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Determining interested persons and related parties

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In the last two articles, we explored the duty of directors to avoid conflicts of interest, how full disclosure and proper actions are necessary to discharge a director's fiduciary duties, and how perception is sometimes reality when managing conflicts of interest in the public sphere under the media spotlight.

In this article, we turn our focus to a specific type of conflict of interest that directors face: transactions with interested persons and related parties.

How they arise

It is a commercial reality that companies often conduct business with other parties that are related to the companies' directors, key management personnel or controlling shareholders. This may, in fact, be done for sound business reasons. For example, it could be argued that these parties have more familiarity with, and a better understanding of, the company's business than unrelated third parties. In addition, directors may argue that they are able to exert more control over related parties and have more influence over the business outcome than they might otherwise do with unrelated parties.

That said, transactions with related parties are open to potential abuse. For starters, a conflict of interest may arise when it comes to pricing and other negotiated outcomes.

Consequently, laws, regulations and corporate governance best practices have been developed to manage such conflicts to ensure that there is fair play in arms-length negotiation and transparency in disclosure, and that the interests of the company and its shareholders are not adversely affected.

Depending on the regulatory context, such transactions are called interested person transactions (IPTs) or related party transactions (RPTs). While the two terms are often confused with each other, and appear to address the same thing, their regulatory objectives and definitions are very different and may require different actions from directors.

Different objectives

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IPTs are governed and regulated by Chapter 9 of the SGX-ST Listing Rules (Chapter 9), which applies to listed companies. RPTs are governed by an accounting standard, the Singapore Financial Reporting Standard 24 (FRS24), which applies to both listed and unlisted companies.

The objective of Chapter 9 is to guard against the risk that interested persons could influence the listed company, its subsidiaries or associated companies, to enter into transactions that may adversely affect the interests of the company or its shareholders.

When there is an IPT, Chapter 9 may require the listed company to make an immediate announcement of the material terms of the transaction and the interested person's interest and relationship with the listed company, its management and controlling shareholders. Depending on the relevant materiality thresholds of the listed company concerned, it may also require audit committee approval, the publication of an independent financial advisor's opinion, and independent shareholders' approval at a general meeting before the transaction is executed.

FRS24 on the other hand, being an accounting standard, focuses on the disclosure of related party transactions in the periodic financial statements. The need to review related party transactions to ensure that they are at arms' length is not spelt out as a specific requirement of FRS24. Instead, the duty to review and approve RPTs is driven by corporate governance requirements and practices, and the Companies Act.

Different definitions

FRS24 defines related parties much more broadly than Chapter 9's definition of interested persons. FRS24 also requires disclosure of more relationships and transaction types than Chapter 9 does.

There is some overlap between the definitions, but there are also differences. For example, directors, CEOs, controlling shareholders, their spouses, children, adopted children, step-children and parents, are both simultaneously interested persons and related parties under Chapter 9 and FRS24, respectively. Where a controlling shareholder is a company, then its subsidiary, holding company or a fellow subsidiary, or a company in which the controlling shareholder has control are also generally considered as interested persons and related parties under Chapter 9 and FRS24.

However, certain interested persons under Chapter 9 may not be considered related parties under FRS24, and they include siblings of a director, CEO and controlling shareholder.

And conversely, related parties who may not be considered interested persons include:

- A key management person who is not a director or CEO;
- Companies that provide key management personnel services to the reporting entity or its parent.

Disclosure and prompt action critical

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The main provision in the Companies Act dealing with conflicts of interest is Section 156, and it applies to both IPTs and RPTs of Singapore companies.

Chapter 9 provides additional specific safeguards against IPTs. Where a RPT is involved, in addition to the disclosure required under FRS24, directors have to fall back on good corporate governance practices such as requiring the review by, and approval of, the audit committee or independent directors.

Given the stringent, complex and sometimes confusing requirements, the board and, especially the audit committee, should ensure that management has a formal and robust process to identify, differentiate and manage both IPTs and RPTs.

All deliberations by the board and audit committee on IPTs and RPTs should be comprehensively documented as minutes. Additionally, the conflicted person should recuse himself from all discussions and abstain from voting on the transaction.

Most critically, directors must ensure that there is prompt and comprehensive disclosure where needed to comply with the relevant laws and regulations.

The writer is the treasurer of the Singapore Institute of Directors. This article first appeared in BTInvest, <http://www.btinvest.com.sg/specials/boardroom/conflicts-of-interest-are-interested-persons-the-same-as-related-parties/>