Amended Shareholder Rights Directive: impact on Main Market companies

June 2019

On 10 June 2019 the UK implemented the amended Shareholder Rights Directive. The changes primarily affect companies with shares traded on the UK Main Market or another EU regulated market, institutional investors, asset managers, intermediaries in the investment chain and proxy advisers.

Key points

- Certain additional information will have to be included in directors' remuneration reports that cover a financial year that begins on or after 10 June 2019.

- There is now an additional category of "material" related party transactions (5% or more in any class test) that must be announced via a RIS even if they are not caught by the existing Listing Rules (LR 11). For most companies, such a transaction will also have to be approved by the board before it is entered into. Companies must comply with this new requirement from the start of their first financial year that begins on or after 10 June 2019.

The Shareholder Rights Directive

The original Directive was implemented in the UK in 2009, primarily through changes to the rules in the Companies Act 2006 on general meetings of quoted companies. The amendments to the Directive are designed to make improvements in five areas:

- Shareholder engagement and transparency of ownership.

- Engagement and transparency among institutional investors and asset managers.

- Transparency of proxy advisers.

- Transparency and shareholder control over directors' remuneration.

- Transparency and control over transactions with related parties.

This note highlights the key changes for Main Market companies in the latter two areas.

Directors' remuneration

In most respects the existing UK legislation on directors' remuneration is already aligned with the amended Directive and does not need to be changed. In particular, there is no change to the requirements to (i) put a remuneration policy to a binding shareholder vote at least every three years; (ii) ensure that all payments to directors are consistent with the policy; and (iii) publish a remuneration report and put it to an advisory shareholder vote every year.

However, a few changes are needed. Mostly the changes will not affect companies' existing practices, but there are three changes in relation to the remuneration report worth noting:

- The remuneration report must be available free of charge on the company's website for ten years. Previously a report had to be available only until the next one was published.

- The report must specify any changes to the exercise price and date for the exercise of shares or share options by directors.

- The report must compare the annual change in each director's remuneration to the annual change in pay of the company's employees (on average) over a five year rolling period. Previously the report had to disclose changes only to the CEO's remuneration compared to employees, and only compared to the previous year.

Unquoted trading companies must comply

The rules on remuneration policies and reports have been extended to "unquoted trading companies", such as those with shares admitted to the High Growth Segment or Specialist Fund Segment. In practice most, if not all, such companies already comply with the rules.

Timing

The new requirement for the remuneration report to be available on the company's website for 10 years applies to a report that is published on or after 10 June 2019. The new requirements on the contents of the remuneration report apply where the report covers a financial year beginning on or after 10 June 2019.

Legislative vehicle

The new requirements have been introduced via The Companies (Directors' Remuneration Policy and Directors' Remuneration Report) Regulations 2019 (SI 2019/970), which amend Parts 10 (resolutions and meetings) and Parts 15 and 16 (accounts and audit) of the Companies Act 2006 and the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008.

Related party transactions

As with directors' remuneration, in many respects the existing UK rules for premium segment companies on related party transactions (RPTs) contained in chapter 11 of the Listing Rules (LR 11) are already aligned with the amended Directive and do not need to be changed. However, in certain respects the amended Directive has a slightly wider scope than the rules in LR 11.

New DTR 7.3

As the existing LR 11 rules are well established and understood, the FCA sensibly decided to leave them un-amended. However, in the Disclosure Guidance and Transparency Rules (DTR) a new section 7.3 has been inserted: this reflects the scope and provisions of the Directive but otherwise is closely modelled on LR 11. (For background see the FCA's Policy Statement PS 19/13 and Consultation Paper CP 19/7.)

DTR 7.3 generally applies to:

- Companies with voting shares admitted to the premium segment. They must comply with *both* DTR 7.3 *and* LR 11. However, this is less significant than first appears because, as explained further below, if the company complies with LR 11 it will be treated as having also complied with DTR 7.3.

- Companies with voting shares listed on the standard segment.

However, companies whose registered office is in another EEA state do not have to comply with DTR 7.3; instead, they must comply with equivalent rules of that state.

DTR 7.3 requirements

Where a company proposes to enter into a transaction with a "related party" that is "material" then, unless the transaction is exempt, the company must:

- Make a **RIS announcement** containing certain specified information about the transaction; and
- Obtain **board approval** for the transaction before it is entered into, and ensure that any director who is the related party, whose associate is the related party or who also sits on the board of the related party does not participate in board discussions of the transaction and does not vote on it. However, if the company is not incorporated in an EEA state, it need not obtain board approval.

