Related Party Transactions on the London Stock Exchange: What Works and What Does Not

Law Working Paper N° 624/2022
January 2022

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ECGI Working Paper Series in Law

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Abstract

The rules governing companies listed on the Main Market of the London Stock Exchange and its Alternative Investment Market fill an important gap in the general law regulating related party transactions (RPT). The regulatory techniques used by in these “Exchange rules” are principally disclosure to the market at the time of the transaction and, in a more limited range of cases under the Main Market rules, prior approval of the transaction by a majority of the uninvolved shareholders. This article investigates the outcomes of these rules by analysing the RPT announcements made by companies on these two markets over a twelve-month period beginning in June 2019. These announcements related to nearly 500 RPT. The article concludes that neither mechanism works at an optimum level. The Main Market shareholder approval requirements catch only a small number of companies, predominantly outside the FTSE 350. The disclosure rules omit an important element in the information the market needs, namely the company’s analysis why the transaction is considered fair. In cases where there is an operative shareholder approval requirement (from whatever source), then the need to obtain shareholder approval is likely to force revelation of the company’s fairness analysis, but this driver does not operate across the majority of RPT. The article makes some suggestions for simple reforms to address these defects. An edited version of this article will appear in the Business Law Review, volume 43, 2022, published by Kluwer Law International.

Keywords: Related party transactions, London Stock Exchange, disclosure to the market, shareholder approval, authority to issue shares, pre-emption, independent directors, fairness certification

JEL Classifications: K22

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RELATED PARTY TRANSACTIONS ON THE LONDON STOCK EXCHANGE:

WHAT WORKS AND WHAT DOES NOT

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The Issue

Related-party transactions (RPT) occur when someone connected with the company appears, directly or indirectly, on both sides of a corporate transaction. This generates the risk that they are able to influence the terms of the transaction in their favour, as compared with an arm's length transaction, to the detriment of both the company and its non-connected shareholders. For UK lawyers familiar with only the common law of companies and the Companies Acts (CA), this is both a familiar and an unfamiliar problem. Related-party transactions with directors have been at the core of the concerns of corporate law since the earliest days of modern company law.[1] Substantial shareholders, however, fell outside these rules, despite their potential influence over corporate transactions. Only in 2015 was the core statutory provision dealing with RPT clearly extended to shareholders who fell within the category of a "shadow" director.[2] Even this reform did not completely fill the gap in the coverage of the rules: a substantial shareholder who does not take a continuing role in any part of the company's management will remain outside them[3] and in a position to influence one or more transactions on an ad hoc basis.

It might be thought that substantial shareholders constitute a theoretical, rather than a real, gap in the coverage of the UK's RPT rules, at least in relation to companies whose shares are publicly traded, because of the conventional view that the shareholdings in such companies

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[1] *Aberdeen Ry Co v Blaikie Bros* (1854) 1 Macq. 461.

[2] Companies Act 2006 (CA), s 177, applied to shadow directors by s.170(5), which was introduced into the CA by the Small Business, Enterprise and Employment Act 2015, s 89(1).

[3] A "shadow" director is "a person in accordance with whose directions or instructions the directors of the company are accustomed to act" (s. 251). This requires some continuing involvement in at least part of the company's business strategy: what "is required is that what is said by the shadow directors to the board … is usually followed over a wide enough area and for long enough" (*Secretary of State v Deverell* [2000] BCLC 133, CA at [33] – counsel's submission accepted by the court at [36].)

are highly dispersed. However, Table 3, discussed in more detail below, shows that outside the very largest publicly traded companies (the FTSE 100), more publicly traded companies have at least one (and sometimes more than one) shareholder holding 10% or more of a class of the company's shares than do not. So, the gap in the regulatory coverage appears to be a real one.

However, hiding in plain sight, are rules which do bring substantial shareholders (defined as those able to control the exercise of 10% or more of the voting rights at a general meeting of the company) and their associates within the regulatory perimeter. (Of course, they apply to directors and their associates, as well.) These are the special rules applying companies whose shares are publicly traded on the London Stock Exchange (LSE). There are in fact two sets of rules, one applying to Main Market companies (the Listing Rules - LR) made (now) by the Financial Conduct Authority (FCA);[4] the second applying to companies on the Alternative Investment Market (AIM) and still made by the Exchange itself.[5] There is in fact a substantial commonality in the structure of the rules, perhaps because the modern version of both sets of rules dates from the early 1990s when the LSE was the rule-maker in both cases. When referring to both sets of rules the term "Exchange rules" is used in this paper.

In addition to their gap-filling potential in relation to UK company law, it is important to note that the rules apply to all companies which are listed on the relevant markets, no matter where incorporated. A further international dimension to the Exchange rules is the reputation they have acquired outside the UK for being a demanding set of requirements. In this vein, they had a substantial influence on the European Commission's proposals of 2014 for the RPT element of the revised Shareholder Rights Directive, though those proposals were significantly

[4] *FCA Handbook, Listing Rules, Chapter 11 ("Related Party Transactions")*

[5] London Stock Exchange, *AIM Rules for Companies*, 2021 (ARC), rule 13 and Sch.4.

watered down in the EU's legislative process.[6] Thus, on both domestic and wider European dimensions there are good reasons for investigating the operation in practice of these rules.

