



**ASIC**

Australian Securities & Investments Commission

**REPORT 233**

# **Response to submissions on CP 142 Related party transactions**

March 2011

## **About this report**

This report highlights the key issues that arose out of the submissions received on Consultation Paper 142 *Related party transactions* (CP 142) and details our responses to those issues.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 76 *Related party transactions* (RG 76).

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## A Overview/Consultation process

- 1 In Consultation Paper 142 *Related party transactions* (CP 142), we sought feedback on our proposed guidance for public companies (companies) and responsible entities of registered managed investments schemes (registered schemes) on complying with Ch 2E and Pt 5C.7 of the *Corporations Act 2001* (Corporations Act) when providing financial benefits to related parties.
- 2 In CP 142, our proposed guidance related to:
  - (a) the application of the ‘arm’s length’ exception in s210 from the member approval requirement;
  - (b) when an independent expert report may be necessary for a related party transaction and how the expert should assess the transaction;
  - (c) the independence of experts preparing reports on related party transactions; and
  - (d) information that should be disclosed to investors about related party transactions in meeting materials and other disclosure documents.
- 3 This report highlights the key issues that arose out of the submissions received on CP 142 and our responses to those issues.
- 4 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 142. We have limited this report to the key issues.

### Responses to consultation

- 5 We received 13 responses to CP 142 from relevant industry bodies, accounting firms, law firms and one bank. We are grateful to respondents for taking the time to send us their comments.
- 6 For a list of the non-confidential respondents to CP 142, see the appendix. Copies of these submissions are on the ASIC website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp) under CP 142.
- 7 We received two confidential submissions.
- 8 Overall, responses were supportive of the proposals in CP 142, as well as the objectives behind our proposals.
- 9 The main issues raised by respondents related to:
  - (a) the practicality of addressing the proposed factors to consider when determining whether the arm’s length exception applies;

- (b) when the arm's length exception may be relied on instead of seeking member approval for related party transactions;
- (c) additional types of related party transactions that may warrant an independent expert report and use of the separate 'fair' and 'reasonable' test; and
- (d) disclosure of all related party transactions in disclosure documents.

10 We have updated our guidance in Regulatory Guide 76 *Related party transactions* (RG 76) to reflect changes in the law since its last revision in 1997, and to incorporate the new guidance proposed in CP 142, as modified through the consultation process. This report outlines the submissions received on our proposed new guidance and summarises our response to these submissions.

## B The ‘arm’s length’ exception

### Key points

In CP 142, we proposed five factors to consider when determining whether the arm’s length exception to obtaining member approval in s210 may be relied on.

While submissions strongly supported the proposed guidance, some concerns were raised about the practicality of addressing all the factors proposed. These concerns have been addressed by further clarification in RG 76.

We also proposed that entities consider seeking member approval if there is doubt as to whether the arm’s length exception (or any other exception) applies. Submissions on this proposal were mixed and we have consequently clarified this guidance in RG 76.

### Relevant factors for determining the application of s210

- 11 In CP 142, we proposed five relevant factors to consider when determining whether the terms on which the financial benefit is given are arm’s length terms for the purposes of the exception in s210 from the member approval requirement. These factors included:
- (a) how the terms of the overall transaction compare with those of any comparable transactions between unrelated parties in similar circumstances;
  - (b) the nature and content of the bargaining process;
  - (c) the impact of the transaction on the company and non-associated members;
  - (d) any other options available to the company; and
  - (e) any expert advice received by the company on the transaction.
- 12 There was strong support for the proposal and agreement that the factors listed were appropriate. However, some respondents thought that not all the factors may apply, or that other factors may be appropriate, depending on the circumstances.
- 13 Some respondents noted it is for directors to decide what is important, in light of their directors’ duties, and that they would already have considered this information in determining whether to enter into the transaction.

- 14 In relation to the factor about comparable transactions between unrelated parties, some respondents expressed concerns about increased costs, as well as difficulties in accessing appropriate information.
- 15 One respondent noted that there may be some difficulty in addressing factors that are dependent on future performance. We have understood this to be a reference to the third factor about the impact of the transaction on the company.
- 16 Another respondent noted our proposal reads as if we consider the exception in s210 to only apply where the financial benefit is given on terms consistent with comparable transactions between parties dealing at arm's length terms and that the proposal ignores the hypothetical nature of the exception.

#### *ASIC's response*

We have clarified our guidance by including statements that:

- the list of factors is not exhaustive (see RG 76.71);
- all the factors should be considered, but some may not be relevant after consideration (see RG 76.72); and
- entities can determine the appropriate weight (as demonstrated in Examples 1 and 2 in CP 142) of each of the relevant factors in the decision-making process (see RG 76.72).

