

PUBLIC COMPANIES

Related-Party Transactions Guide – 2024

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PUBLIC COMPANY GATEWAY

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I. Introduction

A. WHY ARE RELATED-PARTY TRANSACTIONS IMPORTANT?

In the intricate landscape of corporate governance and financial reporting, related-party transactions hold a significant place. These transactions, which occur between a company and its affiliates, subsidiaries, or other persons with which it has a close association, can have profound implications for the transparency, integrity, and overall financial health of a public company. Understanding the nuances of related-party transactions is crucial for stakeholders, including investors, regulators, and corporate management, to ensure that these dealings are conducted fairly and disclosed appropriately.

One of the primary reasons for the heightened scrutiny of related-party transactions is the potential for conflicts of interest. When transactions occur between parties with pre-existing relationships, there is an inherent risk that these dealings may not be conducted at arm's length. This can lead to terms that are more favorable to one party over another, potentially disadvantaging shareholders or other stakeholders. Transparency in disclosing these transactions is essential to maintain trust and confidence in the company's financial statements and governance practices.

Public companies are subject to stringent regulatory requirements concerning related-party transactions. Various regulatory bodies, including the Securities and Exchange Commission (SEC) in the United States, mandate detailed disclosures of related-party transactions in financial statements and annual reports. These regulations are designed to provide investors with a clear view of the nature and extent of these transactions, enabling them to make informed decisions. Non-compliance with these regulations can result in severe penalties, legal repercussions, and damage to the company's reputation.

Effective corporate governance practices necessitate rigorous oversight of related-party transactions. Establishing robust policies and procedures for identifying, evaluating, and disclosing related-party transactions is essential for maintaining ethical standards and protecting shareholder interests. By understanding the importance of these transactions and adhering to regulatory requirements, public companies can enhance their governance practices, ensure accurate financial reporting, and maintain investor confidence.

B. WHO WILL BENEFIT FROM THIS GUIDE?

PUBLIC COMPANY BOARDS

Public company boards are at the forefront of corporate governance and are responsible for overseeing the management and strategic direction of the company. This guide will be valuable to board members as it provides a comprehensive understanding of related-party transactions, which are often complex and fraught with potential conflicts of interest. By familiarizing themselves with the intricacies of related-party transactions, board members can ensure that they are fulfilling their fiduciary duties, maintaining transparency, and protecting shareholder interests. The guide will also help boards establish robust policies and procedures to identify, evaluate, and approve related-party transactions, thereby enhancing corporate governance standards and mitigating risks associated with these transactions.

EXECUTIVES

Executives, including chief executive officers, chief financial officers, and other senior management, play a critical role in the day-to-day operations and strategic decision-making of a public company. This guide will benefit executives by providing them with a thorough understanding of the regulatory requirements and best practices related to related-party transactions. With this knowledge, executives can ensure that their actions and decisions comply with legal standards and ethical norms, thereby avoiding potential legal pitfalls and reputational damage. Additionally, the guide will help executives recognize the importance of transparency and disclosure in related-party transactions, fostering a culture of accountability and trust within their organizations.

LEGAL TEAMS

Legal teams within public companies are tasked with ensuring compliance with a myriad of regulations and laws, including those governing related-party transactions. This guide will serve as a resource for in-house counsel and legal advisors by offering detailed insights into the legal framework surrounding related-party transactions. It will provide practical guidance on how to navigate regulatory landscapes and advise the board and executives on compliance matters. Further, the guide will help legal teams develop and implement effective compliance programs that address the unique challenges posed by related-party transactions, thereby safeguarding companies from legal risks and enhancing overall governance frameworks.

II. Definition and Scope

A. WHAT IS A RELATED-PARTY TRANSACTION?

A related-party transaction refers to any financial transaction, arrangement, or relationship between a company and a related party. The definition of related-party transactions can vary slightly depending on the regulatory body. According to the SEC, a related-party transaction involves any transaction, arrangement, or relationship (including any indebtedness or guarantee of indebtedness) in which the amount involved exceeds \$120,000 and in which any related party had or will have a direct or indirect material interest. The Financial Accounting Standards Board (FASB) defines related-party transactions as those that occur with a related party.

B. WHO ARE CONSIDERED RELATED PARTIES?

Related parties encompass a broad range of individuals and entities that have a close association with the company. These include:

Directors and Executives: Individuals who hold significant positions of authority within the company, such as board members and senior management.

Family Members: Immediate family members of directors and executives, including spouses, children, siblings, and parents.

