Disclosure and Approval of Related Person Transactions: Examining the Revised Regulations

By Ning Chiu and Richard Truesdell

In August 2006, the SEC published its final release to completely overhaul the rules and regulations for executive compensation disclosure, which was met with intense debate and focus. Although the release is titled "Executive Compensation and Related Person Disclosure,"[1] the amendments to the disclosure of related person transactions[2] received significantly less attention and were in many ways overlooked. The impact, examined more than two years after the effectiveness of the revised regulations, has become a closer review of the nature and scope of related person transactions and an additional layer of scrutiny at the board level as a result of the new requirements to disclose the policies and procedures for approving transactions.

Expansion of Defined Terms

SEC regulations require disclosure of any transaction over $120,000 that has occurred since the last fiscal year or is currently proposed, in which the company is a participant and any related person has a direct or indirect material interest.[3] "Transactions" include, but are not limited to, financial transactions, arrangements or relationships.[4] As under the prior regulations, the term clearly encompasses a company's compensatory arrangements and employment relationships with related persons. Subsequent SEC staff interpretations indicate that all compensation, not just the employee's salary, must be counted toward determining whether the employment arrangement meets the $120,000 reporting threshold. In response, companies generally disclose the employee's salary, cash bonus and equity awards (either the number of awards granted or some measure of dollar value[5]).

"Related persons" include directors, nominees, executive officers and five percent shareholders (the "primary reporting persons") and their immediate family members, which now includes stepparents, stepchildren and others living in the same household (other than a tenant or employee).[6] Companies use directors' and officers' questionnaires (D&O questionnaires) to annually collect from their primary reporting persons information about their family members' affiliations with entities that have transactions with the company. One difficulty encountered in this data gathering may be the responses from the primary reporting persons that their family relationships do not afford them to know, with the necessary degree of specificity, the employment and other business dealings of all of these relatives. The regulations do not account for strained family dynamics. Additional inquiries arise whenever a primary reporting person remarries, as the nuptials present a host of new relatives who constitute "related persons" such as in-laws and stepchildren. Wading deeper into family matters, the SEC staff has clarified that immediate family members include only those currently related to the primary reporting person, disregarding relationships fractured by divorce. In addition, only individuals who are related by blood or step-relationships to the primary reporting person, or his or her spouse, are affected.

Drawing a line in the sand, related persons do not encompass every relative. Aunts, uncles or cousins of the primary reporting person who have entered into major transactions with the company are excluded. Contrary to the prior regulations, transactions must be considered if the individual was a "related person" during any part of the last fiscal year,[7] other than significant shareholders and their immediate family members. A company may need to send D&O questionnaires to former directors or executive officers to obtain information about their immediate family members, which can be awkward and prove useless if the directors or officers terminated their relationships with the company on bad terms and now refuse to respond.

Shift to Materiality Judgment with Limited Exemptions

The revised regulations eliminated prior instructions that had helped to delineate reportable from excludable transactions. The focus has shifted

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to relying on a principle-based standard, with an emphasis on analyzing the materiality of the transaction. The regulations do not provide any instructions, although the final release states that materiality is "to be determined on the basis of the significance of the information to investors in light of all the circumstances." The release focuses on the relationship of the related persons to the transaction; the relationship of the related persons to each other; the importance of the interest to the related person; and the amount involved in the transaction. These factors concentrate largely on the impact of the transaction to the individuals involved, and it can be difficult to ascertain the "importance of the interest" to the related person because of the fact-specific nature of the inquiry. The regulations also require disclosure of any information regarding the transactions or the related persons that could be material.[8]

The regulations continue to exempt certain types of transactions from disclosure, but the exceptions are narrowly defined. Director and executive officer compensation that is disclosed pursuant to other regulations or otherwise approved by the compensation committee is exempt. However, compensation above $120,000 paid to immediate family members employed by the company must be disclosed, a lesson that continues from the *Disney* enforcement action.[9] A company is not required to disclose the compensation of an executive officer who is not a named executive in the company's proxy statement, if the officer's compensation is appropriately approved, but the compensation of that officer's parents, stepparents, spouse, siblings, children, stepchildren, or in-laws who are also employed by the company must be disclosed if above $120,000, regardless of the status of the employee's position.

A more challenging concept pertaining to family members' employment by entities other than the company is articulated in an October 2006 speech by John White, at that time SEC Director of Corporation Finance.[10] To emphasize that "all types of transactions" must be analyzed for possible disclosure, he discussed an example in which a company makes a sizable charitable contribution to a nonprofit organization that employs the CEO's son, and the contribution saved the organization from shutting down its operations. His primary purpose was to articulate that contributions to nonprofit organizations could constitute reportable transactions, but in his example the related person (the CEO's son) was a nonexecutive employee of the entity on the other side of the transaction.

