

3 Steps FPI Directors Can Take to Oversee Related-Party Transactions

Developing a process for foreign private issuers to pursue frequently beneficial business opportunities.

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Investors and regulators in the current corporate governance environment have increased their focus on companies' transactions with their directors, senior management, and other related persons. These related-party transactions raise special disclosure issues for non-US companies, known as foreign private issuers (FPIs), that are listed on US stock exchanges.

FPIs may engage in related-party transactions that remain undisclosed as a matter of customary market practice in their home jurisdictions. Concurrently, the US Securities and Exchange Commission (SEC) requires FPIs to disclose related-party transactions that are material to the company, without referencing a specific transaction amount. This approach, which is separate from home country disclosure and shareholder consent rules for related-party transaction disclosures, differs from the US\$120,000 transaction threshold that applies to US domestic companies.

While SEC rules use a general materiality threshold for FPI disclosure of related-party transactions, non-disclosure of these kinds of transactions may unpleasantly surprise shareholders that are familiar with US governance practices and disclosure requirements. Expectations run high among US investors that FPIs will have implemented controls for transactions involving insiders, close associates, or other related parties.

In many non-US business environments, transactions involving potential conflicts are typical and sometimes even inevitable, given the extensive networks of interests that may exist for controlling shareholder groups. Moreover, these transactions can benefit companies by providing products and services essential to their operations.

Directors of FPIs can address concerns that may arise from related-party transactions by implementing three steps to increase governance oversight in this area.

1. Identify Related-Party Transactions

Oversight of related-party transactions begins with identifying them. International Financial Reporting Standards (IAS 24) require companies to report material transactions with related parties, and the US Public Company Accounting Oversight Board rules (AS 18) require auditors to determine whether related-party transactions have been properly identified.

Control relationships can extend through complex chains of individuals and intermediaries. Local law, securities regulations, or stock exchange rules may also afford a framework for understanding such transactions and provide specific contours for relationships to review.

In particular, directors may consider:

- Whether the board of directors has implemented a clear and consistent definition for related parties that captures both direct and indirect control relationships
- How the independent auditors have applied audit procedures to related-party transactions
- Whether procedures are in place to ensure that the board has oversight over the most consequential transactions and relationships involving the listed company

2. Involve Non-Affiliated Board Members

Directors who are independent of control parties can foster open discussions when the company is considering related-party transactions and can take steps toward enhanced governance by having:

- Transparent qualifications for director independence and an adequate number of directors who meet these qualifications
- Agreed-upon procedures for director conduct, including procedures under which unaffiliated directors can deliberate among themselves
- Authority to hire valuation experts and other advisors to assist in evaluating the terms of related-party transactions
- Periodic third-party evaluations of board practices using internationally accepted benchmarks and protocols

3. Develop a Knowledge Base

Directors may seek out training and education programs — such as those offered by their company, a local or US stock exchange, an association of directors, a corporate governance institute, or outside counsel — that address related topics. For instance, directors can participate in training sessions focusing on how to:

- Exercise their oversight function
- Identify potential red flags when vetting related-party transactions
- Develop governance arrangements that adequately address related-party transactions

FPI directors may find these three steps useful in discharging their oversight function. Maintaining a transparent and consistent process can help companies address governance concerns while improving their ability to support a range of other core business activities.





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