SRD II: UK implementation: new related party transaction regime

An overview of the FCA final rules for a new related party transaction regime (PS19/13).

The FCA has published a policy statement (PS 19/13) with its final rules for implementation of parts of the revised EU Shareholder Rights Directive II (SRD II). This includes its rules for a new related party transaction regime which run alongside the existing related party regime in chapter 11 of the Listing Rules (Chapter 11 regime). The new regime requires companies with shares admitted to trading on a regulated market to disclose and obtain board approval for material related party transactions.

This follows the FCA’s consultation paper (CP19/7) published in February 2019.

When do the new rules apply?

Companies within scope must comply with the new requirements from the start of their first financial year following 10 June 2019. The aggregation rules apply to any transaction or arrangement entered into on or after the start of that financial year.

SRD II

SRD II amends the Shareholder Rights Directive to strengthen shareholder engagement and increase transparency. It:

- includes new rules which allow companies to ask for information about the identity of their shareholders from intermediaries and place various obligations on intermediaries to transfer information to and from the issuer and its shareholders
- aims to tackle a perceived lack of shareholder engagement in the market by requiring asset managers and institutional investors to put in place a shareholder engagement policy and to increase the transparency of their investment strategies
- has new rules for proxy advisors
- introduces a new related party transaction regime that runs in parallel to the existing related party regime in Chapter 11 of the Listing Rules, and
- requires listed companies to publish a remuneration policy and to give shareholders a vote on the remuneration policy. Member States can decide whether this should be a binding vote or an advisory one only. This is already a
binding vote in the UK and will remain so.

All of the provisions had to be implemented into national law by 10 June 2019 other than those relating to the identification of, and communication with, shareholders which do not apply until 10 September 2020.

See “SRD2 - are you ready?” for the new obligations on asset managers and life insurers.

**Material related party transaction regime**

**Where are the new rules?**

The current Chapter 11 regime, which only applies to premium listed companies, remains in place and the FCA has not made any changes to this regime.

The SRD II regime has been implemented by adding another regime in the corporate governance rules in the Disclosure Guidance and Transparency Rules (DTRs).

Amendments have also been made to the Listing Rules to bring certain companies in scope.

**Who is in scope?**

The new regime applies to all companies with their registered office in the UK and whose shares (carrying voting rights) are admitted to trading on a regulated market, whether in the UK or elsewhere in the EU, as required by SRD II.

This includes UK incorporated issuers of non-listed shares admitted to trading on a regulated market (such as the Specialist Fund Segment or High Growth Segment in the UK, or a regulated market elsewhere in the EU).

To reconcile the SRD II scope with the principle that all issuers in a given listing category should meet the same requirements, the FCA has also extended the scope to include:

- all issuers with a premium listing (other than open-ended investment companies subject to LR16) not already caught, and
- all issuers with a standard listing of equity shares (LR14) not already caught (other than standard listed GDR issuers).

In each case as though they were a company within scope, subject to certain exemptions for non-EU issuers.

The FCA has also extended the scope to include all sovereign controlled companies and, in the case of these companies, is extending it to include shares and GDRs.

**Exemptions**

Although the FCA has decided to still extend the new regime to non-EU issuers, following feedback, it has modified its proposals for them.

Acknowledging the difficulties in operating an exemption regime, it is no longer offering an exemption for compliance with "equivalent" overseas related party regime. Instead, as interaction with potentially conflicting corporate governance
obligations in other jurisdictions was a concern, non-EU issuers do not have to get board approval for a related party transaction and only have to announce material related party transactions when the terms are agreed.

Non-EU issuers will also have the choice of using the definition of "related party" either in International Financial Reporting Standards or in the alternative accounting standards that they use to prepare their consolidated annual financial statements, where they are deemed to be "equivalent" for the purposes of the Transparency Directive. The FCA state that these changes should reduce the risk of conflicting obligations on issuers and should also make the costs of complying with the new regime more proportionate.

**Who is a related party?**

Related party has the meaning given in the International Financial Reporting Standards (IAS 24) which is wider than the definition in the Chapter 11 regime. (This definition will change if the definition in the IAS changes.)