He then went on to suggest that disclosure may be appropriate even if the CEO's child was not employed by the charity, but that after receipt of the contribution, the head of the charity wrote an important letter of recommendation for the child, which led to the child's employment by a wholly separate entity with no involvement in the transaction. The facts underlying similar situations rarely provide for a clear and direct causal link between the transaction and the related person's employment. When evaluating transactions between the company and an entity that employs an immediate family member of a primary reporting person, the family member's position at that entity, such as whether the individual is an executive officer or the equivalent, is often a significant factor in determining the materiality of the related person's interest in the transaction.

The regulations exempt from disclosure certain types of indebtedness,[11] and further exclude as "indirect material interest" any interest arising from an individual's position as (a) a director of an entity

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involved in the transaction, (b) an equity owner of less than 10 percent or (c) a limited partner with less than a 10 percent interest.[12] This equity ownership exclusion, coupled with another exception indicating that disclosure is not required if the interest arose solely from ownership of equity securities and all holders received the same benefit,[13] eliminates from consideration altogether transactions that result from minimal equity ownership. Additional exemptions include certain bank depository or similar services,[14] and those transactions with rates or charges determined by competitive bids.[15] Unfortunately, subsequent SEC staff interpretations with respect to these later exemptions generally serve to limit their scope. For example, the staff has stated that to meet the competitive bid exception a formal process must be instituted and the company must accept the lowest bid.

The SEC considered but then rejected exempting transactions undertaken in the ordinary course of business, that are conducted on the same terms as with individuals who are not related persons. The final release makes the fairly obvious and unhelpful point that disclosure may not be required for an ordinary course transaction if the transaction is not material to either the company or the other entity involved.

Association with Director Independence

If the related person transaction involves a non-employee director who is otherwise considered by a company's board of directors to be independent, then the transaction must also be examined from the standpoint of whether it bears upon such director's independence. In evaluating director independence, it is important to be knowledgeable of standards similar to the SEC regulations, as all of the issues need to be considered given the board's obligation to determine director independence in light of the specific facts and circumstances.[16]

Both NYSE and Nasdaq have established specific standards regarding transactions involving independent directors. The directors (and in some cases their immediate family members) may not have commercial or advisory relationships with the company such that payments would exceed $120,000, other than for board service for the directors or as employees (but not executive officers) for the directors' family members.[17] NYSE also disqualifies a director from being considered independent if the director is an executive officer, partner or controlling shareholder participating in a transaction with the company that is greater than $1 million, or two percent, of the other company's gross revenues.[18] Nasdaq has a similar bright-line test if the transaction is the greater of $200,000, or five percent, of the recipient's gross revenues during the year.[19] While the NYSE standard considers the impact of the transaction only on the other entity, Nasdaq's standard evaluates the effect of the transaction from the perspective of both parties. Nasdaq also explicitly includes charitable contributions under this test. Even if a company determines that transactions with independent directors or their immediate family members are not reportable related person transactions, the board is likely informed of the transactions pursuant to its full review of any relationships that may affect directors' independence from the company and management.

Directors who meet the independence definition of the listing standards may nonetheless fail to be considered independent under the guidelines imposed by the proxy advisory service, RiskMetrics Group (RMG). RMG includes in its classification of "affiliated outside directors,"[20] a category separate from independent directors, any director who is related to numerous employees of the company, with "numerous" undefined. The classification also includes directors (or their immediate family members) who are employed by entities involved in transactions in which the company makes or receives annual payments exceeding the greater of $200,000, or five percent, of the recipient's gross revenues (the Nasdaq standard), or if the director has any "material financial tie or other related-party transactional relationship to the company." RMG will recommend voting "withhold" or "against" any such director who serves on the three key committees that are supposed to be composed of fully independent members: audit, compensation, or nominating. NYSE-listed companies therefore may need to examine relationships under the Nasdaq standard for this purpose. In addition, companies that decide to disclose immaterial transactions involving independent directors for the sake of transparency may find their efforts backfiring, as it could result in a "withhold" or "against" recommendation for that director's election by RMG.

Implementation of Related Person Transaction Policies

The revised SEC regulations include an entirely new requirement to describe a company's policies and procedures for the review, approval, or ratification of any reported related person transaction. The regulations state that the description may include: (a) the types of transactions that are covered by such policies and procedures, (b) the standards to be applied pursuant to such policies and procedures, (c) the persons or groups of persons on the board of directors or otherwise who are responsible and (d) a statement of whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.[21] Companies usually had only general conflict of interest policies, and as a result, many have adopted separate written related person transaction policies and procedures. A study of the Dow 30 companies' 2008 proxy statements indicates that all but one disclosed the existence of a written policy (and that one company later disclosed the adoption of a policy in its 2009 proxy statement).

Related person transaction policies vary in length and the level of detail, particularly as to the description of the due diligence process necessary to uncover the existence of transactions in the first instance. Some policies place the burden entirely on the primary reporting persons to inform the law department of related person transactions, while others place an additional responsibility on the company to conduct independent diligence. One example of a standard policy goes so far as to stipulate that once the law department has the names of all individuals who are "related persons" and their affiliated entities, in-house counsel should conduct an Internet search to verify the information and expand the list of applicable entities to include parent companies, subsidiaries and sister companies. Then the law department should provide this information to those responsible within the company for purchase and sales decisions and for making charitable contributions.

