"Related Party Transactions: Refresher & Lessons Learned From Enforcement Focus"

Wednesday, December 6, 2023

Course Materials

“Related Party Transactions: Refresher & Lessons Learned From Enforcement Focus”

Wednesday, December 6, 2023

2 to 3 p.m. Eastern [archive and transcript to follow]

Related party transactions are often one of the most sensitive disclosure topics for newly public companies. It’s not uncommon for a company — or the individuals involved — to want to keep related party transaction information private. But SEC and stock exchange rules as well as U.S. GAAP provide prescriptive disclosure and governance requirements for these transactions.

In 2023, the SEC has brought at least three enforcement actions against public companies for related party transaction disclosure failures. These enforcement actions have identified some common pitfalls and highlighted the SEC’s expansive view of when a company is a “participant.” Now’s the time — ahead of the 2024 proxy season — to review your disclosure controls for related party transactions and make any necessary upgrades to your processes, policies or procedures.

Joining us are:

- **William Calder**, Chief Auditor, Deloitte
- **Bob Dow**, Of Counsel, Maynard Nexsen
- **Maia Gez**, Partner, White & Case
- **Zach Swartz**, Partner, Vinson & Elkins

Among other topics, the program will cover:

- Overview of Disclosure Requirements
  - Transactions and time periods covered by Item 404 of Regulation S-K
  - Definitional issues
  - Where disclosure may be required
  - Exhibit filing requirements
  - Special considerations for SRCs

- Common Types of RPTs & Computing Transaction Amounts
  - Family member employees
  - Participation in a public offering

  - Leases and aircraft
  - Loans
  - Charitable gifts

- Financial Statement Requirements & Note Disclosures
  - Treatment under GAAP and Regulation S-X
  - Role of the auditor and communications to the Audit Committee

- Related Party Transaction Due Diligence and Process
  - D&O questionnaires, process and technology
  - AS 18 questionnaires
  - Company books and records
  - Audit Committee approval requirements and policies

- Interplay with Other Considerations
  - Director independence
  - Conflicts of interest

- Wrap-Up & Recent Enforcement Focus

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Course Outline/Notes

1. Overview of Disclosure Requirements

    a. Transactions and time periods covered by Item 404 of Regulation S-K

    b. Definitional issues

    c. Where disclosure may be required

    d. Exhibit filing requirements

    e. Special considerations for SRCs

2. Common Types of RPTs & Computing Transaction Amounts

    a. Family member employees

    b. Participation in a public offering

    c. Leases and aircraft

    d. Loans

    e. Charitable gifts

3. Financial Statement Requirements & Note Disclosures

    a. Treatment under GAAP and Regulation S-X

    b. Role of the auditor and communications to the Audit Committee

4. Related Party Transaction Due Diligence and Process

    a. D&O questionnaires, process and technology

    b. AS 18 questionnaires

    c. Company books and records

    d. Audit Committee approval requirements and policies

5. Interplay with Other Considerations

    a. Director independence

    b. Conflicts of interest

6. Wrap-Up & Recent Enforcement Focus

“Related Party Transactions: Refresher & Lessons Learned From Enforcement Focus”

Table of Contents — Course Materials

Vinson&Elkins

Related Party Transactions Disclosures in SEC Crosshairs Once Again

Insight

V&E SEC Update

September 25, 2023

The Securities and Exchange Commission ("SEC") recently brought two enforcement actions against public companies regarding related party transaction ("RPT") disclosures. The actions against Lyft and Maximus should remind public companies to make sure that their RPT disclosure controls are effective and warn them about the severe consequences that can follow from disclosure violations.

Background: The Disclosure Requirement

A public company is required to disclose information about transactions involving the company and its directors, executive officers and other enumerated parties in its proxy statements or annual reports on Form 10-K. Transactions that must be disclosed include any transaction since the beginning of the company's latest fiscal year, or any currently proposed transaction, in which:

- the company was — or is to be — a participant
- the amount involved in the transaction exceeds $120,000; and

- any "related person" [1] had — or will have — a direct or indirect material interest

When an RPT must be disclosed, the company must describe the transaction, including:

- the related person's name and relationship to the company;
- the related person's interest in the transaction with the company, including the related person's position or relationship with, or ownership in, a firm, corporation, or other entity that is a party to — or has an interest in — the transaction
- the approximate dollar value of the transaction and of the related person's interest in the transaction; and
- any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction.

Recent SEC Enforcement Actions

On September 18, 2023, the SEC announced settled charges with Lyft Inc. ("Lyft") for failing to disclose a Lyft director's role in a large shareholder's private sale of approximately $424 million of shares of Lyft prior to Lyft's IPO. According to the SEC's order, prior to Lyft's IPO in March 2019, a Lyft director arranged for a shareholder to sell its shares to a special purpose vehicle ("SPV") set up by an investment adviser affiliated with the same director. The director then contacted an investor interested in purchasing the shares through the SPV. Lyft approved the sale and secured a number of terms in the contract. The director (who left Lyft's board at the time of the transaction) received millions of dollars in compensation from the investment adviser for his role in structuring and negotiating the deal. The SEC order states that the director "did not disclose his compensation or his material interest in the transaction to Lyft." As a result, Lyft failed to disclose information regarding the sale in its Form 10-K for 2019. Without admitting or denying the SEC's findings, Lyft agreed to a cease-and-desist order and to pay a $10 million civil penalty.

On September 11, 2023, the SEC announced settled charges against Maximus, Inc. ("Maximus") for failing to make required disclosures related to Maximus's employment of the siblings of one of its executive officers. According to the SEC's order, Maximus appointed a longtime employee as an executive officer in 2019. The officer's two siblings were also longtime employees of Maximus who each received annual compensation in excess of $120,000. Maximus filed annual reports and proxy statements for fiscal years 2019 through 2021 that did not disclose this information. Without admitting or denying the SEC's findings, Maximus agreed to pay a civil penalty of $500,000.

These recent actions join many other SEC enforcement actions about failures to disclose related party transactions, including *In re The Walt Disney Company* (Dec. 20, 2004) (compensation to family members, payments to affiliated corporations of directors, and other transactions), *SEC v. Keyuan Petrochemicals* (Feb. 28, 2013) (numerous types of transactions with directors, officers and large shareholders and a secret, off-balance sheet account for payments and perquisites to senior officers), *In re Eagle Bancorp, Inc.* (Aug. 16, 2022), (bank loans to a family trust associated with the CEO and other related parties), and *In re The Greenbrier Companies, Inc.* (Mar. 2, 2023) (charter of CEO's private aircraft from a third-party aircraft management company).

Takeaways for Public Companies

The Lyft and Maximus cases suggest a few lessons:

- *Disclosure Violations Can Have Severe Consequences.* The documents that the SEC made public contain no evidence that either Lyft or Maximus acted nefariously or attempted to "hide the ball" with respect to the RPTs at issue. In fact, the SEC stated that the Lyft director did not disclose his interest in the transaction to Lyft and noted favorably that Maximus had self-reported its issue. It seems more likely that both of these companies simply did not realize that they had disclosure obligations with respect to these transactions. Nonetheless, the proceedings — and, most notably, the negotiated monetary penalties — make clear that the SEC takes the RPT disclosure requirements seriously.

- *The RPT Disclosure Requirements Are Nuanced and Complex.* One of the reasons Lyft and Maximus may not have fully appreciated their disclosure obligations is that the RPT disclosure requirements are complex and, in many cases, subject to interpretation. In the Lyft case, the transaction did not involve a payment between Lyft and a related party. Nevertheless, RPT disclosure is required where, assuming the other requirements are satisfied, a registrant is a "participant" in the transaction. This includes situations where a company benefits from a transaction with a related person that the company has arranged or in which it participates, even if the company is not a party to the contract. In finding that Lyft was a "participant" in a sale of Lyft's shares to a third party, the SEC noted that the approval of Lyft's board was required under a shareholders' agreement for the sale, a special committee of the board reviewed the sale, and Lyft negotiated for and secured various commitments from the seller and the buyer as a condition to the committee's approving the sale.

- *Companies Should Revisit Best Practices.* Best practices that public companies should consider to comply with the RPT disclosure requirements include:

  - Regularly review and, if advisable, update the company's RPT policies. This process should involve consideration of the best person or department at the company to be notified of the facts and circumstances of potential RPTs and submit them to the board or a committee of the board for review and approval. The process should also involve consideration of which directors or board committee will oversee and administer the policy. Companies should also remember that the stock exchanges have specific rules and requirements concerning RPTs and should make sure their policies and procedures reflect the latest rules of the applicable stock exchange.

  - Merely having and regularly reviewing and updating an RPT policy is not enough. Companies should also regularly communicate (at least annually) with directors, executive officers and director nominees to make sure that they are aware of the existence of the policy (and what it requires).

  - Regularly educate directors, director nominees and executive officers on the RPT disclosure requirements so that all relevant transactions are identified and brought to the attention of the appropriate people. Related persons should understand that they have an affirmative obligation to notify the company of potential RPTs to facilitate compliance with the RPT disclosure requirements (as well as the company's RPT policy).

  - Ensure that the company's form D&O questionnaire takes into account the RPT disclosure requirements. Additionally, consider implementing additional protocols (above and beyond the annual D&O questionnaire process) to help identify RPT transactions on a real-time basis, including requiring related persons periodically to submit a list of names of immediate family members and entities with which they and their immediate family members are affiliated. The company can then regularly cross check this list against internal records to determine whether any of these covered people/entities have engaged in transactions involving the company that involve more than $120,000.