Our review of related party transactions indicated that there were varying practices and views about the circumstances in which companies applied the arm's length exception from the obligation to obtain member approval under Ch 2E. For example:

- in some cases, companies did not appear to take into account whether directors with a conflict of interest were involved in, or privy to, negotiations with the related party when assessing whether the terms of a financial benefit were arm's length; and
- in many cases, companies appeared to rely on the arm's length exception with insufficient consideration given to the reasons for doing so, or only by reference to isolated factors without considering all relevant factors.

We expect that, in many cases, entities will have already considered most of the factors when deciding whether to enter into a transaction as part of the due diligence process. However, our guidance applies to the subsequent decision about whether to obtain member approval, and applies regardless of the nature of due diligence conducted.

In light of this, we consider that entities should generally be in a position to use the information at hand, as well as the experience of directors, advisers and employees, to decide whether the arm's length exception applies. However, we do not intend to discourage entities from seeking appropriate advice if the

directors believe that this information will help them make a judgement about whether the exception applies.

We also do not intend to suggest that entities always need to obtain expert advice for the purpose of the fifth factor, but that any advice that has been obtained in connection with the transaction should be considered. This is our intention regardless of whether it will be included in meeting materials or disclosure documents.

We expect entities to consider the financial impact of a transaction as part of internal board deliberations, both in deciding whether to enter into the transaction and whether to obtain member approval, regardless of the difficulty involved.

We agree that it is possible for transactions on terms not directly comparable to other transactions to be on arm's length terms. For this reason, we proposed (and have included in our updated guidance) five factors to take into consideration, rather than this one factor alone.

We also agree that s210 allows entities to consider how hypothetical unrelated parties would transact, as opposed to actual unrelated parties. In our experience, and as noted in case law, actual transactions between unrelated entities can often provide useful guides and entities have difficulty considering what terms unrelated parties would agree on for novel transactions.

## Seeking member approval where there is doubt

- 17 In CP 142, we proposed that companies and responsible entities of registered schemes should consider seeking member approval under Ch 2E in cases where, having taken into account all the factors in the above proposal, there is doubt about whether the transaction is on arm's length terms.
- 18 Respondents generally agreed with the proposal, but for different reasons. Some stated that it reflected the default position at law, while others stated that it reflected the prudent course of action.
- 19 Some respondents were of the view that the proposal should be more strongly worded. One respondent stated that it added a further element of subjectivity to the decision. Others considered that the proposal may create an automatic requirement to seek member approval, which may result in costs being incurred unnecessarily.
- 20 One respondent stated that the proposal was unnecessary because the law speaks for itself. This respondent also queried the standard of doubt that would be required and raised concerns with the use of the word 'doubt'. They cited the difficulty that criminal law judges experience with this term in the phrase, 'beyond reasonable doubt'.



*ASIC's response*

We intended this proposal to encourage entities to obtain member approval where it is unclear whether a transaction meets the s210 exception. As a matter of prudent practice, directors should only rely on the exception when they are persuaded that the exception does apply, rather than it being merely arguable that it applies.

To remove any potential ambiguity, we have reworded our guidance to state that member approval should be sought if it is not clear that the transaction falls within the arm's length exception (or any other exception in Ch 2E): see RG 76.95.

## C Independent expert reports

### Key points

In CP 142, we proposed to provide guidance on when an independent expert report for members may be necessary and the approach that experts should take in assessing related party transactions.

The majority of submissions were supportive of the proposals and some suggested additional types of related party transactions to which our proposals could apply.

We also proposed that expert reports be prepared by an expert that is independent. All respondents that commented on this proposal supported it, although some mentioned potential difficulties in finding independent experts in certain circumstances.

We have updated our guidance in RG 76, and also in Regulatory Guide 111 *Content of expert reports* (RG 111) and Regulatory Guide 112 *Independence of experts* (RG 112), in light of the submissions received.

### When an independent expert report may be needed

- 21 In CP 142, we proposed to incorporate guidance in RG 76 that it may be necessary for companies to include a valuation from an independent expert with a notice of meeting for member approval under Ch 2E where:
- (a) the transaction is significant from the point of view of the company;
  - (b) the financial benefit is difficult to value;
  - (c) the non-interested directors do not have the expertise or resources to provide independent advice about the value of the financial benefit; or
  - (d) the related party transaction is a component of a control transaction for which the company is commissioning an expert report (e.g. for member approval under item 7 of s611).
- 22 Submissions were generally supportive of our proposed guidance. We received many suggestions about the particular situations or types of transactions for which an independent expert report should be prepared, including:
- (a) related party underwriting in control transactions or where the practical effect is related party acquisition of a significant stake;
  - (b) material share issues and options issues, other than in the context of an employment relationship;

- (c) other share transactions affecting the control exercised by a related party;
- (d) certain transactions currently covered by item 7 of s611;
- (e) the sale or purchase of a significant asset, business or liability; and
- (f) the provision of material commercial services by a related party.

