Linklaters

New rules for related party transactions take effect on 10 June

Main Market listed companies will need to put procedures in place to comply with new requirements for material related party transactions, including a need for board approval and public announcement.

The requirements, which are being brought in to comply with the EU Shareholder Rights Directive, will apply to both standard-listed and premium-listed companies when they enter into certain types of transaction in financial years starting on or after 10 June 2019.

In this note we provide an overview of the new regime and action points for companies to consider.

What does it mean for listed companies?

Premium-listed issuers are used to complying with related party transaction rules under the current Listing Rule 11, but the new rules are slightly broader in scope. Companies will need to ensure that they can identify related parties as defined by the new rules (see box overleaf). They should also review their procedures for assessing whether transactions are in the ordinary course of business.

For standard-listed companies on the other hand, the rules are entirely new. Such companies will need to establish an effective process for the identification and correct treatment of related party transactions, as well as ensuring that relevant transactions are approved by the independent board members and announced to the public. The rules apply with modifications to standard listed companies incorporated outside the EEA.

Other companies caught by the new rules are those with a sovereign controlling shareholder and a premium listing of shares or GDRs under Listing Rule 21, closed-ended investment funds with a premium listing under Listing Rule 15, and UK-incorporated companies with a listing of shares on a regulated market elsewhere in the EU. Companies with a standard listing of GDRs are outside the scope of the rules. Companies incorporated elsewhere in the EEA but listed in London have to comply with the corresponding rules of their home country instead.

What transactions are caught?

The rules apply to material (see first box overleaf) transactions between an issuer or a subsidiary undertaking of an issuer on the one hand, and a related party (see second box overleaf) on the other. They also apply to any arrangement whereby such parties invest in or provide finance to another undertaking or asset.

Ordinary course of business and normal market terms

There is a blanket exemption for transactions which are in the ordinary course of business and on normal market terms. Issuers must maintain adequate procedures, systems and controls to enable them to assess whether a transaction falls within the exemption. Anyone who is connected with the related party in question should not take part in that assessment.

Other exemptions

As well as the ordinary course exemption, the new rules will not apply to:

> Transactions or arrangements between an issuer and its subsidiary undertaking, as long as no other related party has an interest in that subsidiary undertaking. Company secretaries should maintain a running list of any non-wholly owned subsidiaries where another shareholder is a related party in its own right.

> Transactions or arrangements regarding directors' remuneration which are in accordance with the directors' remuneration policy already approved by shareholders under the Companies Act 2006. This exemption will be of little use to issuers incorporated outside the UK.

> A transaction offered to all shareholders on the same terms where equal treatment of all shareholders and protection of the interests of the issuer is ensured. This is potentially useful for transactions such as share buybacks and rights issues, although it is unclear whether the usual exclusion of overseas shareholders from participating in such a transaction would mean that this exemption does not apply (as the transaction will then not be offered to all shareholders).

What if you enter into more than one transaction with the same related party?

Transactions with the same related party and any of its associates over a 12-month period have to be aggregated. If the materiality threshold is met on aggregation, the rules have to be complied with for each transaction or arrangement. From the beginning of the first financial year starting on or after 10 June 2019, listed companies should keep records of all transactions and arrangements with related parties (even small ones) unless they are in the ordinary course of business and on normal market terms. Any time a new related party transaction is entered into, that list can then be checked to see if there are other transactions over the last twelve months that need to be aggregated when applying the materiality test.

What are the requirements for a material RPT?

If an issuer or its subsidiary undertaking enters into a material related party transaction which is not exempt:

> an announcement (see below) must be made at the time the terms are agreed; and

> unless the issuer is incorporated outside the EEA, the board must approve the transaction before it is entered into. Any director who is, or an associate of whom is, the related party, and any director who is a director of the related party, must not take part in the board's consideration of the matter or vote on the board resolution. Companies should check that their constitutional rules allow them to exclude directors from board decisions in this way.

Announcements

Announcements should be made on an RIS and need to include the name of the related party and the nature of the relationship, the date and value of the transaction or arrangement, and any other information necessary to assess whether it is fair and reasonable from the perspective of the issuer and of the non-related shareholders (including minority shareholders).

Do these rules still have to be met by a premium-listed company that complies with LR 11?

If you have complied with LR 11.1.7 for large related party transactions (eg obtained shareholder approval and made an announcement) or with LR 11.1.10 for smaller related party transactions (eg obtained a fair and reasonable opinion and made an announcement) in relation to the transaction in question, that will automatically satisfy the new requirements.