  - Ensure that compensation to immediate family members of related persons is approved by a committee of the board comprised of disinterested independent directors. This is likely a requirement of the company's RPT policy and should also help facilitate compliance with RPT disclosure requirements.

  - If a director previously identified as "independent" under applicable stock exchange rules enters into an RPT, consider the effect of the RPT on the director's independent status or committee eligibility.

[1] "Related persons" include directors and executive officers of the company, or their immediate family members, and 5% shareholders of the company, or their immediate family members.

Client Alert | Public Company Advisory Group

NYSE to Re-Amend its "Related Party Transaction" Review Rule to Align More Closely with SEC Disclosure Requirements

August 25, 2021

Authors: Era Anagnosti, Colin Diamond, Maia Gez, Danielle Herrick, Scott Levi

On August 19, 2021, the New York Stock Exchange ("NYSE") proposed to amend its related party transaction rule for a second time in 2021. Below is a summary of the key developments regarding this rule change.

What happened initially?

Earlier this year, on April 2, 2021, the NYSE amended Section 314.00 of its Listed Company Manual to require a company's audit committee or another independent body of the board of directors to "conduct a reasonable prior review and oversight" of all "related party transactions" ("RPTs") for potential conflicts of interest and to prohibit any transaction that it determined to be inconsistent with the interests of the company and its shareholders.

The amendment also defined RPTs as (i) for domestic companies, any transaction required to be disclosed pursuant to Item 404 of Regulation S-K, but **without** applying the $120,000 transaction value threshold of Item 404; and (ii) for foreign private issuers ("FPIs"), any transaction required to be disclosed pursuant to Form 20-F, Item 7.B, but **without** regard to the materiality threshold of that provision.

In the period since the adoption of this amendment, it became clear to the NYSE that the amended rule's exclusion of the applicable transaction value and materiality thresholds was inconsistent with the historical practice of many listed companies and had unintended consequences, including by requiring companies to adopt for the first time two separate standards for related party transactions – one for disclosure and another for review and approval.

What changes with the new amendment?

On August 19, 2021, the NYSE filed a rule proposal with the SEC to conform the related party transactions subject to the prior review and approval requirements of NYSE rules to those transactions subject to the applicable disclosure requirements of SEC rules.[1]

Accordingly, under the amended NYSE rule, the term "related party transaction" will apply the same thresholds currently included in SEC rules (i.e., the $120,000 transaction value from Item 404 for domestic companies and the materiality threshold of Item 7.B of Form 20-F for FPIs).

[1] The proposed amendment is available here.

The new amendment does not change the requirement that the audit committee or another independent body "conduct a reasonable **prior** review and oversight" of all RPTs. However, note that SEC rules (under Item 404(b) covering domestic companies) still specifically allow for a company to disclose a policy that permits the "ratification" of an RPT and further require a company to "identify" any RPT where a company did not follow its own policy (including via ratification of such an RPT). Accordingly, given the NYSE's emphasis on the "**reasonable** prior review and oversight" of all RPTs for potential conflicts of interest, each company should determine whether this new NYSE standard qualified by reasonableness may be met, while still allowing for the specific "ratification" of any RPT in accordance with SEC rules.

The new text of the amendment to Section 314.00 is as follows (with deleted text shown as stricken):

> A company's audit committee or another independent body of the board of directors shall conduct a reasonable prior review and oversight of all related party transactions for potential conflicts of interest and will prohibit such a transaction if it determines it to be inconsistent with the interests of the company and its shareholders. For purposes of this rule, the term "related party transaction" refers to transactions required to be disclosed pursuant to Item 404 of Regulation S-K under the Securities Exchange Act ~~(but without applying the transaction value threshold of that provision)~~. In the case of foreign private issuers, the term "related party transactions" refers to transactions required to be disclosed pursuant to Form 20-F, Item 7.B ~~(but without regard to the materiality threshold of that provision)~~.

When is the amendment effective?

The proposed rule change will take effect on September 18, 2021, unless the SEC designates an earlier operative date. Accordingly, the NYSE listed company manual will only be updated once the rule change has become operative.

In addition, at any time within 60 days of the filing date (or before October 19, 2021), the SEC may temporarily suspend the rule change if it seems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. Comments may be submitted on the rule change no later than 21 days after publication in the Federal Register.

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Related Party Transactions Disclosure Handbook

(Item 404 of Regulation S-K)

Editors:
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July 2023

Instruction 5.a to Item 404(a) does not apply to the immediate family member because she was not an executive officer. [Aug. 8, 2007]

III. How the Rules Work

a. Overall Disclosure Requirements

The main elements of Item 404 are:

- Item 404(a) contains a general disclosure requirement for related person transactions, including those involving indebtedness.
- Item 404(b) requires disclosure regarding the company's policies and procedures for the review, approval or ratification of related person transactions.
- Item 404(c) requires disclosure regarding promoters and certain control persons of a company.
- Item 404(d) has special rules for smaller reporting companies.

Special rules apply to "foreign private issuers," as defined in Exchange Act Rule 3b-4. See Section III.f of this Chapter.

The disclosure requirements of Item 404 are expansive and largely principles-based. The determination of whether a transaction must be disclosed often turns on a materiality analysis of the transaction and the parties involved. As noted in the SEC's 2006 Adopting Release (Release No. 33-8732A, 8/29/06), the materiality of any interest is determined on the basis of the significance of the information to investors in light of all the circumstances. In conducting this materiality analysis, the company should look to, among other things, the relationship of the related persons to the transaction (and with each other), the importance of the interest to the person and the amount involved.

b. Item 404(a): Related-Party Transaction Disclosure

What Transactions Must Be Reported

Item 404(a) requires disclosure regarding any transaction since the beginning of the company's last fiscal year, or any currently proposed transaction in which:

- Company was—or is to be—a participant;
- Amount involved exceeds $120,000; and
- Any related person had—or will have—a direct or indirect material interest.

What Must Be Disclosed About Reportable Transactions

When a related-party transaction must be disclosed under Item 404(a), the company must describe the transaction, including:

- Person's name and relationship to the company;
- Person's interest in the transaction with the company, including the related person's position or relationship with, or ownership in, a firm, corporation, or other entity that is a party to—or has an interest in—the transaction;
- Approximate dollar value of the amount involved in the transaction and of the related person's interest in the transaction; and
- Any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction.

What is a "Transaction"?

The term "transaction" has a broad scope in Item 404(a). Under Instruction 2 to Item 404(a), the term includes—but is not limited to—any financial transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships, specifically including indebtedness and guarantees of indebtedness.

A contract between a reporting company and its >5% beneficial owner pension fund manager is a disclosable related person "transaction," as is an agreement by a company with a related person under which the company would repurchase shares from the related person's estate in the event of the related person's death. See Interpretations 230.06 and 230.08 in the Regulation S-K Compliance and Disclosure Interpretations.

John White, then Director of the SEC's Division of Corporation Finance, suggested in an October 2006 speech, "Principles Matter," that charitable gifts might be disclosable under Item 404(a) in certain situations. See our discussion regarding charitable gifts in Section IV.a of this Chapter.

Definition of "Amount Involved"

"Approximate Dollar Value": The term "approximate dollar value" in Item 404(a)(3) refers to the specific dollar value of the amount involved in the transaction. "Approximate" indicates that amounts need not be precise if they can only be estimated (for example, in the case of a valuation where property or goods are exchanged instead of cash). However, we think the SEC Staff would object to vague disclosure that the amount "exceeds $120,000." It seems clear from the language of the rule and the instructions regarding computation of the dollar amount involved in certain circumstances that a specific dollar amount is required (see, *e.g.*, Instructions 3 and 4 to Item 404(a)).

Aggregation of Related Transactions: A series of related transactions must be aggregated in determining the threshold amount for potential disclosure. For example, in the case of a lease or other transaction providing for periodic payments, the dollar value should include the aggregate amount of all periodic payments due on or after the beginning of the company's last fiscal year, including any required or optional payments due during or at the end of the lease or other transaction. See Instruction 3.a to Item 404(a).

Computation of Amount Involved in Specific Situations

Below is a summary of how to calculate and report the "amount involved" for specific types of transactions. Although this section refers to the $120,000 disclosure trigger, remember that there's a lower threshold for smaller reporting companies. See Section III.e of this Chapter.

Indebtedness: Item 404(a)(5) provides that, with respect to indebtedness, disclosure of the "amount involved" must include the largest aggregate amount of principal outstanding during the period for which disclosure is provided, as well as the amount of principal and interest paid during the period for which disclosure is provided, the aggregate amount of principal outstanding as of the latest practicable date, and the rate or amount of interest payable on the indebtedness.

Instruction 4 to Item 404(a) provides that the following items may be excluded from the calculation of the amount of indebtedness and need not be disclosed:

- Amounts due from the related person for purchases of goods and services subject to usual trade terms;
- Ordinary business travel and expense payments; and
- Other transactions in the ordinary course of business.

Related Person Has Material Interest in Transaction: Item 404(a)(4) requires that the dollar value of the related person's interest in the transaction be computed without regard to the amount of the profit or loss involved in the transaction.