23 Two respondents noted that the word ‘significant’ requires further clarification.

#### *ASIC’s response*

We consider that some of the suggested examples for when an independent expert report may be necessary are already dealt with in other guidance, the Corporations Act or the ASX Listing Rules.

Our review of related party transactions indicated that expert advice was often obtained on the issue of securities to, and the acquisition of assets from, related parties but far less often on other transactions, such as related party loans or contracts for administrative, technical or other services.

We consider that the need for an independent expert report often depends on the facts applicable in each case, and that it may be appropriate to be less prescriptive than suggested in the submissions. However, in our guidance in RG 76 and RG 111, we encourage directors to consider their duty to provide full and frank disclosure to members to enable them to decide how to vote or invest, and have retained the references to case law on this point: see RG 76.102 and RG 111.54. Further, we have added our view that conflicts of interest inherent in related party transactions may mean it is appropriate to obtain an independent expert report.

We acknowledge that the word ‘significant’ is not precise. However, the proposal, as drafted in CP 142, allowed for flexible application of the policy in various circumstances. We have included the discussion set out in CP 142 on matters to consider when determining whether a transaction is ‘significant’ in RG 76 and have added that a very complex transaction may also be ‘significant’: see RG 76.112.

## **How experts should assess related party transactions**

24 In CP 142, we proposed to provide guidance in RG 111 about the approach experts should take when assessing related party transactions, including that they should:

- (a) focus on the substance of the related party transaction, rather than on the legal mechanism;

- (b) consider whether further transactions are planned between the entity, the related party or any of their associates;
- (c) express an opinion on whether the transaction is 'fair and reasonable', from the perspective of non-associated members, when analysing a related party transaction that involves an asset acquisition or disposal, and apply this as a separate test of 'fairness' and 'reasonableness' rather than as a composite test;
- (d) determine 'fairness' by comparing the value of the financial benefit provided to the related party to the value of the consideration being provided to the entity; and
- (e) consider certain factors listed in the draft updated RG 111 when determining 'reasonableness'.

25 The proposed guidance was set out in draft updated RG 111, released with CP 143 *Expert reports and independence of experts: Updates to RG 111 and RG 112* (CP 143).

26 The majority of respondents broadly agreed with the intent of the proposal.

27 Some respondents were of the view that it was more appropriate to consider 'fair and reasonable' as a compound phrase for related party transactions.

28 Some respondents felt that there was scope to extend the guidance beyond expert reports relating to transactions involving asset acquisitions and/or disposals. Suggestions included:

- (a) management, director or employee remuneration arrangements;
- (b) loans to/from related parties;
- (c) underwriting agreements that result in the underwriter obtaining a significant stake in the issuing entity;
- (d) the provision of material professional services (including legal and corporate);
- (e) the provision of material management, administration and/or responsible entity or other similar services;
- (f) licensing and royalty arrangements;
- (g) commercial agreements that have the practical effect of a significant exchange of value from the company to a related party;
- (h) an issue of a material number of convertible instruments or options, other than in the context of an employment relationship;
- (i) control transactions; and
- (j) any expert report on a related party transaction.

- 29 One submission stated that the proposal implied there would be two ways to assess a related party transaction, depending on whether it involved an asset acquisition or disposal.
- 30 Submissions on question C2Q3 in CP 142 generally stated the view that our guidance should apply where a related party transaction involves member approval under item 7 of s611. Some cited consistency as a reason for this view. However, some respondents referred to the existing guidance in RG 111 and considered that no further guidance was necessary.
- 31 All but one respondent who made submissions on C2Q5 considered that a separate analysis should be undertaken of a related party component of a broader series of transactions. Some respondents also stated that the benefit of the broader transaction must be considered. Some respondents noted that the interrelation of transactions increases the potential for the absence of transparency and, accordingly, a separate analysis should be undertaken. One respondent mentioned that the consideration of the related party component should be integrated with the report considering the broader transaction rather than a separate report.

#### *ASIC's response*

We consider that some of the suggested examples (listed in paragraph 28) for when the separate 'fair and reasonable' test could be applied include situations where we may not expect, as a general rule, an independent expert report to be prepared—unless, for example, the related party transaction was occurring in a control context, or was significant in the circumstances.

