

Related-party transactions

Position paper

Norges Bank Investment Management position

1. Transactions with related parties may represent conflicts of interest and expose shareholders to potential abuse. Related-party transactions should be carried out on market terms and be clearly beneficial to all shareholders.
2. The board is responsible for managing conflicts of interest inherent in related-party transactions to ensure that shareholders are treated fairly. Independent board members should approve transactions that are material to the company. In addition, non-conflicted shareholders should have a vote on extraordinary transactions.
3. The board is responsible for providing disclosure on transactions with related parties. The board should disclose what constitutes a material transaction, especially if the jurisdiction does not define materiality, and what makes a transaction extraordinary, including the size of the transaction relative to the company's assets.

Background

The board is responsible for guiding company strategy, monitoring management performance and providing accountability to shareholders. Ensuring that corporate transactions maximise returns for all shareholders is of fundamental importance to investors. This position paper considers the importance of independent approval and proper disclosure for related-party transactions.

A related-party transaction (RPT) is defined by the International Financial Reporting Standards as a transfer of resources, services or obligations between the company and a related party, which can be another entity, such as a subsidiary, or a person, such as one of the company directors.

All major markets recognise that RPTs pose risks to the equitable treatment of shareholders and regulate such transactions through a combination of private and public enforcement. Private enforcement typically includes ex ante approvals, ongoing disclosures and ex post remedies through private litigation. The EU Shareholder Rights Directive strengthened transparency requirements and shareholders' control rights, requiring ad hoc disclosures and approval by either shareholders or the board.

Arguments for the position

RPTs can extract company value and expropriate shareholders

Controlling shareholders or insiders may have incentives to engage in transactions to their own advantage, particularly in companies with concentrated ownership structures. To protect the interests of the company and its shareholders, RPTs should be carried out on market terms and at arm's length.

The board has a duty to avoid conflicts of interest

It is the role of the board to demonstrate that RPTs are in the interest of the company and its shareholders by having a robust process for their monitoring, approval and disclosure. For approvals to be effective, they need to be provided by independent board members and, where appropriate, by shareholders not involved in the transaction.

Full disclosure facilitates scrutiny of RPTs

Transparency on all material RPTs enables shareholders to evaluate whether a transaction is carried out on market terms and at arm's length, and thus, whether it is in the company's interest. Transparency also enables shareholders to scrutinise the approval process even if it does not include a shareholder vote.

Arguments against the position

RPTs are often commercially viable

When certain market mechanisms are not well developed or contracting costs are high, RPTs can help overcome market shortcomings.

Restricting RPTs will in some cases force companies to transact with parties providing less value or not to transact at all, reducing the benefits to all shareholders.

The board can manage risks associated with insiders

Since the board has been elected by all shareholders, it is best placed to decide on RPTs on their behalf. The very purpose of the board is to be independent and to act in the best interest of the company.

Existing requirements reflect the local market and are stringent enough

Local practices consider the business needs between related parties, the legal framework and ownership structures. Fewer requirements can be an indication of a lower number of problematic transactions in the past, requiring less regulation.

Norges Bank Investment Management's consideration

Weighing the arguments, we find that approval by unrelated parties and robust disclosure do not limit value-creating RPTs but lend confidence that they are carried out in the interest of the company and its shareholders.

While the board should have sufficient independence to manage conflicts of interest, we encourage the board to disclose its policies and procedures for monitoring, approving and disclosing RPTs. We believe that material RPTs should be reviewed and approved by independent board members. Additional safeguards are warranted for extraordinary transactions, which should be approved by a shareholder vote, thereby discouraging RPTs that are not in the interest of all shareholders.

We acknowledge that markets regulate RPTs in different ways, reflecting local circumstances. However, we believe there is a need for some consistency in reporting across markets so that market participants can analyse and compare transactions. The board should disclose what constitutes a material RPT and what makes a transaction extraordinary. Disclosure of extraordinary RPTs should occur immediately the terms have been agreed on and periodically for all material RPTs. Companies should disclose at a minimum the transaction date, the name of each party involved, their affiliation, the business rationale and the nature of the transaction as well as its terms.

This position will serve as a basis for our discussion with boards.