Specific disclosure of the cost of the assets to the purchaser, and the cost of the assets to the seller is not required. However, if such information is material under Item 404(a), because, for example, the recent purchase price to the related person is materially less than the sale price to the company—or the sale price to the related person is materially more than the recent purchase price to the company—disclosure of such prior purchase price and related information about the prices could be required.

In determining when the "amount involved" in the transaction exceeds $120,000 and a related person has a material interest in the transaction, it is the total amount of the transaction that is determinative, not the amount of the related person's interest. See Interpretation 230.03 of the Regulation S-K Compliance and Disclosure Interpretations. Thus, even if the related person's interest is less than $120,000, it may be disclosable.

Compensatory Arrangements: When calculating the amount paid to an employee who is the family member of a related person, Regulation S-K CDI 230.12 makes it clear that the amount reportable includes all compensation, not just salary (also see CDI 130.04 about valuing unexercised in-the-money stock options). However, that doesn't mean that you need to compute "all compensation" exactly the way you would do so under Item 402 for the Summary Compensation Table.

Disclosure typically includes the person's salary, bonus, any equity grant, and maybe a narrative statement that the employee participates in the company's general welfare plans. Our experience has been that companies do the calculation based mostly on the Summary Compensation Table calculation of total compensation, except for the change in pension value and above-market deferred compensation earnings column.

In the case of a multi-year contract, the "amount involved" will span more than one year, since Item 404 disclosure covers transactions since the beginning of the last fiscal year (through the present time). We have seen a trend to use just the annual compensation number, rather than trying to compute additional earnings for the "stub" period from the end of the fiscal year, as is generally required by Item 404. We think you might be able to get away with this when it comes to disclosing the amount of compensation that was paid—particularly if you're dealing with recurring payments that haven't been materially adjusted during the period between the fiscal year end and the date of filing, and you've got an adequate narrative describing the terms of the contract relating to the amounts payable. But when it comes to determining whether Item 404 disclosure is triggered, the language in the rule requires you to include the stub period.

Disclosure for these relationships tends to be more detailed as the family member's compensation increases. Make sure to verify any statements of fact—e.g., the amount of the family member's pay and the company's conclusion that it's commensurate with that provided to other employees in similar positions. We see a lot of boilerplate statements that say the individual received compensation "commensurate with that provided to other employees in similar positions"—but we don't know how thoroughly that declaration has been vetted.

Even if these statements are qualified by "the company believes," we recommend that companies look at their disclosure controls & procedures in this area. Companies should confirm the reliability of verification efforts that apply to the subjective characterizations of compensation to family members.

Transactions In Which Company is "Participant"

Item 404(a) calls for disclosure if a company is a "participant" in a transaction rather than if it is a "party" to a transaction. In part, the use of the broader term was intended to make it clear that transactions by a subsidiary would be covered.

Being a participant encompasses situations where the company benefits from a transaction but is not technically a contractual party to the transaction. In response to concerns that the concept of a "participant" might be too broad and far-reaching, the SEC offered the following example of a case where disclosure might be required even if the company is not a contractual party: "[d]isclosure would be required if a company benefits from a transaction with a related person that the company has arranged and in which it participates, notwithstanding the fact that it is not a party to the contract." See the 2006 Adopting Release at footnote 418. This loose boundary may be problematic to monitor since it carries with it the possibility that disclosure could be required in a situation where the company does not have a "material interest" (as would be required for the related person) in the transaction. Presumably, the company would be aware of the transaction if it had a hand in "arranging" the transaction, but there may be other situations that are not as evident to those tasked with tracking potentially disclosable transactions.

Instruction 6(a) to Item 404(a) would seem to indicate that the role of the entity on the other side of the transaction must be that of a "party" to the transaction. However, the text of Item 404(a)(2), which requires disclosure of the related person's connection to "any entity that is a party to, *or has an interest in*, the transaction," implies that there may be situations in which disclosure would be required if a related person is an executive officer and/or 10% equity holder of an entity that merely "has an interest" in the transaction.

Company "Participation" May Require Further Inquiry

We've heard of situations where Company A owns a sizable, but not majority, interest in Company B, while a director of Company A sits on the board of Company B and Company B pays director fees to the director. In this situation, because the concept of "participation" is very broad under Item 404, we think you'd need to inquire and understand how those individuals became directors of Company B and what their role is on the board. For example, if they are serving as director designees of Company A, then their service and compensation is indirectly at the behest of Company A, and it isn't too much of a stretch to conclude that Company A is participating in the arrangement.

Identifying "Related Persons"

Instruction 1 to Item 404(a) defines "related person" to include:

- Any director or executive officer of the company, or an immediate family member
- Any director nominee, or an immediate family member
- A 5% shareholder, or any immediate family member

Executive Officers: Exchange Act Rule 3b-7 defines "executive officer" as a company's president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the company. Aside from the expressly enumerated president, officers' duties rather than their titles should guide the determination as to whether they are executive officers based on the company's particular facts and circumstances.

For more on the definition of "executive officer" and how it compares to the definition used by Exchange Act Section 16, see our "D&O Biographical/Director Qualifications & Skills Disclosure" Chapter.

Director Nominees: Item 404(a) requires disclosure of transactions involving a director nominee only if the disclosure required by this Item is being presented in a proxy or information statement involving the election of directors. Ongoing disclosure is not required regarding nominees for director who were not elected, unless of course a nominee has been nominated again for director.

5% Shareholders: For purposes of Item 404(a) disclosure, identification of 5% shareholders is based on the beneficial ownership test set forth in Item 403(a), *i.e.*, it includes shares which the owner has the right to acquire within 60 days. The test is based on shareholders "known to the company" to own 5% or more of a class of outstanding shares. This knowledge is usually based on public filings on Schedules 13D and 13G, which are required for all 5% shareholders. Note, however, that the company cannot rely solely on public filings if it knows, or reasonably should know, of other 5% shareholders.

Immediate Family Members: Instruction 1 to Item 404(a) defines immediate family member to mean "any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law or sister-in-law," as well as "any person, other than a tenant or employee, sharing the household" of any director, nominee for director, executive officer or significant shareholder of the company.

The modifier "sharing the household" may only apply to the people who are not legally relatives. The rest of the enumerated "family" members are deemed to be "immediate family" whether they share the same household with the insider or not. See Regulation S-K CDI 230.07.

By interpretation, the Staff has limited the relatives who are in-laws, stepchildren, and stepparents to include: (1) only those persons who are currently related to the primary reporting person (*e.g.*, a person who is divorced from a director's daughter would no longer be a son-in-law whose transactions must be reported); and (2) only those persons who are related by blood or step relationship to the primary reporting person or his spouse (*e.g.*, the sister of a director's spouse is considered a sister-in-law for purposes of this item; that sister's husband, however, is not considered a brother-in-law for purposes of this item). See Interpretation 230.01 of the Regulation S-K Compliance and Disclosure Interpretations.

Some companies have included a question in their D&O questionnaires seeking a listing of immediate family members of directors and officers as well as the D&Os employers & entities in which they or their family members have an ownership interest. See the "D&O Questionnaires" Chapter for more on this topic.

Disclosure of Other Information About the Transaction

Item 404(a)(6) calls for disclosure of "any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction." When it comes to related party transaction disclosure, we think you run a risk of omitting potentially material information if you are too terse. When a transaction involves an entity and a related person has an ownership interest in that entity, we think it's prudent to include details about that related person's ownership and the impact of the transaction on that ownership interest.

Meaning of "Since the Beginning of Registrant's Last Fiscal Year"

Item 404 requires disclosure of any transaction "since the beginning of the registrant's last fiscal year." The beginning of the company's last fiscal year means the beginning of the last completed fiscal year. Therefore, if a calendar-year company is filing its 2019 Form 10-K on March 15, 2020, all transactions from 1/1/2019 through 3/15/2020 would be covered.

We don't know of any Staff acknowledged cut-off date—and we think companies just do the best they can. The Staff recognizes that companies have to utilize a cut-off date to commence their due diligence.

Three-Year Lookback for Disclosure in Registration Statements: If Item 404(a) disclosure is being made in a Securities Act or Exchange Act registration statement, the company must provide data since the beginning of not only the most recent fiscal year, but also the two preceding fiscal years (*i.e.*, three years total), unless the information is being incorporated by reference in Form S-4, in which case, only information since the beginning of the last fiscal year is required. See General Instruction 1 to Item 404.

Form S-3 Arguably Has Shorter Lookback: There's some ambiguity about the lookback period for related party disclosure in Form S-3—and by extension, the reports incorporated by reference into active shelf registration statements. There's no specific line item in Form S-3 calling for Item 404 disclosure, and there's an old Securities Act Forms Telephone Interpretation that says if you're incorporating information from a proxy by reference into a Form S-4 or S-3, you only need to include information for the latest fiscal year:

> 58. Form S-4; Item 404 of Regulation S-K
>
> Form S-4 permits the incorporation by reference of Item 404 information from the Form 10-K of a company meeting the requirements for use of Form S-2 or Form S-3 (see Items 17(b), 18(c)). If such information is incorporated by reference,

> it is not necessary to furnish the three years of information that would ordinarily be required in a Securities Act registration statement (Instruction 2 to Item 404). This is consistent with Form S-2 and Form S-3, which also permit the furnishing of Item 404 information by incorporation by reference from Form 10-K, and therefore only include such information for the latest fiscal year.

