or relating to, the inspection or require the officers of such micro- financing institution to discuss any such matter with the officers of the National Bank; b) depute one or more of its officers to watch the proceedings at any meeting of the board of directors of the inspected micro-financing institution or of any committee or of any other body constituted by it and require the inspected micro-financing institution to give an opportunity to the officers so deputed to be heard at such meetings; c) instruct in writing corrective actions to be taken by the inspected micro-financing institution;

d) impose a fine, as prescribed by its directives, on the inspected micro-financing institution's one or more directors, the chief executive officer and other senior officers, or order their suspension or dismissal from duty; e) prohibit the micro-financing institution from opening new branches; f) restrict, suspend or prohibit payment of dividends;

g) direct the inspected micro-financing institution to temporarily suspend any one or all of its micro-financing business; or h) revoke the license of the micro-financing institution and initiate the process of its liquidation. This is provided in article (18(7). Generally, it can be said that the National Bank of Ethiopia can take one or more of the administrative sanctions including fines in case of non-compliance with the relevant laws. Yet, article 25 of Proclamation No.626/2009 deals specifically with the penalties in case of violations of this proclamation. Particularly, article 25(1) provides that “Any director, officer or employee of a micro-financing institution who: obstructs the proper performance by an auditor of his duties in accordance with the provisions of this Proclamation or inspection

of a micro-financing institution by an inspector duly authorized by the National Bank or with intent to deceive, makes any false or misleading statement or entry, or omits any statement or entry that should be made in any book, account, report or statement of micro-financing institution; shall be punished with a fine from Birr 50,000 to Birr 100,000 and with rigorous imprisonment from 10 to 15 years.” Besides, article 25(2) states that “ Without prejudice to sub-article (1) of this Article, any person who contravenes or obstructs the provisions of this Proclamation or regulations or directives issued to implement this Proclamation shall be punished with a fine up to Birr 10,000 and with an imprisonment up to three years.” The following points can be made with regard to the above article. In the first place, the penalties above can be classified into fines and imprisonment. The range of fines generally is from 10,000-100,000. And the range of imprisonment is from three years to 15 years. The first sub article is applicable to physical person whereas the second sub article is applicable to both. From a cumulative reading of all the above proclamations, it can be said that the penalties in Ethiopia in case of violations of the above laws on the financial sector in Ethiopia include administrative, civil and criminal sanctions.

On the other hand, to see what the practice looks like, I raised to my interviewees from the National Bank of Ethiopia the question: How do you enforce related party transactions in the Ethiopian financial sector? Three of the interview participants from the National Bank of Ethiopia, namely, Ato Zeray G/wahid and Semir Teka and Ato Semere W/eyesus said that they use the public enforcement mechanisms in general. Particularly, Ato Zeray G/wahid and Semir Teka replied that they can take the administrative measures including the dismissal of the persons who involves in abusive related party transactions. Ato Semere W/eyesus also expressed the opinion that it will take some years to come up with the self- regulation rules and enforce them in the present Ethiopian financial market situation. Over and above, I forwarded to my questionnaire participants the question: Did you know/hear a legal suit in relation to related party transactions in the Ethiopian financial sector? In this regard, 12 of them replied me in the affirmative but 10 of them in the negative. Finally, a study on the “Reports on the Observance of Standards

and Codes in Ethiopia” in 2007 indicated that Ethiopia has not yet experienced litigation on financial reporting. This is because there are no records of litigation dealing with financial reporting. But, it is mentioned here that the study team understands that the country has recorded minor litigation on governance issues, particularly with director’s remuneration. This study also provided that as sophistication of the economy increases, increased litigation would be more likely so that there will also be an increase in the need for good financial reporting infrastructure as well as overall good corporate governance infrastructure.<sup>326</sup>

#### **5.4. Class Actions and Derivative Suits**

Below some points will be raised whether or not the class action and derivative suits are available in the Ethiopian legal system in general and in enforcing related party transaction claims in the Ethiopian financial sector in particular. As discussed in unit four, particularly 4.3, the applicability of class action and/ or derivate suits to related party transaction claims is clearly provided in some countries. But, efforts will be exerted below to look at some laws which may have relevance in Ethiopia.