The rules are more likely to affect a premium-listed company in the case of transactions which benefit from one of the exemptions under LR 11 (and therefore are not announced or approved under that rule) but are not exempt under the new rules. However, any transactions that fall in this category may need to be announced anyway (perhaps as inside information or under the class transaction rules in LR 10). See the checklist at the end of this note for actions companies should take to make sure they do not inadvertently trip up on the new rules.

Where can I find the new rules?

The rules are contained in a new DTR 7.3, as modified for different types of issuer by the relevant chapters of the Listing Rules.

Click here for the FCA's policy statement PS19/13 including the final rules.

What is a material transaction?

Issuers will need to run a series of four tests to determine a percentage ratio. If the ratio is 5% or more on any one of those tests, the transaction or arrangement will be material.

The tests are the same that premium-listed issuers apply on significant transactions, namely:

> Gross assets: the gross assets which are the subject of the transaction divided by the gross assets of the issuer.

> Profits: the profits attributable to the assets which are the subject of the transaction divided by the profits of the issuer.

> Consideration: the consideration for the transaction as a percentage of the aggregate market value of all the ordinary shares of the issuer.

> Gross capital: the gross capital of the company or business being acquired divided by the gross capital of the issuer.

Who is a related party?

The new rules borrow the definition of related party from accounting standards. This includes a wider range of potential related parties than the existing regime under LR 11. Issuers will need to carefully consider who their related parties are, in conjunction with their accountants or others conversant with International Accounting Standard 24.

In particular, related parties include:

> All of the issuer's directors and key managers, as well as those of any parent company, together with all of their close family members and any entities they control or jointly control. An issuer should know about many of these related parties as they should be identified on the list of closely associated persons maintained under the Market Abuse Regulation. However, the test is not exactly the same and so issuers should double check there are no additional related parties in this category.

> Group companies, although transactions or arrangements with a subsidiary undertaking will be exempt from the rules unless another related party holds an interest in that subsidiary undertaking.

> Associates and joint ventures: any entity that is an associate or joint venture of the issuer or its group, and any subsidiaries of such associate or joint venture, will be related parties. The rules are quite subjective in this area and need to be carefully considered.

  > An associate relationship exists where one entity has significant influence over the other. This will be presumed where one entity holds 20% or more of the voting rights but can also arise where one entity has the power to participate in the financial and operating decisions of the other.

  > A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to its net assets. It will typically arise where key decisions require unanimous consent. However, other types of joint venture may still lead to related party relationships as the JV entity may well be a group company of the issuer or an associate. Note that a joint venture partner may well be a related party if the JV entity is a subsidiary undertaking of one of the partners and an "associate" of the other.

Issuers incorporated outside the EEA can instead use the definition of related party from the accounting standards used in their accounts.

Action plans for companies

The table below sets out suggested actions for listed companies to take so that they are in the best position to comply with the new rules. Linklaters has been closely monitoring the development of the new rules, as well as being experienced in advising our clients on the existing related party transactions regime. Please contact one of those named below or your usual Linklaters contact if we can be of any assistance.

Who are your related parties?	> Create (or revise for premium-listed issuers) your list of related parties by reference to the IAS 24 definition. Ask accountants to help. > Are there any related parties listed in your last accounts that should be added? > Ask directors and senior managers to update their lists of family members and controlled companies. Include directors of subsidiary undertakings. > Don't forget "internal" related parties like the directors themselves and any subsidiary undertakings that have a related party as a shareholder. > Set-up a process to review and revise the list periodically, as relationships change.
What is your process for identifying related party transactions?	Consider your existing processes and whether they need to be looked at again to be fit for the new rules. In particular, no transactions should be entered into by any group company with anyone on the related party list without an appropriate person (this might be someone in Group Legal) confirming that the new rules are not triggered and considering whether the transaction needs to be recorded for aggregation purposes.
How will you assess if a transaction or arrangement is in the ordinary course of business and on normal market terms?	Consider how this is best achieved. For example, by drawing up internal guidelines including examples of transactions which are or are not likely to be in the ordinary course of the company's business. Ensure no related party or person connected with such party is involved in the assessment.
What will be your process for assessing materiality of non-exempt transactions?	If a premium-listed company, will you involve your sponsor? Who will lead this internally?
How will you ensure relevant transactions or arrangements are aggregated?	How will you ensure that all relevant transactions are recorded, and that the list is checked for aggregation purposes before a new transaction is entered into?
Can you exclude interested directors?	Check that your constitution is consistent with excluding related party directors from the board deliberation and approval of any material related party transaction.
Who do you need to brief internally?	Board members, procurement, corporate finance, investor relations and company secretarial teams will all need to be aware of the new rules and the new processes you are putting in place to comply with them.

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