Because there's no line item calling for Item 404 disclosure in a Form S-3, one could argue that this interpretation should still apply. However, it was really focusing on Form S-4 (which does call for Item 404 disclosure)—and it didn't find its way into the CDIs—which leaves the status of this interpretive position up in the air.

Two-Year Lookback for Disclosure by Smaller Reporting Companies: Smaller reporting companies are generally required to provide the information for the preceding two fiscal years, regardless of whether the information is presented in an annual report or a registration statement. See General Instruction 2 to Item 404(d) and Section III.e of this Chapter.

Transactions Prior to Becoming—or After No Longer Being—Related Person

Instruction 1(a) to Item 404(a) provides that transactions involving the company and a related person, other than a 5% shareholder, which occurred during the fiscal year, must be disclosed if the person was a related person during any part of that year. This means that transactions that occurred before—or after—an executive officer or director held office could be subject to disclosure, as would a transaction involving a director who is not standing for re-election.

Further, a transaction in January with a person becomes potentially disclosable if an immediate family member of that person becomes an executive officer or director in the following December. In addition, a transaction with an employee who was promoted to an executive officer role later in the year would be disclosable.

Note that significant shareholders are analyzed differently. Transactions involving persons (and their immediate family members) whose connection to the company is solely as a shareholder only need to be examined if the person held the 5% or greater position at the time that the transaction arose unless (i) the transaction was continuing (*e.g.*, by the ongoing receipt of payments) or (b) the transaction resulted in the person becoming a 5% holder. See Instruction 1(b) to Item 404(a) and Question 130.03 of the Regulation S-K Compliance and Disclosure Interpretations.

Exceptions to Item 404(a) Disclosure Requirement

The Instructions to Item 404 detail a number of situations in which disclosure is not required. These exceptions are outlined below:

Executive and Director Compensation

Item 404 captures information about transactions and relationships so that shareholders can evaluate any potential management conflicts, as well as the independence of directors and director nominees. Due to the nature of this requirement, there is some unavoidable overlap with the executive compensation disclosure requirements of Item 402 of Regulation S-K.

In situations in which the logical place for the primary disclosure is under Item 404 because a transaction with a third party is involved, but is also responsive to Item 402 requirements, duplicative disclosure is possible. Item 402 does not exclude information disclosed as a related person transaction under Item 404(a) from its disclosure requirements, so there may be situations in which the compensation information is disclosed under Item 402 and the transaction giving rise to the compensation is also disclosed under Item 404.

This could occur, for example, in situations in which transactions with third parties give rise to compensation payable to executive officers or directors. Thus, if a director is the sole shareholder and officer of a company that does over $120,000 in consulting work for the company, then the director's interest in the revenues to his company would be reported under Item 402(k) as compensation and the transaction would be reported under Item 404.

Compensation to Named Executives Officers and Directors

If the primary disclosure is under Item 402 because the transaction involves compensation payable by the company, the compensatory information only appears once. Instruction 5(a)(i) to Item 404(a) provides that no disclosure under Item 404 is required for a compensatory transaction that is disclosed under Item 402 (*e.g.*, for a named executive officer or director).

Compensation to Employees Other Than Named Executive Officers

Instruction 5(a)(ii) to Item 404(a) provides that compensation paid to an executive officer who is not a named executive officer does not have to be disclosed as a related person transaction under Item 404(a) if:

- The compensation would have been reported under Item 402 if the executive had been a named executive officer;
- Such compensation was approved (or recommended to the board of directors for approval) by the compensation committee (or other independent directors performing a similar function); and
- The executive is not an immediate family member of an executive officer, director, nominee, or 5% holder.

Note that to qualify for the exemption, the transaction must have been "approved"—so after-the-fact ratification may not suffice. The approval requirement is similar to that required for executive compensation by many stock exchanges. However, the approval required for this Item 404(a) exemption must cover all elements of the executive's compensation—garden-variety compensation committee approval may not be sufficiently comprehensive to avoid disclosure.

Clawback Compensation Disclosed in Item 402(w)

Instruction 5.a.iii. to Item 404(a) provides that if the transaction involves the recovery of erroneously awarded compensation (computed pursuant to Rule 10D-1(b)(1)(iii) and applicable listing standards) and is disclosed pursuant to Item 402(w), it does not have to be disclosed as a related person transaction under Item 404(a).

Compensation of Immediate Family Members

If the compensation is paid to an immediate family member, Item 404(a) requires disclosure of "the approximate dollar value of the amount involved in the transaction." For these purposes, the "amount involved" includes all compensation, not just the salary of the employee. See Interpretation 230.12 of the Regulation S-K Compliance and Disclosure Interpretations.

The Staff has informally indicated that this would likely include equity awards, but not the level of detail required for named executive officers. This may cover the prior year as well as the present year up to the date of disclosure.

Note that if all elements of compensation paid to immediate family members have not been approved or ratified by the compensation committee or the board, disclosure of the failure to do so will be required under Item 404(b), as discussed in Section III.c of this Chapter.

Certain Indebtedness Transactions

Under Instruction 4 to Item 404(a) in the case of transactions involving indebtedness, the following items may be excluded from the calculation of the amount of indebtedness and need not be disclosed:

- Amounts due from the related person for purchases of goods and services subject to usual trade terms;
- Ordinary business travel and expense payments; and
- Other transactions in the ordinary course of business.

Further, if the lender is a bank, thrift or broker-dealer extending credit under Federal Reserve Regulation T, and the loans are not disclosed as nonaccrual, past due, restructured or potential problems, disclosure under Item 404(a) may consist of a statement that the loans to such persons satisfied the following conditions:

- Made in the ordinary course of business;

- Made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the lender; and
- Did not involve more than the normal risk of collectability or present other unfavorable features.

Note that this bank loan exemption has historically been interpreted narrowly. It would not apply, for example, to banks that offered loans to their rank-and-file employees on different terms than those offered to the general public. For purposes of the exemption, "persons not related to the lender" means persons with no relationship to the lender at all other than the lending relationship. Employees are considered "related" to the lender by virtue of their employment relationship. See Question 130.05 of the Regulation S-K Compliance and Disclosure Interpretations.

In addition, only loans that are deemed non-problematic under SEC Industry Guide 3 as of the end of the company's fiscal year qualify for the disclosure exemption. See Interpretation 230.10 of the Regulation S-K Compliance and Disclosure Interpretations.

Certain Indirect Interests Not Deemed Material

Disclosure is required only if a related person has a material interest in the transaction, regardless of whether that interest is direct or indirect.

Instruction 6 to Item 404(a) provides that a person who has a position or a relationship with a firm, company or other entity that engages in a transaction with the company will not be deemed to have an indirect material interest within the meaning of Item 404(a) if:

- Interest arises only: (i) from the person's position as a director of another company that is a party to the transaction; or (ii) from the ownership by such person and all other related persons, in the aggregate, of less than a ten-percent equity interest in another person (other than a partnership) which is a party to the transaction; or (iii) from both such position and ownership; or
- Interest arises only from the person's position as a limited partner in a partnership in which the person and all other related persons have an interest of less than ten percent, and the person is not a general partner of and does not have another position in the partnership.

This means, for example, that if a director of Company A is only a director of Company B, no further inquiry is necessary. But if the director of Company A is the CEO of Company B, then Company A must track all payments involving Company B to determine whether disclosure might be required.

A person also does not have a material interest in the transactions of an entity in which the aggregate holdings of all related persons (no matter who they are related to) does not exceed an aggregate of 10% of that entity. Conversely, a person *may* have a disclosable indirect interest if

they are an executive officer, general partner, and/or (together with all other "related" persons) a 10% equity holder in the other party.

Exemption for Specific Transactions

Instruction 7 to Item 404(a) provides that disclosure is not required if:

> (a) The transaction is one where the rates or charges involved are determined by competitive bids, or where the transaction involves the rendering of services as a common or contract carrier or public utility at rates or charges fixed in conformity with law or governmental authority;
>
> (b) The transaction involves services as a bank depositary of funds, transfer agent, registrar, trustee under a trust indenture or similar services; or
>
> (c) The interest of the related person arises solely from the ownership of a class of company equity securities and all holders of that class received the same benefit on a pro rata basis.

These exceptions should be read narrowly—they do not create a general ordinary course exception. Instruction 7(a) does not apply, for example, to a contract awarded, after a competitive bidding process, to a company that did not submit the lowest bid. Nor does it apply to a contract awarded after a purported "competitive bidding" process which did not involve the formal procedures normally associated with competitive bidding situations. See Interpretation 230.04 of the Regulation S-K Compliance and Disclosure Interpretations.

Although the SEC declined to create a more general ordinary course exception, it did provide the following useful guidance in the 2006 adopting release: "[w]e note that whether a transaction which was not material to the company or to the other entity involved and which was undertaken in the ordinary course of the business of the company and on the same terms that the company offers generally in transactions with persons who are not related persons, are factors that could be taken into consideration when performing the materiality analysis for determining whether disclosure is required under the principle for disclosure." See the 2006 adopting release at pages 165-66, and text following note 464.

Thus, in the case of a director who is the CEO of an office supply company, the fact that the prices are the same ones offered to everyone buying in the same quantities in the ordinary course is likely to mean that the director would not have a material interest in the transaction—so there would be no need to disclose the office supply purchases. In other words, the transaction is not excluded because it is "ordinary course." Rather, it is excluded because the director did not have a material interest in the transaction (a likely, but not necessarily pre-determined result if the transaction is routine). On the other hand, a director who is the sole owner of the office supply company would be deemed to have a material interest in the transaction.