#### **Class Actions**

Though the laws in the Ethiopian financial sector do not contain clear provisions on the application of class action to related party transaction claims, we can see some laws such as the 1995 Federal Democratic Republic of Ethiopia Constitution and the Ethiopian Civil Procedure Code which have a general application in class action suits. Particularly, even if it is very general, article 37(2) of the Constitution of the Federal Democratic Republic of Ethiopia deals with the concept of class action. Accordingly, we may argue that the related party transactions may be subject to class action in so far as the issue is justiciable matter. Besides, article 38 of the civil procedure code provides with class actions in civil case matters. One may also argue that article 367 of the commercial code of Ethiopia provides the concept of class actions but not clearly used the terms class

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<sup>326</sup> . Supra note 293, p.10

action. This is because, as I have raised it on 4.3 above, class actions are shareholders direct actions. But, the idea in class actions is that there is plurality of the shareholders in the action so that there is a representative litigation. Thus, we can argue that the above laws can be used in the class actions in related party transaction claims in the Ethiopian financial sector.<sup>327</sup>

### **Derivative Suits**

The discussion here will be made clear when shareholder derivative suit is discussed in comparison to shareholders direct actions. In the first place, direct action refers to the claim of the shareholder(s) to sue the company, directors or third party in on his/their own right and name because of a harm done to the shareholder(s) himself or themselves. However, derivative action/suit refers to the claims of a shareholder(s) to sue the directors or third parties on the right and on behalf of the company because of the harm done to the company itself. From the above definitions, it could be inferred that the right of shareholder(s) in direct action is direct (original), whereas in case of derivative suit their right is indirect (secondary) in general.

When we come to discuss these concepts in Ethiopia, even if it is not clearly provided in the laws dealing with the regulation of related party transactions in the Ethiopian financial sector, one can argue that the commercial code has some relevant provisions with respect to shareholders derivative and direct actions. Mention can be made that article 365, particularly 365(4) talks about shareholders derivative action. But, article 367 is concerned with shareholders direct actions. Each article is provided and discussed below briefly. Article 365 of the Commercial Code of Ethiopia deals with proceedings to enforce the liability of directors<sup>328</sup> and reads: 1) No proceedings shall be instituted against the directors without a resolution of a general meeting to this effect. Such a resolution may be moved on and adopted although not on the agenda. 2) Where a

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<sup>327</sup> . For details on the class actions in Ethiopia, please see: Getachew Aberra: “The Scope and Utility of Class Actions under Ethiopian Law: A Comparative Study,” Journal of Ethiopian Law, Vol. XX, August, 2009, p.ps.21-61.

<sup>328</sup> . Please read the Amharic version of the same code for clarity.

resolution to institute proceedings or to compromise a claim is adopted by a vote of shareholders representing at least one fifth of the capital, the director concerned shall be removed. The same meeting shall appoint a director to replace the director who has been removed. 3) A resolution not to institute proceedings and to compromise shall not be adopted where shareholders representing at least one fifth of the capital vote against the resolution. 4) Where a resolution under sub-article (2) is adopted but the company fails to institute proceedings within three months, the shareholders who voted for the resolution may jointly institute proceedings. Generally, article 365(4) appears to have recognized the concept of derivative action of share holders. This is because we can see here that the right of the shareholders to institute an action against the director(s) is not a direct one. Rather, their right is based on and derived from the right of the company. It is clearly provided in the above provision that the shareholders have the right to sue directors if the company itself does not sue the directors where a resolution to sue them was supported by the votes of shareholders representing at least one fifth of the capital within three months. Besides, it should be clear here that it is not all the shareholders of the company who can sue even derivatively against the directors. It is only those shareholders who represent at least one fifth of the capital of the company and voted to proceed against the director(s). However, article 367 of the commercial code talks about proceedings instituted by shareholders and third parties against director(s). In particular, this article provides that “Nothing in this section shall affect the rights of shareholders or third parties who have been injured by the fault or fraud of the directors.” This provision is partly about the shareholders direct action against directors. The idea here is that even if the shareholders can derivatively sue the directors on the name and on behalf of the company, this will not prevent a shareholder(s) or a third party (parties) to institute an action on their own name and right if these shareholders or third parties faced a harm as a result of a fault or fraud committed by the concerned director(s). In general, these provisions and their practice appear logical because the company and the concerned shareholders are suing the directors for the damage each suffered by the faults, frauds or negligence of the directors. Conversely, the implication here is that the same cause of action could enable both the company and the shareholders to institute actions against the directors.