Significant Shareholders: Individuals or entities that own a substantial portion of the company's shares, typically defined as owning more than 5% of the voting shares.

Affiliates: Entities that are under common control with the company or have significant influence over the company's operations.

Other Related Entities: Any other entities that are controlled by or significantly influence the company, including joint ventures and partnerships.

C. TYPES OF RELATED-PARTY TRANSACTIONS

Related-party transactions can take various forms, each with its own implications for corporate governance and financial reporting. Common examples include:

Loans: Transactions where the company extends credit to a related party or vice versa. These loans may be subject to different terms than those available to unrelated parties.

Leases: Agreements where the company leases property or equipment to or from a related party. These leases may involve favorable terms that would not be available in an arm's-length transaction.

Service Agreements: Contracts where the company provides or receives services from a related party. These agreements can include consulting services, management fees, or other professional services.

Sales and Purchases of Goods: Transactions involving the sale or purchase of goods between the company and a related party. These transactions may be conducted at prices that differ from market rates.

Guarantees: Situations where the company provides guarantees for the obligations of a related party, potentially exposing the company to additional risk.

III. Regulatory Framework and Compliance Requirements

A. OVERVIEW OF RELEVANT REGULATIONS

SEC RULES AND REGULATIONS

The SEC plays a pivotal role in regulating related-party transactions for public companies. Item 404 of the SEC's Regulation S-K mandates the disclosure of any transaction exceeding \$120,000 in which the company is a participant and any related person has a direct or indirect material interest. The disclosure must include the nature of the relationship, the transaction's terms, and the amount involved. Additionally, companies must describe any ongoing contractual obligations resulting from these transactions. Further, the SEC's Regulation S-X requires detailed financial statement disclosures about related-party transactions, ensuring that these transactions are presented fairly and accurately in the company's financial reports.

SARBANES-OXLEY ACT REQUIREMENTS

The Sarbanes-Oxley Act of 2002 (SOX) introduced stringent reforms to enhance corporate governance and restore investor confidence. Section 402 of SOX prohibits personal loans to directors and executive officers, thereby curbing potential conflicts of interest. Further, Section 404 requires management and external auditors to report on the adequacy of the company's internal controls over financial reporting. This includes controls related to the identification and disclosure of related-party transactions, ensuring that such transactions are conducted transparently and in compliance with established policies.

STOCK EXCHANGE LISTING STANDARDS

Public companies listed on major stock exchanges such as the New York Stock Exchange (NYSE) and Nasdaq must adhere to specific listing standards that govern related-party transactions. For instance, NYSE Listed Company Manual Section 314.00 requires companies to conduct an appropriate review and oversight of all related-party transactions for potential conflicts of interest. Similarly, NASDAQ Listing Rule 5630 mandates that audit committees or another independent body of the board review all related-party transactions.

INTERNATIONAL FINANCIAL REPORTING STANDARDS AND OTHER INTERNATIONAL GUIDELINES

The International Financial Reporting Standards (IFRS), particularly IAS 24, provide comprehensive guidelines on the disclosure of related-party transactions. IAS 24 requires entities to disclose the nature of related-party transactions, types of transactions, and outstanding balances, including commitments. Other international guidelines, such as those issued by the International Organization of Securities Commissions, emphasize the importance of transparency and proper disclosure in related-party transactions to maintain market integrity and investor trust.

B. CONSEQUENCE OF NON-COMPLIANCE

Non-compliance with regulations governing related-party transactions can lead to significant legal repercussions for public companies. These may include regulatory sanctions, fines, and penalties imposed by the SEC or other regulatory bodies. Companies may also face litigation risks from shareholders or other stakeholders who may allege breaches of fiduciary duty or securities fraud. Moreover, non-compliance can result in reputational damage, loss of investor confidence, and a decline in stock price. In severe cases, it may lead to delisting from stock exchanges, further exacerbating a company's financial and operational challenges.

IV. Identification and Disclosure of Related-Party Transactions

A. IDENTIFICATION PROCESSES

Identifying related-party transactions within a company is a critical step in ensuring compliance with regulatory requirements and maintaining transparency. The process begins with a thorough understanding of what constitutes a related party. According to the FASB and IFRS, related parties include entities or individuals that have control, joint control, or significant influence over the company, as well as key management personnel and their close family members.

To effectively identify related-party transactions, companies should implement robust internal controls and procedures. This includes maintaining an updated list of related parties, which should be reviewed and approved by the board of directors or an appropriate committee. Regular training sessions for employees, particularly those in finance, legal, and compliance departments, are important to ensure they understand the criteria for identifying related parties and the importance of reporting such transactions.