Disclosure of Indebtedness Transactions with Significant Shareholders Not Required

Disclosure of indebtedness transactions of significant shareholders or their immediate family members is not required. See Instruction 4(b) to Item 404(a).

Disclosure of Section 16 Short-Swings Not Required

Disclosure of amounts possibly owed by a related party to the company under the short-swing trading provisions of Exchange Act Section 16(b) is not required under Section 404(a). The 2006 amendments to Item 404 eliminated required disclosure of an officer's or director's unpaid Section 16 liability as "indebtedness" if the amount exceeded the reporting thresholds. In the 2006 adopting release, the SEC explained that Section 16(b) liability is not the type of indebtedness that Item 404 was designed to address. See pages 159-160 of the 2006 adopting release.

Definition of "Materiality"

Disclosure is required only if a related person has a material interest in the transaction, regardless of whether that interest is direct or indirect. Instruction 6 to Item 404(a) provides a safe harbor under which certain types of relationships will not be deemed "material interests" for purposes of Item 404 disclosure.

The materiality of any other kind of interest continues to depend on the significance of the information to investors in light of all the circumstances and the significance of the interest to the person having the interest. The relationship of the related persons to the transaction, and with each other, and the amount involved in the transaction would be among the factors to consider.

In the 2006 adopting release at page 149-50, plus text accompanying note 413, the SEC stated that this is determined as follows:

> The materiality of any interest will continue to be determined on the basis of the significance of the information to investors in light of all the circumstances ... T]he relationship of the related persons to the transaction, and with each other, the importance of the interest to the person having the interest and the amount involved in the transaction are among the factors to be considered in determining the materiality of the information to investors.
>
> The materiality test under Item 404 is ultimately based on the Supreme Court opinions in *TSC Industries v. Northway* (US Sup. Ct. 1976) and *Basic, Inc. v. Levinson* (US Sup. Ct., 1988). Under these opinions, materiality depends on the significance that a reasonable investor would place on the information. There must be a substantial likelihood that, under all the circumstances, the omitted or misrepresented fact would have assumed actual significance in a reasonable investor's investment decision. Stated differently, there must be a substantial

> likelihood that reasonable investors would have viewed disclosure of the fact omitted as having significantly altered the total mix of information.

Overdisclosure Typical Due to Vague Materiality Standard

The reality is that there's probably over-disclosure in this area due to a number of factors—such as the wording of Item 404(a) itself (which focuses on whether the related party has a material interest in the transaction) and the murkiness of the language in the SEC's adopting release. For example, here's some language from the adopting release: "As was the case before adoption of amended Item 404(a), the relationship of the related persons to the transaction, and with each other, the importance of the interest to the person having the interest and the amount involved in the transaction are among the factors to be considered in determining the materiality of the information to investors."

So the materiality to the individual related party remains part of the analysis even in the context of a transaction that is quite small from the company's perspective. When you combine this vague guidance with the scrutiny that gets placed on related party disclosures (which has been ramped up even more with Auditing Standard #18), a lot of companies just throw in the towel and make disclosures under Item 404 about transactions that might defensibly be excluded.

Some companies have taken a more aggressive approach to related-party disclosures and have successfully argued that certain related-party transactions involving amounts in excess of $120k should not be subject to disclosure. Here's an excerpt from a response letter to a Corp Fin comment that addresses disclosure of related-party transactions between AOL and Time Warner (see https://www.sec.gov/Archives/edgar/data/1468516/000119312509213323/filename54.htm):

> Comment: You disclose that you are currently a party to various agreements with Time Warner and its subsidiaries that cover a range of services, including the provision of computer/technology hosting and other technical support, advertising sales and advertising placement arrangements, licensing and content distribution arrangements, web and sponsored search services arrangements, and miscellaneous sublease arrangements. You also state that prior to the separation, you have had various agreements and arrangements with Time Warner, including arrangements whereby Time Warner provides cash management and treasury services to AOL. Please confirm that these agreements and arrangements do not exceed $120,000 and are not required to be disclosed pursuant to Item 404(a) of Regulation S-K.
>
> Response: The Company acknowledges the Staff's comment and, in response to the Staff's comment, has revised its disclosure beginning on page 150 to provide further information with respect to certain specified transactions.

The Company further advises the Staff that, in making its disclosure determination, the Company applied the test under Item 404(a) of Regulation S-K and the guidance set forth in SEC

Release No. 34-54302A (the "Release") in order to identify the agreements and arrangements that should be disclosed pursuant to Item 404(a). The Release provides in relevant part that:

> "... [A] company must disclose based on whether the related person had or will have a direct or indirect material interest in the transaction. The materiality of any interest will continue to be determined on the basis of the significance of the information to investors in light of all the circumstances. As was the case before adoption of amended Item 404(a), the relationship of the related persons to the transaction, and with each other, the importance of the interest to the person having the interest and the amount involved in the transaction are among the factors to be considered in determining the materiality of the information to investors."

> "... [W]hen the amount involved in a transaction exceeds the prescribed threshold ($120,000 under the amended rule we adopt today), a company should evaluate whether the related person has a direct or indirect material interest in the transaction to determine if disclosure is required. As was the case with Item 404(a) prior to adoption of these amendments, there may be situations where, although the instructions to Item 404(a) do not expressly provide that disclosure is not required, the interest of a related person in a particular transaction is not a direct or indirect material interest. In that case, information regarding such interest and transaction is not required to be disclosed under Item 404(a)."

In this connection, the Company identified all relevant transactions with "related persons," as that term is defined under Instruction 1 to Item 404(a) of Regulation S-K. The Company then assessed each such transaction to determine whether the amount involved exceeds $120,000. For each transaction with a related person involving an amount exceeding $120,000, the Company considered the materiality of the related party's interest and the significance of the information to investors in light of all the circumstances, in each case in accordance with Item 404(a) and the guidance set forth in the Release. On the basis of this analysis, the Company advises the Staff that all transactions required to be disclosed pursuant to Item 404(a) have been disclosed in the Registration Statement.

c. Item 404(b): Approval Procedures

What Must Be Disclosed About Related Party Transaction Policies

Item 404(b) requires disclosure about the policies and procedures established by the company regarding related party transactions. While state corporate law, exchange rules, the Sarbanes-Oxley Act and increasingly robust corporate governance practices support establishment of policies and procedures for transactions involving conflicts of interest, such policies and procedures may need to be reviewed and updated to accommodate Item 404(b). We have included a Sample Annotated Related Party Transaction Policy from Gibson, Dunn & Crutcher as Appendix A in this Chapter.

Specifically, the company must describe the material features of its policies and procedures for the review, approval or ratification of transactions with related persons that are reportable under Item 404(a). While the material features of such policies and procedures will vary depending on the particular circumstances, pursuant to Item 404(b)(1), examples of such features may include:

- Types of transactions covered by the policies and procedures, and the standards to be applied pursuant to such policies and procedures;
- Persons or groups of persons on the board of directors or otherwise who are responsible for applying the policies and procedures; and
- Whether the policies and procedures are in writing and, if not, how they are evidenced.

Item 404(b)(2) requires identification of any transactions required to be reported under Item 404(a) that did not require review, approval or ratification under the company's policies and procedures or where policies and procedures applied but were not followed. Disclosure of any transaction under Item 404(b)(2) does not obviate the need to disclose the transaction itself pursuant to Item 404(a).

Companies must provide Item 404(b) disclosure about their related party transaction policies and procedures even if they have no transactions disclosable under Item 404(a), as the SEC Staff affirmed in Question 130.06 of the Regulation S-K Compliance and Disclosure Interpretations.

Item 404(b) disclosure is not required for smaller reporting companies, in accordance with Item 404(d) and Question 130.07 of the Regulation S-K Compliance and Disclosure Interpretations.

The Instruction to Item 404(b) indicates that disclosure isn't required for any transaction that occurred before the related person entered into the relationship that would trigger disclosure under Item 404(a) if the transaction did not continue after that time. For example, disclosure would not be required under Item 404(b) in a company's Form 10-K for the fiscal year ended December 31, 2012 of a transaction that occurred in March 2012 between the company and an immediate family member of a person who later became a director of the company in August 1, 2012 provided that the transaction did not continue after August 1, 2012. However, disclosure would be required under Item 404(a) in this circumstance.

The Item 404(b) Instruction does not apply to transactions of "significant" shareholders (*i.e.*, >5% beneficial owners under Item 403(a) of Regulation S-K), because Item 404(a) does not require disclosure of transactions with parties that occur or exist before they attain that significant shareholder status.

Any compensation in excess of $120,000 paid to an immediate family member of a related person will be required to be disclosed pursuant to Item 404(a). See Instruction 5.a.ii. to Item 404(a). It is important to make sure that any compensation paid to an immediate family member of a related person has been approved or ratified under the procedures to be described under Item 404(b) to avoid further negative disclosure (*e.g.*, not only was the CEO's stepson paid, but the payment was never reviewed, approved, or ratified).

Best Practices for Ensuring Compliance with Policies & Procedures

There are several steps that those tasked with managing the related party transaction process should take to ensure that all required information is collected and properly evaluated:

- Education—It is important to communicate the scope of the disclosure requirements to the directors, director nominees and executive officers (at a minimum) so that all relevant potential transactions are identified and brought to the attention of the appropriate persons within the company. These related persons will need to understand that, as is the case with potential conflicts of interest, they have an affirmative obligation to identify and bring forward to the company's attention such potential transactions and relationships on a real-time basis for purposes of complying with the company's policies and procedures and disclosure requirements.