Policies also differ on whether only reportable transactions must be approved by a board-level committee. Some policies dictate that the law department review the transaction first to determine whether it requires disclosure. Then only a reportable transaction would be further reviewed and approved or ratified by the relevant board committee. Other policies indicate that the board committee should be informed of, and approve, all transactions, regardless of whether the transactions will ultimately be disclosed. A blended approach exists as well where policies provide for both concepts, by fully informing the board committee of all existing transactions but having the committee formally approve only those which will be disclosed. While the approach used is not evident from their brief descriptions, 11 of the Dow 30 surveyed state that either management, the law department or some combination of internal personnel conducted an initial review of a transaction prior to board committee approval. All but nine of the companies designated approval responsibility to the governance committee.

Since the regulations exempt specific types of transactions from disclosure, many companies' policies also explicitly exclude a list of transactions. Sixteen of the Dow 30 companies describe categories of transactions exempt from review under their policies. Most repeat the exemptions already available under SEC regulations, but many also preclude additional categories of transactions. While not stated, it could be understood that a general determination had been made that these transactions would not be considered material in any respect.

Interestingly, although the SEC specifically declined to exempt transactions made in the ordinary course of business from the regulations, these are the most common types of exempt transactions that companies added to their policies. Some ordinary course transactions are exempt only if they fall below specific dollar amount thresholds, but most are written as blanket exemptions. It is unclear whether, for example, a fairly sizable transaction would immediately fit within this exemption so long as the terms are judged to be the same as a transaction made on an arm's-length basis, or whether the amount of the transaction alone would mean that it gets evaluated notwithstanding the policy. In reality, every transaction needs to be examined in some respect, even to make the initial determination of whether it qualifies as an exempt transaction under the company's policies or SEC rules.

Other exempt transactions that companies have added to their policies borrow from the director independence listing standards of the NYSE and Nasdaq, even for transactions involving non-directors. Some policies exempt from review charitable contributions and commercial transactions with any entity where the related person was not employed in an executive position, within similar amount thresholds to those used in the listing standards. These additional exemptions, not available in the regulations, represent an assumption by companies that the listing standards not only serve as a bright-line test for evaluating director independence, but also as a proxy in determining materiality upon which companies can rely for all related person transactions. Since the listing standards implicate only transactions with entities (other than the company) that employ immediate family members as executive officers or in an equivalent position, these exemptions would remove from review the example used in John White's 2006 speech.

Disclosure of Transactions

It is unclear whether the revised SEC regulations have resulted in more disclosure of related person transactions. Nineteen of the Dow 30 surveyed disclosed related person transactions, the most common being employment of immediate family members. This was likely the case for many large companies that employ tens of thousands of people, even under the prior SEC regulations. SEC enforcement actions on related person transactions tend to involve the omission or misstatement of fairly significant self-dealing transactions with senior executives. There have not been any enforcement cases under the revised regulations to indicate any changed views by the SEC, and the SEC staff provided only minimal comments on related person transaction disclosure when it recently undertook an extensive review of executive compensation disclosure. However, the combination of the expansion of defined terms used, more reliance on materiality judgments and board-level approvals pursuant to written policies and procedures has resulted in a closer examination and review of transactions with related persons.

Notes

1. "*Executive Compensation and Related Person Disclosure*," SEC Release Nos. 33-8732A and 34-54302A; August 26, 2006.

2. Item 404 of Regulation S-K.

3. Item 404(a) of Regulation S-K.

4. Instruction 2 to Item 404(a) of Regulation S-K.

5. Companies often disclose the FAS 123(R) accounting value or the intrinsic value of the awards.

6. Instruction 1(a)(iii) to Item 404(a) of Regulation S-K.

7. Instruction 1(a) to Item 404(a) of Regulation S-K.

8. Item 404(a)(6) of Regulation S-K.

9. *In the Matter of The Walt Disney Company*, Release No. 50882, December 20, 2004.

10. "*Principles Matter: Related Person Transactions Disclosure and Disclosure Controls and Procedures*," remarks before the Society of Corporate Secretaries and Governance Professionals New York Chapter by John W. White, October 12, 2006.

11. Instruction 4 to Item 404(a) of Regulation S-K.

12. Instruction 6 to Item 404(a) of Regulation S-K.

13. Instruction 7(c) to Item 404(a) of Regulation S-K.

14. Instruction 7(b) to Item 404(a) of Regulation S-K.

15. Instruction 7(a) to Item 404(a) of Regulation S-K.

16. NYSE 303A.02(a) and Nasdaq 4200.

17. NYSE 303A.02(b)(iii) and Nasdaq 4200(15)(B).

18. NYSE 303A.02(b)(v).

19. Nasdaq 4200(15)(D).

20. RiskMetrics Group 2009 U.S. Proxy Voting Manual.

21. Item 404(b)(i) of Regulation S-K.