Related party transactions involve a higher likelihood of conflicts of interest than regular transactions and warrant a higher degree of scrutiny. We therefore consider that the separate 'fair' and 'reasonable' test is preferable and appropriate for use when assessing these transactions.

To ensure consistency of approach by experts, and as suggested in submissions, we have extended our guidance in RG 111, as proposed, so that the approach to be taken by experts applies whenever an independent expert report is prepared for a related party transaction: see RG 111.55.

We have not specifically extended our guidance to apply where a related party transaction involves member approval under item 7 of s611. This is because, in practice, related party transactions that also require approval under item 7 of s611 are issues of securities, and RG 111 makes it clear that experts should express their opinion using the 'fair' and 'reasonable' approach, except for a sale of securities, as covered in RG 111.41–RG 111.46.

We have modified our guidance in RG 111 about the separate analysis of a related party transaction component of a broader series of transactions (that involve non-related parties). The revised guidance states our view that an expert should carefully

consider what level of analysis is required for the related party aspect of a series of transactions. In doing so, the expert should bear in mind whether the report has been sought to ensure that members are provided with sufficient information to decide whether to approve giving a financial benefit to the related party, as well as to approve the broader transaction.

This guidance aims to ensure that investors are provided with any necessary information about the related party benefit involved in the broader transaction.

We have also clarified that, when a report is being prepared for multiple reasons (e.g. for s208 approval and for approval under item 7 of s611), generally only one analysis of whether a transaction is 'fair and reasonable' may be all that is needed: see RG 111.63. However, this assumes that the one analysis provides sufficient information under the separate requirements for each purpose of obtaining approval.

## Independence of experts

- 32 In CP 142, we proposed that experts who prepare reports on related party transactions should meet the standards of independence set out in RG 112. The draft updated RG 112, released with CP 143, included changes to RG 112 to give effect to this proposal.
- 33 There was strong support for this proposal, although some respondents cited the practical difficulty of finding qualified independent experts in all situations.

### *ASIC's response*

As there was strong support from respondents, we have made no changes to our proposed updates in RG 112.

We consider that the difficulty in finding qualified independent experts is remote and that our guidance reflects existing market practice.

## D Disclosure about related party transactions

### Key points

In CP 142, we proposed to provide guidance on the content requirements for prospectuses, Product Disclosure Statements (PDSs) and other disclosure documents where a company or registered scheme has existing related party arrangements, including whether member approval has been obtained.

While there was general support for this proposal, respondents cited concerns with the level of disclosure required, and many suggested introducing some kind of materiality threshold.

We also proposed to update our guidance on the information that should be included in notices of meeting and explanatory statements (meeting materials) provided when seeking member approval of a related party transaction under Ch 2E. Most respondents supported this proposal.

### Disclosure of material information to investors

- 34 In CP 142 we proposed to provide guidance on the minimum disclosure required about related party transactions in disclosure documents. We outlined five items that should be covered in these documents. This included disclosure of ‘all related party arrangements, including the value of the financial benefit if it can be quantified’.
- 35 The majority of respondents were generally supportive of the proposal, but also considered a materiality threshold should be inserted. Some respondents noted that concepts of materiality already apply under the Corporations Act for disclosure. Some respondents suggested that exceptions should be included for subsidiaries of responsible entities providing administrative services to the responsible entities, for fees and other remuneration payable to responsible entities and for transactions with agents of (or persons engaged by) the responsible entity. One respondent suggested exceptions for transactions below a certain amount or for transactions that do not continue for more than two years.
- 36 One respondent was of the view that the current legislative framework adequately addressed related party disclosure requirements and that further ASIC guidance would only serve to extend the length of PDSs and hamper the ability of consumers to absorb the information contained in a PDS.
- 37 Another matter we proposed should be disclosed about related party transactions was whether a transaction was on arm’s length terms. One

respondent considered we should extend this to require disclosure of the reasons for determining whether the transaction terms were arm's length.

- 38 Two respondents noted that disclosure of whether a transaction was on arm's length terms, or whether some other exception applied, could result in significant time and cost.
- 39 Some respondents were of the view that the guidance should be brought in line with the Australian Accounting Standards Board (AASB) accounting standard AASB 124 *Related party disclosures* (AASB 124).
- 40 Another respondent queried whether we expected disclosure that had already been made to be repeated each time the company issued a disclosure document. This respondent also noted that the media often reports relevant information about related party transactions.