Additionally, companies should establish a system for monitoring transactions that may involve related parties. This can be achieved through automated systems that flag potential related-party transactions based on predefined criteria or through manual reviews of significant transactions. Regular audits and reviews by internal or external auditors can further enhance the identification process by providing an independent assessment of the company's controls and procedures.

B. DISCLOSURE TIMING

Timing and manner of disclosures are also critical. Companies must include related-party transaction disclosures in their annual reports on Form 10-K and proxy statements. If a material related-party transaction occurs after the end of the fiscal year but before the filing of these reports, companies must disclose it in their quarterly reports on Form 10-Q. Ensuring timely and accurate disclosures helps maintain investor confidence and compliance with SEC regulations.

C. DOCUMENTATION AND RECORD-KEEPING

Maintaining comprehensive records of related-party transactions is essential for both regulatory compliance and internal governance. Best practices for documentation and record-keeping include creating detailed records of all identified related-party transactions, including supporting documentation such as contracts, invoices, and minutes of board meetings where these transactions are discussed or approved.

Companies should establish a centralized repository for storing related-party transaction documentation, accessible to relevant personnel such as compliance officers, auditors, and legal advisors. This repository should be regularly updated and reviewed to ensure completeness and accuracy.

Implementing a formal policy for record retention is also important. This policy should specify the duration for which related-party transaction records must be retained, typically in line with regulatory requirements or industry standards. Regular audits of the record-keeping system can help identify any gaps or areas for improvement, ensuring that companies remain compliant with all relevant regulations.

V. Approval Processes and Best Practices

A. BOARD COMMITTEE OVERSIGHT

The oversight of related-party transactions is a critical responsibility of the board of directors and the audit committee. The board of directors plays a pivotal role in ensuring that related-party transactions are conducted in the best interest of the company and its shareholders. This involves a thorough review and approval process to prevent any potential conflicts of interest and to maintain the integrity of the company's financial statements.

The audit committee, a subset of the board, is typically tasked with the detailed examination of related-party transactions. This committee is responsible for scrutinizing the terms and conditions of such transactions to ensure they are fair and reasonable. The audit committee's role includes evaluating the necessity and benefits of the transaction, assessing any potential risks, and ensuring compliance with relevant laws and regulations. By doing so, the audit committee helps to safeguard the company's assets and uphold its fiduciary duties.

B. APPROVAL PROCEDURES

The approval procedures for related-party transactions involve several key steps designed to ensure transparency and accountability. These steps include:

Identification of Related Parties: The first step is to identify all related parties, which may include directors, officers, significant shareholders, and their immediate family members. This identification is crucial for recognizing potential related-party transactions.

Disclosure: Once related parties are identified, any proposed transactions involving these parties must be disclosed to the board or audit committee. Full disclosure includes the nature of the relationship, the terms of the transaction, and any potential conflicts of interest.

Independent Review: An independent review is conducted to assess the fairness and reasonableness of the transaction. This may involve obtaining external valuations or opinions to ensure that the transaction is conducted at arm's length.

Approval by Non-Interested Directors: The transaction must be approved by directors who do not have an interest in the transaction. This helps to ensure that decisions are made objectively and without undue influence.

Documentation and Reporting: All related-party transactions must be thoroughly documented, including the rationale for approval and any conditions imposed. Regular reporting to shareholders and regulatory bodies may also be required to maintain transparency.

C. BEST PRACTICES

To mitigate risks associated with related-party transactions, companies should implement robust policies and procedures. Best practices include:

Comprehensive Policies: Comprehensive policies that clearly define what constitutes a related-party transaction, outline the approval process, and specify disclosure requirements. These policies should be regularly reviewed and updated to reflect changes in regulations and best practices.

Training and Awareness: Regular training for directors, officers, and employees on the importance of identifying and managing related-party transactions. This helps to foster a culture of compliance and ethical behavior.

Regular Monitoring and Audits: Regular monitoring and internal audits to ensure compliance with related-party transaction policies. This includes periodic reviews of transactions to detect any potential issues early.

Whistleblower Mechanisms: Whistleblower mechanisms that allow employees to report concerns about related-party transactions confidentially. This can help to uncover potential conflicts of interest that may not be immediately apparent.

Independent Oversight: Where possible, independent third parties should be involved in the review and approval process. This adds an additional layer of scrutiny and helps to ensure that transactions are conducted fairly.