A related party in IAS 24 is currently a person or an entity that is related to the reporting entity:

- a person or a close member of that person’s family is related to a reporting entity if that person has control, joint control, or significant influence over the entity or is a member of its key management personnel.
- an entity is related to a reporting entity if, among other circumstances, it is a parent, subsidiary, fellow subsidiary, associate, or joint venture of the reporting entity, or it is controlled, jointly controlled, or significantly influenced or managed by a person who is a related party.

**What is a related party transaction?**

The transactions are the same as for the Chapter 11 regime, namely:

- a transaction between an issuer and a related party
- an arrangement under which an issuer and a related party each invests in, or provides finance to, another undertaking or asset, or
- any other similar transaction or arrangement between an issuer and any other person where the purpose and effect of which is to benefit a related party.

It also includes any transactions or arrangements by the issuer’s subsidiary undertaking.

**Which transactions are excluded?**

The FCA has excluded the following:

- any transaction or arrangement in the ordinary course of business and concluded on normal market terms
- any transaction or arrangement between an issuer and its subsidiary undertakings if the subsidiary undertaking is wholly owned or no other related party of the issuer has an interest in the subsidiary undertaking
- any transaction or arrangement offered to all shareholders on the same terms where equal treatment of all shareholders and protection of the issuer’s interests is ensured, and
- any transaction or arrangement regarding a director’s remuneration that is to be awarded or due under the issuer’s director’s remuneration policy approved in accordance with the UK Companies Act 2006. (ie provisions which implement the remuneration aspects of SRD II).

The FCA notes that, in practice, remuneration paid to directors may be disclosable by non-EU issuers if the director is a
related party (under the IFRS definition of a related party or the definition in the alternative "equivalent" accounting standard) and the transaction is not in the ordinary course of business and concluded on normal market terms.

There are no exemptions for transactions entered into by credit institutions nor for transactions for which UK law requires approval in a general meeting (with protections for the fair treatment of all shareholders and the interests of the company and non-related party shareholders).

Companies must maintain adequate procedures, systems and controls so that they can assess whether a transaction or arrangement with a related party is in the ordinary course and on normal market terms.

**When is a related party transaction material?**

Member States can set their own materiality thresholds and the FCA has used the same class tests as those in Chapter 10 of the Listing Rules so far as possible to determine whether a transaction is material.

A transaction will be material where any of the percentage ratios is 5% or more (reduced from the 25% originally proposed).

**What approval is required?**

Under the new regime, material related party transactions must be:

- approved by the board (not the shareholders as is the case under the Chapter 11 regime) before it is entered into and any director (or any of their associates) who is a related party cannot take part in the board’s consideration or vote, and
- announced no later than when the terms of the transaction are agreed.

The FCA has decided not to require a report assessing whether the transaction is fair and reasonable (which is an option under SRD II) but the announcement must include "any other information necessary to assess whether transaction is fair and reasonable from the perspective of the issuer and the shareholders".

If there is a material change to the terms of the transaction before completion, then the issuer must comply again with the approval and announcement requirements. An increase of 10% or more in the consideration is generally considered to be a material change.

**Do transactions have to be aggregated?**

Yes, if an issuer enters into more than one transaction or arrangement with the same related party (and any of its associates) in a 12-month period, and none of the previous transactions or arrangements has already been a material related party transaction then they must be aggregated.

If any of the percentage ratios is 5% or more for the aggregated transactions, then the issuer must comply with the approval and announcement requirements for each transaction and arrangement included in the aggregation.

In the feedback, one respondent queried how issuers could announce the earlier transaction(s) "no later than the time when its terms are agreed" and obtain board approval for it "before entering into it". The FCA states that it recognises the challenge for issuers in complying with these provisions for completed transactions included in the aggregation. However, issuers that are proposing to enter into a sequence of smaller transactions with the same related party, will
need to take into account and plan for how they will be able to meet their future obligations for those individual transactions under the aggregation rules.

**What are the key differences to the Chapter 11 regime?**

The key differences are:

- the scope is much wider and catches many more companies
- the related party definition is wider and there are, therefore, a small number of instances in which the existing premium listing requirements will not cover SRD II requirements and premium listed companies will have to consider both regimes
- ordinary course transactions are only exempt if they are also concluded on normal market terms
- not as many transactions are excluded, and
- only board approval is needed, there is no need to go to shareholders.

This document (and any information accessed through links in this document) is provided for information purposes only and does not constitute legal advice. Professional legal advice should be obtained before taking or refraining from any action as a result of the contents of this document.