- Information Collection and Tracking Systems—The company's form of D&O Questionnaire should reflect the related party transaction disclosure requirements. Keep in mind that disclosure may be required for former executive officers and directors and directors not standing for re-election for any reportable transactions that occurred during the fiscal year. For more on questionnaires, see our "D&O Questionnaires" Chapter.

  In addition, the company should consider implementing additional procedures to assist in identifying relevant transactions on a real-time basis during the year, such as requiring each related person to submit annually a list of the names of all of their immediate family members, as well as the names of all the entities in which such persons are officers and/or significant equity holders. This will allow the company to periodically run the list of names through the company's accounts payable/receivables to determine whether there are any transactions that involve more than $120,000.

  The company may also consider developing additional procedures/controls to update related person information throughout the year to capture any new related persons and changes in relationships and transactions that may predate a person's "related" status.

  Most companies already review Schedule 13D and 13G filings on a relatively real time basis for investor relations purposes. Consider integrating this "real time" review into the company's related party transaction procedures.

  The bottom line is that there are a lot of perfectly acceptable variations among practices to fulfill these disclosure requirements. As a practical matter, most companies do not implement formal types of detective controls—rather, they rely on the directors and executive officers to assume responsibility for compliance with the policy.

- Approval of All Elements of Executive Officer Compensation—To avoid disclosing compensation of executive officers who are not named in the Summary Compensation Table as a related person transaction under Item 404(a), companies should make sure that all elements of compensation of all executive officers are approved by the compensation committee in advance.

- Approval of Compensation to Immediate Family Members—Companies should make sure that all elements of compensation of any immediate family members of related persons are approved or ratified by the committee that reviews related person transactions.

- Disclosure Controls and Procedures—Disclosure controls and procedures should be reviewed with the related person disclosure requirements in mind. Since disclosure extends to transactions with immediate family members of directors, director nominees and executive officers, as well as "significant" shareholders, relying solely upon D&O Questionnaire responses and affirmative obligation to bring potential transactions to the company's attention real-time may not be adequate. A written policy should be established and communicated, and implementation of other preventive and detective controls should also be considered.

- Independence of Directors—Regardless of whether a transaction is presumed to be prohibited under the related party transactions policy, when the transaction involves an "independent" director under the applicable stock exchange rules or "non-employee" director as defined in Section 16b-3, the company should always consider the effect of the proposed transaction on the director's independence status.

- Written Policies—Companies, other than smaller reporting companies, should adopt and communicate on a regular basis (at least annually) written related person transaction policies that address the Item 404(b) disclosure requirements. As part of this process, companies will need to decide which person—or department—will be notified of the facts and circumstances of transactions responsible for submitting the relevant information to the board for review and approval. They will also need to decide which directors or board committee will be tasked with administering the policies and procedures.

We have included a Sample Annotated Related Party Transaction Policy from Gibson, Dunn & Crutcher as Appendix A in this Chapter.

Best Practices for Board Oversight of Policies & Procedures

Some of the potential areas that boards may want to consider include:

- Integration With Board's Risk Oversight & Other Company Policies—With an increased focus on the board's role in risk oversight, and given the unique risks presented by related person transactions, it is increasingly important for the board to consider how the related

party transaction review and approval policy fits with the board's risk oversight function and the company's code of conduct and other internal policies and procedures addressing conflicts of interest.

The board should consider whether the appropriate committee is responsible for administering the related party transaction policies and procedures and whether sufficient information regarding these transactions and the approval process is received on a regular basis. Keep in mind that the Section 314.00 of the NYSE Listed Company Manual requires the company's audit committee, or another independent body of the board of directors, conduct a reasonable prior review and oversight of all related party transactions. Nasdaq Rule 5630 requires that a company's audit committee, or another independent body of the board of directors, conduct an appropriate review and oversight of all related party transactions for potential conflict of interest situations on an ongoing basis.

- Scope of the Policy—It is often useful to have the related person transaction policy cast a wider "net" than the disclosure rules require. Some policies do not utilize a materiality qualifier in the definition of "related person transaction." This allows the committee responsible for administering the policy, rather than management, to make the materiality determination. And some companies choose to subject transactions involving less than $120,000 to the review and approval requirements.

- Parameters—It is helpful for the related person transaction policy to specify the parameters under which transactions will be considered, such as whether the committee responsible for administering the policy will specifically consider whether the terms of the transaction are no less favorable than terms generally available to an unaffiliated third party under similar circumstances.

  The policy may also specify the information that should be provided regarding the related person transaction, such as the extent of the related person's interest or the expected benefits for the company, and how that information is to be provided to the board.

- Pre-Approvals—To facilitate effective implementation of the policy, it is often advisable to designate specific types of transactions as pre-approved, such as the types of transactions that are specifically identified in the exceptions noted in instructions to Item 404(a) or transactions meeting certain quantitative thresholds. The policy may also vest pre-approval authority in a particular director for specified types of transactions (such as the chair of the committee tasked with administering the related party transaction policy).

  Some practitioners prefer the pre-approval approach over excepting certain arrangements from the definition of "related person transactions" because they feel there are different disclosure consequences. Our view is that either formulation would require disclosure under Item 404(b) that the transactions weren't subject to review, approval or ratification—because they fell into the category of transactions either pre-approved or excepted from the policy.

- Recusal—The policy should mandate that no director who is involved in a transaction subject to the policy should participate in the discussion or approval of the transaction, except to the extent that it is necessary for that director to provide information about the transaction.

Follow-Up and Follow Through—In terms of best practices, companies should bear in mind that potential conflicts of interest often arise after a director is appointed or an officer is appointed, thus warranting ongoing communication (including associated education and training), monitoring and enforcement of the company's conflict of interest policies.

Both the NYSE and Nasdaq listing rules require companies to adopt codes of conduct applicable to all directors, officers and employees that address conflicts of interest. Since waivers of code provisions granted to directors and executive officers may be approved only by the board (pursuant to the Nasdaq rules) or the board or a board committee (pursuant to the NYSE rules) and disclosed in accordance with the rules, codes often assist in identifying potential conflicts of interest by providing examples of relationships and transactions that can give rise to potential conflicts. Assuming a potential conflict is identified, these codes ordinarily disallow the occurrence or continuation of the relationship or transaction unless specifically authorized or approved by the board or designated board committee in advance, and prescribe specific procedures tailored to the company's existing governance structure and circumstances for reporting and seeking authorization/approval. Any waiver of the code for a director or executive officer must be promptly disclosed.

In addition to the exchange rules, Section 406 of the Sarbanes-Oxley Act (implemented by Regulation S-K Item 406) requires companies to disclose whether they have adopted a code of ethics specifically for their principal executive officer and senior financial officers that addresses actual or apparent conflicts of interest (and, if not, why not) and to disclose any waivers of the code (nature of the waiver, the name of the person to whom the waiver was granted, and the date of the waiver) for such officers.

It is critically important that once an effective related person transaction policy is established, the company continue to follow the policy on a consistent basis with respect to all potential related person transactions, and that appropriate disclosure controls and procedures are implemented to ensure that any transactions reportable under Item 404(b) are identified and reported when necessary. For ongoing related person transactions, it may be appropriate for the policy to provide that the board or designated committee will review and assess the ongoing relationships on a periodic basis (at least annually) to determine if the transactions remain within the policy guidelines.

In terms of whether companies tend to have a conflict of interest policy or a related party transaction policy or both, practice varies. Some companies have stand-alone related party transactions policies, while others embed procedures for review and approval of transactions in other governance documents. Most companies also have some sort of broad-based conflicts of

interest policy that's part of their ethics policy and likely covers matters beyond related party transactions.

Learn more in our "Code of Ethics/Conduct Disclosure" Chapter.

d. Item 404(c): Promoters & Control Persons

Under Item 404(c), a company must disclose the identity of promoters and its transactions with them if the company had a promoter at any time during the last five fiscal years—but only for a Form S-1 or Form 10.

The disclosure must include:

- Names of the promoters;
- Nature and amount of anything of value received by each promoter from the company and the nature and amount of any consideration received by the company; and
- Additional information regarding any assets acquired by the company from a promoter.

For assets acquired by the company from the promoter, the company must disclose the amount at which the assets were acquired or are to be acquired and the principle followed in determining the amount. The identity of the persons making the determination must also be disclosed, as well as relationship they have with the company or promoter. If the promoter acquired the assets within two years before their transfer to the company, the cost to the promoter must be disclosed.

The rules also require the same disclosure that is required for promoters for any person who acquired control, or is part of a group that acquired control, of a company that is a shell company. The term "group" has the same meaning as in Exchange Act Rule 13d-5(b)(1)—that is, any two or more persons that agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an company. The term "shell company" is defined in Securities Act Rule 405 and Exchange Act Rule 12b-2.

e. Item 404(d): Smaller Reporting Companies

Item 404(d) sets forth the disclosure requirements for smaller reporting companies, as defined in Exchange Act Rule 10(f)(1). The requirements parallel the requirements set forth above, with several important differences:

- Smaller reporting companies are not required to disclose the company's policies and procedures for reviewing related person transactions, *i.e.*, the disclosure requirements of Item 404(b) do not apply.
- The threshold for disclosure is the lesser of $120,000 or 1% of the average of the small business company's total assets at year-end for the last two completed fiscal years.