When we come to see the practice in Ethiopia, even if it is difficult<sup>329</sup> to get a case which clearly and purely deals with derivative action, there seems little practice in this area. For example, the case<sup>330</sup> between Ato Gemechu Guta et al and Awash International Bank File No. 188328 at Lideta First Instance Court can be mentioned here. The substance of the case indicates that this case deals with the concept of derivative action. In addition to this case, I have raised to my interviewees from the National Bank of Ethiopia this question: Do you think that derivative suits are applicable to related party transaction claims in the Ethiopian financial sector? In the first place, my interviewees from the National Bank of Ethiopia were not clear with the concept of derivative suits. After my explanation on the concept, particularly, Ato Zeray G/wahid and Ato Semir Teka replied me that there is no such practice so far. This is because the individual victim himself will sue. But, the other National Bank of Ethiopia interviewees jumped this question.

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<sup>329</sup> . This is also confirmed by an interview held with Ato Tamiru Wondimagegnehu.

<sup>330</sup> . This case was instituted by five shareholders of the Bank for the dismissal of three board members, who participated in the case as interpleaders, alleging that they were appointed in the general meeting held in September 11[13] 2003 E.C. The case was initiated on 29/02/2003 E.C. and decided on 22/06/2004 E.C at Lideta First Instance Court. The court framed two issues in this case: 1. whether or not the plaintiffs had the right or interest to sue the Bank; 2. if they had the right to sue, whether or not their claim can be barred by period of limitation. Finally, the court held that the plaintiffs had the right to sue but that their claim is barred by period of limitation. The plaintiffs then appealed to the Federal High Court

## **Chapter Six- Conclusions and Recommendations**

### **6.1. Conclusions**

It should be clear first that, for the sake of clarity and convenience, the discussions in the conclusions are made into two parts; the general remarks and the Ethiopian financial sector context. However, they are not mutually exclusive even if the focus will be on the latter part.

Despite its great negative or positive impact on the company and / or the financial sector, the issue of related party transactions was not given due regard until recent times. It is since recent times, particularly after the occurrences of several financial frauds and collapses of many huge companies in many parties of the world that countries began to regulate related party transactions. Even in the modern days, compared to its impact, the attention given to it is still relatively little in many countries. In the early years there was a misunderstanding on the nature of related party transactions in that it was thought that the abusive related party transaction was only confined to some sectors of the economy and that the problem was limited to some geographic location particularly to America. However, currently, this misunderstanding is greatly avoided. Hence, it can be boldly said that related party transactions have become a global hot topic and thus, has got better attention because of the relationship between undisclosed and abusive related party transactions and the failure of several huge companies in many countries. Besides, we can see that many countries moved from totally prohibiting related party transactions to providing with the general guidelines of disclosure and approval requirements. Thus, during the current time, we can infer the existence of a strong belief that shareholder and investor protection mechanisms such as timely and transparent disclosure, approval processes, effective internal governance systems and enforceable regulations are essential in the regulation of related party transactions. The fact that only some types of related party transactions, such as loans to executives, are prohibited signifies that the regulators have impliedly recognized that the other types of related party transactions are legitimate and that they can enhance efficiency of the company. However, note should be made on