VI. Common Challenges and Solutions

A. CHALLENGES IDENTIFYING RELATED-PARTY TRANSACTIONS

Identifying related-party transactions is a task that requires a thorough understanding of the relationships within and around a company. One of the primary issues is the difficulty in identifying all related parties. This can include not only direct relationships, such as those with subsidiaries or affiliates, but also indirect relationships, such as those involving family members of key executives or significant shareholders. This challenge is compounded by the dynamic nature of these relationships, which can change over time due to new business ventures, mergers, or changes in ownership.

To address these challenges, companies should implement robust internal controls and procedures. This includes maintaining an up-to-date register of related parties and regularly reviewing it to capture any changes. Additionally, companies should ensure that all employees, particularly those in managerial positions, are well-informed about the definition of related parties and the importance of disclosing such relationships. Regular training sessions and clear communication channels can help in identifying potential related-party transactions early and accurately.

B. APPROVAL PROCEDURES

Compliance with regulations governing related-party transactions is another significant challenge for public companies. These regulations are designed to ensure transparency and fairness, but they can be complex and vary significantly across different jurisdictions. Common compliance issues include inadequate disclosure of related-party transactions, failure to obtain necessary approvals from the board or shareholders, and insufficient documentation to support the terms of the transactions.

To navigate these compliance challenges, companies should establish comprehensive policies and procedures that align with regulatory requirements. This can include setting up a dedicated compliance team responsible for monitoring related-party transactions and ensuring that all necessary disclosures are made in a timely manner. Companies should also consider conducting regular audits to assess compliance with internal policies and external regulations. Leveraging technology, such as compliance management software, can further streamline the process and reduce the risk of non-compliance.

C. CONFLICT OF INTEREST MANAGEMENT

Managing conflicts of interest is crucial in maintaining the integrity of related-party transactions. Conflicts of interest can arise when individuals involved in the transaction have personal or financial interests that could influence their decision-making. This can lead to biased decisions that are not in the best interest of the company or its shareholders.

Effective strategies for managing conflicts of interest include establishing a clear conflict of interest policy that outlines the procedures for identifying, disclosing, and addressing potential conflicts. This policy should require all employees and board members to disclose any personal or financial interests that could affect their impartiality. Additionally, companies should implement a process for reviewing and approving related-party transactions that involves independent directors or a special committee to ensure objectivity.

VII. Conclusion

Related-party transactions are a critical aspect of corporate governance and financial reporting for public companies. These transactions, which occur between a company and its affiliates, subsidiaries, or other closely associated entities, carry significant implications for transparency, integrity, and the overall financial health of the organization. Given regulatory requirements and the potential for conflicts of interest, it is imperative for public companies to approach related-party transactions with meticulous attention and robust oversight.

The regulatory framework governing related-party transactions is comprehensive and multifaceted. The SEC's Regulation S-K and Regulation S-X, along with the Sarbanes-Oxley Act and stock exchange listing standards, mandate disclosures and approval processes to ensure that these transactions are conducted fairly and transparently. Non-compliance with these regulations can result in severe penalties, legal repercussions, and damage to a company's reputation. Adherence to these regulatory requirements is not only a legal obligation but also a cornerstone of good corporate governance.

Effective management of related-party transactions begins with the identification and disclosure of such transactions. Companies must implement robust internal controls to identify related parties and monitor transactions involving them. This can include maintaining an updated list of related parties, conducting regular training sessions for employees, and establishing systems for monitoring potential related-party transactions. Timely and accurate disclosures in financial statements and annual reports are essential to maintain investor confidence and comply with regulatory standards.

The approval process for related-party transactions is another critical component of effective governance. Boards of directors and audit committees play a pivotal role in reviewing and approving these transactions to safeguard against potential abuses. This involves a thorough review of the terms and conditions of the transactions, independent assessments to ensure fairness, and approval by non-interested directors to maintain objectivity. Comprehensive documentation and regular reporting further enhance transparency and accountability.

To mitigate risks associated with related-party transactions, companies should adopt best practices such as developing comprehensive policies, providing regular training, implementing regular monitoring and audits, establishing whistleblower mechanisms, and involving independent third parties in the review process. These practices help foster a culture of compliance and ethical behavior within an organization.

Related-party transactions require diligent oversight and transparent disclosure to ensure that they are conducted in the best interest of the company and its shareholders. By understanding regulatory requirements, implementing robust identification and approval processes, and adopting best practices, public companies can enhance their governance standards, ensuring accurate financial reporting and maintaining investor confidence.