#### *ASIC's response*

The Corporations Act sets out tests for the information to be included in disclosure documents. We have modified our guidance to state that related party transactions that are relevant to the investment decision should be disclosed: see RG 76.142–RG 76.148. Entities should be guided by the type of decision that members or investors are making based on the disclosure document and the relevant legislative test when considering what an investor would reasonably expect to find in the document.

Our guidance reflects our belief that related party transactions are likely to be of special interest to investors and members.

We have included discussion in RG 76 about matters to consider when deciding what information about related party transactions to include in disclosure. For instance, in our view, related party transactions that may be considered very minor on their own may be information that investors would reasonably expect to find in a disclosure document when considered together and taking into account their cumulative impact on the entity: see RG 76.143.

While disclosure of the reasons for determining whether a transaction is on arm's length terms would facilitate transparency, we consider that it may unnecessarily expose internal board decisions, and essentially requires entities to explain whether they have complied with the law. The extent to which these kinds of details are required to be disclosed is likely to vary significantly according to different situations. We have therefore decided not to broaden this aspect of the disclosure guidance, but have inserted guidance in Table 2 of RG 76 that, to the extent that it is reasonably required by members, information leading to the conclusion that the arm's length exception does not apply should be included in the explanatory statement.

We do not consider disclosure about whether a transaction is on arm's length terms (or another exception applies) will result in additional time and cost being spent because entities must



consider this under Ch 2E in any event. We have therefore made no change to this aspect of our guidance.

To some extent, our guidance is consistent with certain aspects of AASB 124. However, we note that the accounting standard has different purposes and objectives from those of the Corporations Act, and we do not consider it is appropriate to set policy about the requirements of the Corporations Act based on accounting standards.

We do not expect disclosure from previous disclosure documents to be repeated to an extent that is more than is necessary to meet the requirements of the Corporations Act. However, we note that it is important that investors are able to understand at any point in time the position of the entity. This may include disclosure about related party transactions previously disclosed or making reference to such disclosures.

We do not consider it appropriate for investors and members to rely on the media to report information that should be included in disclosure documents in accordance with the Corporations Act.

## Disclosure in meeting materials

- 41 In CP 142 we proposed to provide guidance about the content of meeting materials for the approval of related party transactions. Table 1 of CP 142 summarised our proposed guidance. We also proposed that the information discussed in the proposed guidance on prospectus disclosure should be included in meeting materials.
- 42 All respondents were supportive of the proposal in principle. One respondent noted that, to the extent that the proposal required disclosure of all related party information as set out in the previous proposal on prospectus disclosure, their support was subject to their comments about materiality on that previous proposal.

### *ASIC's response*

As the submissions were in general agreement with the proposal, we have not significantly changed the guidance proposed in Table 1 of CP 142: see Table 2 in RG 76.

We have modified the guidance to state that the information requirements discussed in relation to prospectus disclosure (see RG 76.142–RG 76.149) may also apply to meeting materials: see RG 76.100.

## E Other feedback

### Key points

In addition to the specific questions posed in CP 142, we received feedback about:

- the application of the proposed guidance to companies limited by guarantee; and
- the extent to which our guidance applies to registered schemes.

### Companies limited by guarantee

- 43 One respondent submitted that it did not appear that we had considered companies limited by guarantee (CLGs) and noted that, because CLGs that have been granted a name licence are exempt from the related party provisions of the Corporations Act, there is potential for abuse of this apparent exception.

#### *ASIC's response*

We consider that the definition of public company in the Corporations Act makes it clear which entities our guidance applies to. However, we have also included further detail about this definition: see RG 76.16.

We do not propose any law reform to include CLGs not covered by the current definition of public company at this time.

### Application of guidance to registered schemes

- 44 One respondent noted that CP 142 appears to consider related party transactions mainly from a public company's perspective and further guidance on these transactions for registered schemes would benefit the market.

#### *ASIC's response*

We have modified our guidance to refer specifically to registered schemes, where appropriate. We have also modified our terminology in RG 76 so that we use the words 'entity' and 'member' when the relevant guidance can apply to either public companies or registered schemes.

## Appendix: List of non-confidential respondents

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- Chartered Secretaries Australia Ltd
  - Deloitte Corporate Finance Pty Limited
  - Ernst & Young
  - Grant Samuel & Associates Pty Limited
  - The Institute of Chartered Accountants in Australia
  - KPMG Corporate Finance (Aust) Pty Ltd
  - Law Council of Australia
  - McCullough Robertson Lawyers
  - McMahon Clarke Legal
  - Pricewaterhouse Coopers Securities Ltd
  - Westpac Banking Corporation
-