the importance to identify whether or not there exists a related party relationship between two or more entities or persons. If it is established that there exist such a relationship, it will be crucial to determine whether there is a transaction between them. The reporting entity is required to disclose such a relationship to the concerned body whether or not there exists a transaction between them. But, the mere disclosure of such a transaction will not make the transaction valid. Approval or ratification of the transaction by the concerned committee, or board of directors or the shareholders, as the case may be, is required. Thus, before the approval or ratification, the fate of the said transaction differs in different jurisdictions. This is because, while some countries nullify the transaction, others suspend the validity of such transaction. Still others assume the transaction valid till it is disapproved by the relevant organ. Thus, in the modern time, it is only when the related party transaction is abusive that such a transaction is prohibited. This implies that not all related party transactions are prohibited. For example, if the related party transaction was concluded at arm's length, such a transaction will not be prohibited. This is because insofar as such a transaction does not affect the interests of the shareholders, company or creditors, there is no reason to prohibit it. On the other hand, it is only when there is a conflict of interest or when it gives an economic benefit to the related party that such a transaction will be prohibited. Therefore, it will be important to distinguish between normal (at arm's length) related party transaction and an abusive related party transaction. But, if after such distinction the transaction is found to be abusive, it should be noticed that different sanctions will be followed. Generally the sanctions are civil, administrative and criminal penalties. From the context of the victim of abusive related party transactions, the above mentioned sanctions will also be provided as remedies. It can also be safely concluded that the main components in the regulation of related party transactions include definition, disclosure, review and ratification, detection and monitoring, approval processes and sanctions and remedies in case of abuse. On the other hand, even though there are several improvements in the regulation of related party transaction, much more remains to be done in some issues such as the need for broad and clear definitions of related parties, disclosure, effective use of shareholders' derivative or class action suits through the introduction of legal incentives such as in the burden of proof, power of discovery and attribution of legal fees. Besides, it is provided that the

regulation of related party transactions should give proper attention to both the adequacy of the legal framework and its enforcement. Further more, in the regulation of related party transactions, due attention should be given to the spirit and substance of the law not merely its letter and form. For example, disclosure requirement should be fulfilled not only for the sake of the satisfaction of legal requirement but it should be adequate enough to enable the users of the financial statement and make decisions on the financial soundness and conditions of the reporting entity.

Coming to the discussion of regulation of related party and their transactions in Ethiopian financial sector, the following points could be specifically mentioned. Even if there is an attempt to deal with the regulation of related party in the banking sector under Directives No.SBB/53/2012, there are many gaps in this area. Thus, the gaps will be discussed briefly below. To begin with, the definition of related party provided in the Directive deals specifically with commercial banks. Hence, there is no clear provision defining related parties to non-commercial banks as defined in the above directive. Further more, there is no clear definition for related party transaction provided in the Directive. As mentioned above, the Directive simply tried to define related party. Over and above, Directives No.SBB/53/2012 only deals with the limitation of loans to related parties in commercial banks as defined in this Directive. It should be clear that the provision of loan to related parties is only one type of related party transactions as clearly provided in IFASB Statement No.57 and in other national accounting standards. Hence, the other types of related party transactions are not clearly recognized. On the other hand, disclosure requirement of related party relationships and related party transaction is provided neither in the above Directive nor in other laws in Ethiopian financial sector. It simply provides for the reporting requirement. Furthermore, the review, approval or ratification requirements in relation to related party transactions are not provided in it. Besides, no clear sanctions are imposed in case when the rules on related party transactions are violated. In addition, the victim of abusive related party transaction is not provided with clear legal remedies in the Ethiopian financial sector. In conclusion, it could be argued that the regulation of related parties in the financial sector in Ethiopia is

given little attention. But, it should be mentioned that there are other relevant laws that deal with different issues of regulation of related party transactions in Ethiopia found scattered here and there. Though, it is good to come up with some provisions dealing with the regulation of related parties in banks, much remains to be done to come up with clear and detailed provisions on related parties and related party transactions with respect to banks, insurance companies and microfinance institutions in Ethiopia.

## **6.2. Recommendations**

Generally, the recommendations below can be grouped into legal framework and institutional frameworks. But, it will be sometimes difficult to classify them into the legal and institutional frameworks. Thus, putting each recommendation in either category was not preferred for that reason. Anyways, the researcher came up with the following recommendations.