- Transactions that meet the disclosure thresholds must be reported if they occurred during the company's last two fiscal years, not just the last fiscal year. See Instruction 2 to Item 404(d).
- Smaller reporting companies must provide the information required by Item 404(c), whether or not the information is being provided in a registration statement.
- Each smaller reporting company must provide a list of parents, showing the basis of control and, as to each parent, the percentage of voting securities or other basis of control by its immediate parent, if any.
- Smaller reporting companies must include information for any material underwriting discounts and commissions upon the sale of securities, if any related person was or is to be a principal underwriter, or is a controlling person or member of a firm that was or is to be a principal underwriter.

f. Foreign Private Issuers

A foreign private issuer will be deemed to have complied with Regulation S-K Item 404 if it provided the information required by Form 20-F Item 7.B. However, if more detailed information is otherwise made publicly available or required to be disclosed by the company's home jurisdiction or a market in which its securities are listed or traded, that same information must also be disclosed pursuant to Item 404. See Instruction 2 to Item 404.

g. Section 16 Short-Swing Trading Rules: Non-Employee Directors

The Exchange Act's short-swing trading provisions give companies the right to recover profits from an officer, director, or ten-percent shareholder realized from a purchase and sale of company stock within a period of less than six months. Rule 16b-3, however, exempts transactions between issuers of securities and their officers and directors under specified conditions. In particular, acquisitions from—and dispositions to—the company are exempt if the transaction is approved in advance by the board or a board committee composed solely of two or more non-employee directors.

The definition of "non-employee director" is a director who:

- Is not currently an "officer" of the company, as defined in Exchange Act Rule 16a-1(f);
- Does not receive compensation, either directly or indirectly, from the company, or a parent or subsidiary of the company, for services rendered as a consultant or in any capacity other than as director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K; and
- Does not possess an interest in any other transaction for which disclosure would be required pursuant to Item 404(a) of Regulation S-K.

Note 4 to Rule 16b-3 provides that, for purposes of determining a director's status under those tests that are based on Item 404(a), a company may rely on the disclosure provided under Item 404 for the company's most recent fiscal year contained in the most recent filing in which Item 404 disclosure is presented. When a transaction disclosed in that filing was terminated before the director's proposed service as a non-employee director, that transaction will not bar such service.

The company must believe in good faith that any current or contemplated transaction in which the director participates will not require Item 404(a) disclosure based on information readily available to the company and the director at the time the director proposes to act as a non-employee director. When the company believes in good faith that a transaction with a director will require Item 404(a) disclosure in a future filing, the director no longer is eligible to serve as a non-employee director.

However, this determination does not result in retroactive loss of a Rule 16b-3 exemption for a transaction previously approved by the director while serving as a non-employee director consistent with the note. Finally, in making determinations under the note, a company may rely on information it obtains from the director, such as pursuant to a response to an inquiry. Learn more in *Romeo & Dye's Section 16 Treatise*.

Can disclosure of related-party transactions cause a director to fall outside the definition of a "Non-Employee Director" under Rule 16b-3? The SEC Staff addressed this question in an interpretive letter to Gibson Dunn & Crutcher dated November 20, 1996. The following is from the text of *Romeo & Dye's Section 16 Treatise*:

> For a disclosable interest in a transaction with the issuer to be disqualifying, the director himself or herself must have a material interest in the transaction. Thus, a transaction that is disclosable because it involves a member of the director's immediate family will not disqualify the director if the director did not have a material interest in the transaction.

h. Relationship with Director Independence Determinations of Item 407(a)

Item 407(a) of Regulation S-K requires companies to identify each director and nominee for director who is "independent" under the applicable standard, based on the standards of the stock exchange on which the company's common stock is listed. Item 407(a)(3) specifically requires that the company describe by general category any transactions or relationships not disclosed pursuant to Item 404(a) that were considered by the board in evaluating independence. This means that, even if the board does not consider a transaction in its independence determination because it does not exceed a categorical threshold, it may still have to consider whether the transaction is material under Item 404(a).

If the board considers the transaction to determine whether it has to be disclosed as a related person transaction—but does not consider it under the company's categorical independence

standards—we think a literal reading of Item 407 requires that there be some disclosure about the transaction, though not with the specificity of the related person transaction disclosure.

i. Item 5.02(c) of Form 8-K

Item 5.02(c) of Form 8-K requires companies to report when they have appointed a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or person performing similar functions. The company must disclose, in addition to the name and position of the officer and certain biographical information, the related-person transaction information required by Item 404(a).

j. Item 5.02(d) of Form 8-K

Item 5.02(d) of Form 8-K requires companies to report when they elect a new director, except when elected by shareholders at an annual or special meeting convened for such purpose. The company must disclose, in addition to the name of the newly elected director, date of election, description of any arrangement between the new director and any other person relating to how such director was selected as a director, committee assignments or planned committee assignments, any material plan, contract or arrangement to which the director is a party, and the related-person transaction information required by Item 404(a).

k. Exhibit Filing Requirements

There is no specific requirement to file all related person agreements. However, some of the requirements of Item 601 may pick up certain related person agreements. For example, Item 601(b)(10)(ii)(A) requires the filing of any contracts to which directors, officers, promoters, voting trustees, security holders named in the registration statement or report or underwriters are parties, other than contracts involving only purchase and sale of current assets having a determinable market price, at such market price. In addition, some of the compensatory contracts contemplated in Item 601(b)(10)(iii) could involve related person transactions.

We note that some members of the Corp Fin Staff have taken the position that even non-material contracts with related persons should be filed. See, *e.g.*, the SEC comment letter to Rite-Aid, dated March 27, 2007. Learn more in our "10-K and 10-Q Exhibits" Chapter.

l. Confidential Treatment Requests

As related party transactions can be highly sensitive, it's not uncommon for a company—or the individuals involved—to want to keep as much of the information private as possible, including any contracts or agreements related to the transaction. The Staff has stated that "except in unusual circumstances," disclosure required by Regulation S-K is not appropriate for confidential treatment and a bullet list calls out related person transactions specifically.

We think that companies should not attempt to seek confidential treatment of line item disclosure required by Item 404. Confidential treatment may still be sought for particular terms of a related person transaction agreement that constitute trade secrets or confidential information that is not otherwise required to be disclosed. Learn more in our "Confidential Treatment Requests" Chapter.

m. PCAOB's Related Party Transactions Standard

In 2015, the PCAOB adopted an auditing standard on related parties—Audit Standard #18—and amended existing auditing standards that relate to significant unusual transactions and financial relationships and transactions by a company with its executive officers (including incentive compensation arrangements).

In an effort to focus auditors' efforts on areas that may pose an increased risk of material misstatement to a company's financial statements, these standards specify auditors' due diligence procedures for related party transactions.

The accounting definition of "related party transaction" differs from Item 404(a)—but there is overlap. It is important for the internal legal & audit teams to discuss this topic with the company's external auditors. AS #18 does not, on its face, have a materiality or significance qualifier in terms of what information the auditor is supposed to gather—but auditors recognize that there is some company-specific threshold that would be clearly immaterial and thus irrelevant under AS #18.

Following discussions with their auditors, most companies have updated their D&O questionnaires and implemented quarterly procedures to identify and gather more information about transactions with related parties. For more information, see the "D&O Questionnaires" Chapter—as well as the "Checklist: Management Representation Letters" available on TheCorporateCounsel.net.

IV. Common Questions & Our Analysis

a. Definition of "Transaction"

Charitable Gift May Be Related Party Transaction

Question: We are considering a donation to a private school; one of our board members sits on the school's board. The donation is not in that director's name and, in fact, is not being made because of the director's affiliation with the donee. We have made donations to the donee in the past and the director is not even aware that a donation is being considered. Would this donation constitute a "director legacy program" that would require disclosure in the Director Compensation Table? Would it require disclosure as a related person transaction under Item 404?

September 27, 2022

Related Party Transactions: Questions Audit Committees Should Ask

As the 2022 edition of Deloitte's "Audit Committee Guide" points out, NYSE and Nasdaq rules require that an independent board committee review & oversee related-party transactions – and that responsibility often falls to the audit committee. Deloitte notes:

> While these types of transactions often occur in the normal course of business, transactions among related parties are sometimes associated with the risk of misstatement or omission in financial reporting, whether by error or fraud. Auditors are required to scrutinize related-party transactions that may pose an increased risk of fraud. These include transactions involving directors, executives, and their families; significant unusual transactions that are outside the normal course of business; and other financial relationships with the company's executive officers and directors. Audit committees must be alert to these transactions as part of their oversight responsibilities.

The Guide suggests that audit committees consider asking these 6 questions:

> 1. What are the business reasons for the transaction? Are these reasons in line with the company's overall strategy and objectives?
>
> 2. Are the terms of the transaction consistent with the market? In other words, would these terms apply to an unaffiliated party?
>
> 3. When and how will the transaction be disclosed? How will investors view the transaction when it is disclosed?
>
> 4. What impact will the transaction have on the financial statements?
>
> 5. Which insiders could benefit from the transaction, and in what way?
>
> 6. Are outside advisers needed to help understand the implications of the transaction?

Visit our "Audit Committees" and "Related Party Transactions" Practice Areas for more guidance on these topics.