Meaning of "related party" and "material" in DTR 7.3

"**Related party**" has the meaning in IAS 24 (Related party disclosures). However, if the company is not incorporated in an EEA state, it can instead choose to use the definition in the accounting standards it uses to prepare its consolidated annual financial reports, provided those standards are treated by the European Commission as equivalent to IFRS for the purposes of the Transparency Directive (e.g. US GAAP).

"**Material**" means where any of the percentage ratios set out in the Annex to DTR 7.3 is ***5% or more***. The class tests in the Annex to DTR 7.3 are substantially the same as the existing class tests in the Annex to LR 10.

Exempt transactions

The following types of transaction are exempt:

- A transaction in the ordinary course of business and concluded on normal market terms.
- A transaction between the company and a subsidiary undertaking that is either wholly owned or where no other related party has an interest in the subsidiary undertaking.
- A transaction relating to the remuneration of a director of the company that is paid in accordance with the company's remuneration policy approved by shareholders under CA 2006.
- A transaction offered to all shareholders on the same terms.

Aggregation

If a company enters into transactions with the same related party or any of its associates in any 12 month period then, unless a previous transaction has already been announced under DTR 7.3, the company must aggregate them.

Timing

Companies must comply with new DTR 7.3 from the start of *the first financial year beginning on or after 10 June 2019*. So a company with a calendar year end will need to start complying with DTR 7.3 from 1 January 2020.

When DTR 7.3 will be relevant for premium segment companies

For premium segment companies, DTR 7.3 will usually not be a concern. This is because most RPTs will either:

- be exempt from both LR 11 and DTR 7.3 - e.g. a "small" RPT where each percentage ratio is 0.25% or less, which will not be "material" for the purposes of DTR 7.3;
- fall within the scope of LR 11 but outside DTR 7.3 – e.g. a "smaller" RPT where each percentage ratio is less than 5% but any one or more exceeds 0.25%. Such a transaction will also not be "material" for the purposes of DTR 7.3; or
- fall within the scope of both LR 11 and DTR 7.3, in which case the company's compliance with LR 11 (RIS announcement; shareholder circular; fair and reasonable opinion from a sponsor; and shareholder approval) will be treated also as compliance with DTR 7.3.

However, a few RPTs will fall outside the scope of LR 11 but within the scope of DTR 7.3. In such cases, a premium segment company will have to comply with DTR 7.3. As noted above, standard segment companies will always have to comply with DTR 7.3.

A transaction could fall outside LR 11 but within DTR 7.3 because:

- It is exempt from LR 11 but not from DTR 7.3. For example, a transaction where the company lends money or gives a guarantee to a related party on normal commercial terms and that has no unusual features is exempt from LR 11 but not from DTR7.3. If the amount in question is "material" for the purposes of DTR 7.3, the company would have to comply with the requirements of DTR 7.3.
- It is with a party that is not treated as a related party under LR 11 but is so treated under IAS 24. For example:
  - A subsidiary undertaking in which another related party has an interest. A transaction between such a company and, say, the parent or wholly-owned main operating subsidiary will not usually be caught by LR 11 but will be caught by DTR 7.3 if the transaction is "material".
  - The element of the definition of related party in IAS 24 that relates to family members of a related party potentially catches a wider range of individuals than the equivalent element of the definition in LR 11. As a result, a transaction between the company and certain members of the family of a director or substantial shareholder might not be caught by LR 11 but could be caught by DTR 7.3.
  - The elements of the definition in IAS 24 that relate to joint venture partners and those with a similar relationship to the company potentially catch a wider range of persons than the equivalent element of the definition in LR 11 ("persons exercising significant influence" over the company). As a result, a transaction between the company and a joint venture partner or similar, or a person who is connected to them, might not be caught by LR 11 but could be caught by DTR 7.3.

Practical steps for companies to take

In practice, premium segment companies should assess first whether a transaction is caught by LR 11. If so, they should comply with LR 11 and need not do anything further to comply with DTR 7.3. If the transaction is *not* caught by LR 11, they should go on to assess whether it is nevertheless caught by DTR 7.3. If so, they should comply with DTR 7.3. Standard segment companies need only assess whether a transaction is caught by DTR 7.3.

In order to comply with their financial reporting obligations, and for the purposes of good governance and risk management, most premium and standard segment companies will already have in place policies, systems and controls to identify transactions that may fall within IAS 24 and, depending on their size, to escalate them to the board or an appropriate committee for approval. Ensuring that the company is able to comply with the new DTR 7.3 should therefore in most cases largely be a question of making sure that the existing policies, systems and controls pick up all the transactions that may fall within DTR 7.3 and, if so, that the company is able to announce the relevant details in a timely manner.

However, this may be an opportune moment for companies to provide a refresher to relevant directors and employees on all the related party transaction rules.

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