Therefore, it is recommended that:

1. The relevant Ethiopian laws shall deal clearly and sufficiently with issues of related party transactions such as remedies available to victims of abusive related party transactions and sanctions against the parties involved in abusive related party transactions. Besides, appropriate sanctions shall also be provided in case of failure of financial reporting, auditing and accounting procedures. More particularly, there shall be relatively wider definitions and some examples of related and non-related parties' provisions illustratively to have a better concept and a better enforcement of the legal and regulatory framework. Again, the definition for related party transaction should be provided in Ethiopian financial sector clearly.
2. There shall be clear approval/disapproval procedures for related party transactions. In addition, there should be an establishment of truly independent board of directors and other relevant committees who approves or disapproves related party transaction.

3. The requirements and the procedures of disclosure should be adopted in the regulation of related party transactions in the Ethiopian financial sector. Further more, there should be timely publication of related party transactions and it should be easily accessible to all interested bodies.

4. Distinctions should be made between material and immaterial related party transactions in the Ethiopian financial sector. This is important for approval, disclosure and reporting purposes.

5. In addition to loan, regulation of other types of related party transactions should also be provided in Ethiopian laws regulating related party transactions in financial sector. The related parties include: sale or purchase of goods, assets, rendering of services, leases, sharing of assets and management and transfer of research and development.

6. The future law reform on the regulation of related parties in Ethiopian financial sector should recognize the role of whistle blowers and clearly provide them with adequate protection. The law should also clearly state that if the employer has dismissed the whistle bower or retaliated him in any other manner, the employer shall be punished in court and /or other administrative measures shall be taken.

7. In addition to the state regulatory framework, due attention should also be given to self regulation, awareness creation program to the business community and training to the concerned organs such as regulatory organs and judges in fighting abusive related party transactions.

8. In the future, the regulator, the National Bank of Ethiopia or an organ authorized by it, should come up with either a simplified form of reporting, disclosure and approval requirements of related party relationship and transactions for small and medium sized enterprises or disclosure, reporting and approval requirements of banks and insurance companies, in relation to microfinance institutions.

9. In order to better understand the concepts and for the better enforcement of related party transactions, the legal spirit and substance, not the legal letter and form should be adhered to in regulating related party transactions in Ethiopian financial sector. Otherwise, literal application of the laws on related party transactions may not achieve the purpose they are intended for.

10. In addition to the need for the adequacy of the legal and regulatory framework, due attention should also be given to the enforcement issue if the objectives of the legal and regulatory framework are to be achieved.

11. Depending on different factors, related party transactions may be harmful to or beneficial to the company, its shareholders and other stakeholders. Thus, to reduce the harms and enhance the benefits, the theories should be considered together in regulation of related party transactions in the Ethiopian financial sector.

12. To be effective, policies in the regulation of related party transactions should be in conformity with the country's legal traditions and also consider other factors such as corporate ownership structures and the need to protect the public interest at large.

13. The relevant financial sector laws dealing on regulation of related party transactions are now found scattered here and there so that such laws should be codified. Or at least, their references or cross-references in other laws shall be made when dealing with related party transactions in the relevant laws. In addition, even if there is no (and could not be expected in the future) perfect regulatory framework in the world, Ethiopia should try to continuously update its regulation on related party transactions to the extent possible and as the time may require.

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## APPENDICES

### I. Questionnaires

#### A. Questionnaires distributed to

No.	Name of the Bank	Branch distributed to
1.	Abyssinia Bank	6 kilo branch
2.	Commercial Bank of Ethiopia	6 kilo branch
3.	United Bank	6 kilo branch
4.	Commercial Bank of Ethiopia	Kidist Mariam branch
5.	Commercial Bank of Ethiopia	4 kilo branch
6.	Commercial Bank of Ethiopia	Birhanina Selam branch
7.	Buna International Bank	Head office
8.	Awash International Bank	4 kilo branch
9.	Commercial Bank of Ethiopia	Sellassie branch
10.	National Bank of Ethiopia	Legal Services Directorate

#### B. Questions in the Questionnaires

##### Hints on how to answer the questions

You can answer questions no. **3,4,5, 6 and 10** by selecting and filling in ‘Yes’ or ‘No’ in the blank spaces provided for each question. But, for the other questions, your opinions should be provided in writing in the spaces provided for each question. Finally, note that the important issue is indicated in **bold**.

## The Questions

1. Why do we regulate related party transactions in the Ethiopia financial sector **now**?

.....  
.....