– **Liz Dunshee**

Posted by Liz Dunshee
Permalink: https://www.thecorporatecounsel.net/blog/2022/09/related-party-transactions-questions-audit-committees-should-ask.html

September 27, 2022

Related Party Transactions: SEC Hooks Auditor for Deficient Procedures

As tends to be the case in late September, and as John predicted last week, the SEC enforcement actions are coming in hot. Hat tip to friend of the sites and Maynard Cooper counsel Bob Dow for highlighting this $1.5 million settlement that landed Friday against an audit firm whose work for a SPAC and another public company was allegedly deficient in regards to identifying related party transactions. Here's more detail from the complaint:

> Friedman failed to exercise professional skepticism when reviewing work papers. First, the work papers that documented the details and testing of accounts receivable and prepaid expenses and other current assets contained names included on iFresh's related party lists. Friedman did not identify the names on the work papers as related parties, so certain related party transactions were not disclosed in the financial statements.
>
> Second, Friedman failed to recognize red flags that indicated undisclosed related parties. For example, schedules provided to Friedman by iFresh in connection with the 2018 through 2020 audits included names of entities that had similar names as iFresh subsidiaries, and transaction descriptions that were inconsistent with iFresh's business.
>
> Friedman also encountered numerous red flags of undisclosed related party transactions with Li Ba HVAC & Construction ("Li Ba"). Li Ba was a related party because it was owned by Deng's brother.

The complaint goes on to detail other "red flags," like this:

> Friedman failed to design and to perform procedures to obtain a sufficient understanding of the following significant unusual transactions involving undisclosed related parties: 1) the sale of commercial refrigeration equipment to Li Ba and the resulting large receivable with long aging and little to no collection for the 2017 through 2020 audits; 2) a legal settlement paid by Li Ba on behalf of iFresh for the 2018 audit; 3) iFresh and Li Ba extending loans to each other for the 2019 and 2020 audits; 4) Deng's payments to iFresh on behalf of White Plains for the 2020 audit; and 5) Jiutian's capital contributions to iFresh on behalf of Deng for the 2020 audit.

There are few things that excite SEC Enforcement more than shady SPACs and related party transactions – and this enforcement action follows remarks by Enforcement Division Director Gurbir Grewal a year ago where he emphasized gatekeeper accountability. The cherry on top is that Friedman is now owned by Marcum LLP, which back in 2020 was sanctioned and prohibited by the PCAOB from conducting audits of China-based businesses for three years. As this Twitter thread from a whistleblower lawyer points out, some companies have used their audit by Friedman to certify compliance with the new HFCAA rules. This settlement doesn't directly impact that approach.

– **Liz Dunshee**

Posted by Liz Dunshee

Permalink: https://www.thecorporatecounsel.net/blog/2022/09/related-party-transactions-sec-hooks-auditor-for-deficient-procedures.html

July 19, 2023

Recent SEC Enforcement Action Highlights Trap for the Unwary SRC

Early this month, the SEC posted an order involving a company's failure to disclose related party transactions involving family members of corporate officers. This omission highlights a trap for the unwary:

> Smaller reporting companies qualify for scaled disclosure — scaled generally meaning less — but not for related-party transactions. Under Item 404 of Regulation S-K, SRCs must disclose related party transactions exceeding the lesser of $120,000 or 1% of the average of the company's total assets at the end of the last two fiscal years, and the disclosure must cover two fiscal years, instead of one.

The company was an SRC during the period in question, and at least one of the undisclosed related party transactions involved dollar amounts below the $120,000 threshold for non-SRCs. According to the order, the relevant thresholds for the company over the covered fiscal years ranged from approximately $20,000 to $30,000, well below $120,000. This is an important reminder — especially for companies who have recently become SRCs or go in and out of SRC status — to update your policies, procedures and internal inquiries, including D&O questionnaires, if and when the lower threshold is relevant.

For other reasons, advisors of life sciences companies should read the entire order. The SEC also took issue with the company's statements in two press releases about a screening test it developed to detect COVID-19. And the SEC wasn't the only regulator who inquired about these statements — the FDA had also contacted the company with concerns about the language used.

– **Meredith Ervine**

Posted by Meredith Ervine
Permalink: https://www.thecorporatecounsel.net/blog/2023/07/recent-sec-enforcement-action-highlights-trap-for-the-unwary.html

September 19, 2023

Enforcement: SEC Brings Another Related Party Transactions Case

We're coming to the end of the SEC's fiscal year, and that's traditionally been a time when we've seen a lot of high-profile activity on the enforcement front. That looks like it may be the case this year, and it also looks like related party transaction disclosure is high on the list of the Division of Enforcement's priorities. Last week, Meredith blogged about a recent RPT enforcement action and the SEC brought another settled enforcement action yesterday, this time targeting alleged shortcomings in related party transactions disclosure by Lyft. This excerpt from the SEC's press release announcing the settlement summarizes the conduct alleged in its order:

> According to the SEC's order, prior to Lyft's IPO in March 2019, a Lyft board director arranged for a shareholder to sell its shares to a special purpose vehicle ("SPV") set up by an investment adviser affiliated with the same director. The director then contacted an investor interested in purchasing the shares through the SPV. According to the SEC's order, Lyft, which approved the sale and secured a number of terms in the contract, was a participant in the transaction, and the director was a related person by virtue of his position and because he received millions of dollars in compensation from the investment adviser for his role in structuring and negotiating the deal. Lyft failed to disclose this information regarding the sale in its Form 10-K for 2019. The SEC's order finds that the director left the Board at the time of the transaction.

Without admitting or denying the SEC's allegations, Lyft consented to an order requiring it to cease and desist from committing or causing any future violations of Section 13(a) of the Exchange Act or Rule 13a-1 thereunder. The company also agreed to pay a $10,000,000(!) civil penalty.

The action provides a reminder that even if a transaction doesn't involve payments between a company and a related party, disclosure may still be required. That's because Item 404(a) requires a description of transactions since the beginning of the registrant's last fiscal year in excess of $120,000 in which it was or is to be a participant, and in which a related person had or will have a direct or indirect material interest.

– **John Jenkins**

Posted by John Jenkins
Permalink: https://www.thecorporatecounsel.net/blog/2023/09/enforcement-sec-brings-another-related-party-transactions-case.html

September 19, 2023

Related Party Transactions: What Does it Mean to "Participate" in One?

The SEC's position in this enforcement action makes it clear that Lyft's involvement in approving and negotiating some of the terms of the transaction was sufficient to characterize the company as a "participant" in it. This excerpt from p. 21 of our "Related Party Transactions Disclosure Handbook" provides additional color on the participation concept & some of the challenges it presents:

> Being a participant encompasses situations where the company benefits from a transaction but is not technically a contractual party to the transaction. In response to concerns that the concept of a "participant" might be too broad and far-reaching, the SEC offered the following example of a case where disclosure might be required even if the company is not a contractual party: "[d]isclosure would be required if a company benefits from a transaction with a related person that the company has arranged and in which it participates, notwithstanding the fact that it is not a party to the contract." See the 2006 Adopting Release at footnote 418.
>
> This loose boundary may be problematic to monitor since it carries with it the possibility that disclosure could be required in a situation where the company does not have a "material interest" (as would be required for the related person) in the transaction. Presumably, the company would be aware of the transaction if it had a hand in "arranging" the transaction, but there may be other situations that are not as evident to those tasked with tracking potentially disclosable transactions.

We also have a bunch of Q&As beginning on p. 48 of the Handbook that address specific situations where "participation" is an issue that you may find helpful. The bottom line is that Item 404 of Reg S-K is designed to cast a very wide net, and the SEC expects companies to be mindful of that fact when preparing disclosure documents. In her blog last week, Meredith suggested that it may be time for companies to consider refreshing their disclosure controls and procedures for related party transactions. That seems like an even better idea this week.

– **John Jenkins**

Posted by John Jenkins
Permalink: https://www.thecorporatecounsel.net/blog/2023/09/related-party-transactions-what-does-it-mean-to-participate-in-one.html

September 15, 2023

Family Member Employees: Do Your RPT Controls Need a Refresh?

Earlier this week, the SEC announced settled charges against Maximus, Inc. "for failing to make required disclosures that it employed the siblings of one of its executive officers" and that Maximus agreed to pay a civil penalty of $500,000. According to the order, in late 2019, the company's board promoted a business segment leader and longtime employee to be an executive officer of the company. Maximus's annual reports and proxy statements for 2019 through 2021 disclosed that the company had no related person transactions even though the newly-appointed officer's two siblings were also longtime company employees and both received annual compensation of greater than $120,000. The order includes the following reminder:

> Disclosure of related person transactions "involving the employment of immediate family members" is required "when the threshold for disclosure has been met and the immediate family member has or will have a direct or indirect material interest." Information required to be disclosed concerning any such related person transaction includes the name of the related person, the basis on which the person is a related person, the related person's interest in the transaction, and the approximate dollar amount of the related person's interest in the transaction.

Our "Related Party Transactions Disclosure Handbook" has tons of practical guidance on this topic, including how to calculate the amount paid to the family member employee, and reminds companies to thoroughly vet contextual disclosure, such as statements that the "individual received compensation 'commensurate with that provided to other employees in similar positions.'"

– **Meredith Ervine**

Posted by Meredith Ervine
Permalink: https://www.thecorporatecounsel.net/blog/2023/09/family-member-employees-do-your-rpt-controls-need-a-refresh.html