2. What do you think is the purpose of regulation of related party transactions in the Ethiopian financial sector?

.....  
.....

3. Are there related party transactions in your **company/institution**? **Yes** or **No**

.....

4. If your answer to question no. 3 above is **Yes**, are they **prevalent**?

.....

5. If your answer to question no. 4 above is **Yes**, are they **abusive**? **Yes** or **No**

.....

6. Do you think that related party transactions are **prevalent currently in Ethiopia**?

**Yes** or **No**

.....

7. Which **specific organ of each individual commercial bank** has the responsibility to identify the existence of related party and/or related party transactions in banks in Ethiopia?

.....

8. What **remedies** are available to a person affected by **abusive** related party transactions in your institution?

.....

.....

9. What **sanctions/measures** can be taken against a person involved in **abusive** related party transactions in your institution?

.....

.....

10. Did you know/hear a **legal suit** in relation to related party transactions in the Ethiopian financial sector? **Yes** or **No**

.....

11. Don't you believe the importance of **whistle blowers** and their legal protection in the identification and prevention of abusive related party transactions in the financial sector in Ethiopia?

.....

.....

12. What do you **recommend** in relation to related party transactions in the Ethiopia financial sector in general?

.....

.....

## II. Interviews

### A. Persons Interviewed

No.	Name of interviewee	His/her position in the NBE <sup>331</sup>	Interview duration
1.	Ato Zeray G/Wahid	Acting chief legal officer	Interviewed Zeray and Semir together for more than 2 hours and 10 minutes
2.	Ato Semir Teka	Legal services directorate	
3.	W/ro Serkaddis Adugna	Insurance directorate- principal Examiner	more than 30 minutes
4.	Ato Abate Mitiku	Microfinance directorate	more than 10 minutes
5.	Ato Semere W/eyesus	Former bank supervision but now in the Credit Information Bureau	more than 1 hour and 20 minutes
6	Zekarias Kenea (Associate professor)	Lecturer at Addis Ababa University, Law School	On 04/04/2005 for about 13minutes
7	Ato Tamiru Wondimagegnehu	Attorney -at -Law-and Consultant	on 10/10/2005 from 4: 30-4:40 for 10 minutes via mobile

<sup>331</sup> . All interviews with persons from NBE were held on 13/03/05 E.C.

## B. Questions for Interview

1. Was there **any research conducted** on the **same issue** in Ethiopia by one of your staff or sponsored by your institution?
2. Do you have a **record** of how many related party transactions occur **each month and/or year** in your institution?
3. Can you **provide me some random copies** of related party transactions in your institution?
4. How do you **identify** between **abusive and non-abusive** related party transactions in the Ethiopian financial sector?
5. Do you think that **class action suits** are applicable to related party transaction claims in the Ethiopian financial sector?
6. Do you think that **derivative suits** are applicable to related party transaction claims in the Ethiopian financial sector?
7. Don't you believe that regulation of related party transactions is important in microfinance institutions?
8. Why the regulation of related party transactions is limited to **loans** and commercial banks in Ethiopia?
9. Don't you think that the **existing laws in Ethiopia** are **inadequate** in the regulation of related party transactions in the financial sector in Ethiopia? Hint: For example, there are no requirements of *disclosure, approval or ratification of related party transactions, no*

*definition for related party transactions and the relevant directives are mainly limited to **commercial** banks only.*

10. Taking into account the **gaps and inadequacies**, as indicated in no. 7 above, of the laws in the regulation of related party transactions, do you **plan to issue directives** in this regard in the near future?

11. How do you **enforce** related party transactions in the Ethiopian financial sector? Hint: *Self/market regulation vs. public enforcement- derivative suits, class action, sanctions, remedies*

**Declaration**

I, the undersigned, declare that the thesis is my original work and has not been presented for a degree in any other university and that all sources of materials used in the thesis have been duly acknowledged.

**Declared by:-**

Getachew Redae

Signature \_\_\_\_\_

Date \_\_\_\_\_

**Confirmed by:-**

Professor Tilahun Teshome

Signature \_\_\_\_\_

Date \_\_\_\_\_