In addition to the broader definition of "related party" used in the Exchange rules, as compared to the CA, the principal regulatory technique they deploy is also different. That technique is disclosure to the market at the time the transaction is entered into, provided the transaction exceeds a certain economic size. Effective disclosure discharges multiple functions.[7] It enables the market to reflect the adverse economic impact of biased transactions in the price of the company's shares (to the detriment of the company if it needs to raise capital and of its directors whose rewards under incentive schemes may become less or who may even face an unwelcome takeover offer). Whether or not the transaction is significant enough to impact on the company's share price, the prospect of disclosure will have some deterrent effect on potential related parties (for reputational reasons). Finally, to avoid these consequences companies will be incentivized to adopt governance structures which reduce the likelihood of unfair transactions being entered into by related parties. Disclosure to the market is a natural technique for Exchange authorities to deploy, since the rule-books for both Main Market and AIM companies have a central concern with the disclosure to the market of information on a wide variety of matters (well outside the area of RTPs), not only when the company makes an offer of its securities to the public but also on a continuing basis.[8] However, it is clear that disclosure cannot effectively achieve any of these goals unless the information disclosed enables the market to make the relevant judgement, in this case whether the RPT is on terms

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[6] See A Gözlügöl, "The Political Economy of the Related Party Transactions Regulation in the Shareholders' Rights Directive II" (2020) 39 *Yearbook of European Law* 497 for the influence of the UK model on the Commission's proposals for this Directive and their subsequent watering down.

[7] R Kraakman, "Disclosure and Corporate Governance: An Overview Essay" in G Ferrarini, K Hopt, J Winter and E Wymeersch (eds), *Reforming Company and Takeover Law in Europe* (2004) at 95.

[8] For a summary see *Gower's Principles of Modern Company Law*, 11th ed, 2021, ch 25 and 27.

which approximate an arm's length transaction and, if not, whether there is a good corporate reason for entering into it despite its bias in favour of the connected person.

By contrast, the regulatory technique deployed in the core CA provision governing RPT is disclosure to the board.[9] The CA does not require the information disclosed to the board to be passed on to the market at the time of the transaction. The information may well be disclosed later (often much later) in the company's annual or semi-annual accounts, under the applicable accounting rules.[10] However, the impact of the information disclosure under those rules will be less, both because the information will be stale and because the signal it gives will be "noisy", ie surrounded by so much other information about the company.

In addition, the LR (but not the AIM Rules) require large RPT to be subject to independent shareholder approval. This is a technique also deployed by the CA in relation to a range of corporate decisions which affect directors' remuneration.[11] In an important extension, prior shareholder approval is also required under the CA for direct or indirect "substantial property transactions" between a director (including shadow directors but not non-directors) and the company.[12] There is therefore a question about what, if anything, the shareholder approval rules in the LR add to those of the CA. As an initial matter, it should be noted that the LR require approval by "independent" shareholders,[13] whereas the CA appears not to exclude related parties from voting on an approval resolution.[14]

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[9] S. 177. The potentially more demanding provisions of s 175 are explicitly not applied to a director's "conflict of interest arising in relation to a transaction or arrangement with the company" (s 175(3)).

[10] See the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch. 1, para. 72 and International Accounting Standard 24.

[11] CA Part 10, Chapter 4 and 4A, chapter 4A not applying to AIM companies because AIM is not a regulated market.

[12] Ss. 190-196.

[13] LR 11.1.7 – related party and associates to be excluded from voting.

[14] CA s.239, excluding directors and connected persons from voting, applies only to shareholder resolutions to ratify a breach of duty, which a resolution to approve a proposed transaction with a director is not.

2. Research Outline

The purpose of this paper is to explore the effectiveness of the special rules applicable to companies publicly traded on AIM and the Main Market of the LSE. It also puts forward some proposals for the improvement of these mechanisms. However, the paper does not address, for reasons of space, the issue whether the Exchange rules should make use of mechanisms entirely different from the ones currently deployed.[15] The rules in LR 11 apply only to companies listed in the "premium segment" (PS) of the Main Market and not to those with a "standard" listing. However, for present purposes, this is not a significant restriction on LR 11. Nearly all companies which are eligible for premium listing will choose it over standard listing for their equities, because of its cost-of-capital benefits. These flow partly from the fact that premium listing imposes higher governance standards on companies than standard listing and partly from the fact that only PS companies are eligible for inclusion in the FTSE indices.[16] Both features make PS companies more attractive to institutional investors than standard listed companies and thus to companies seeking listing. In consequence, the population of Main Market companies of interest to this research was those with a premium segment listing.

The research consisted of the compilation of a data set based on the announcements to the market made over the twelve months beginning in early June 2019 by either AIM or PS companies. Both sets of rules require an announcement at the point at which the transaction is entered into, even where, under the LR, shareholder approval is also required.[17] This exercise yielded data on nearly 500 RPT. Further details of the research methodology are given in the

[15] For a taxonomy of the available techniques see L Enriques, "Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)" (2015) 16 *European Business Organization Law Review* 1.
[16] The FTSE indices are produced by FTSE Russell, a subsidiary of the London Stock Exchange Group.
[17] In this case the transaction will normally be conditional on shareholder approval being given: LR 11.1.7.

Appendix. Where shareholder approval is sought, the company must, in addition, send a circular to the shareholders[18] prior to their meeting. These circulars were also analysed.

In order to understand the data, a little more detail on the Exchange rules is required. Both sets of rules require that the RPT reach a certain minimum economic size before their provisions are triggered. That threshold is expressed as a percentage of the economic size of the company. This exercise has to be performed along a number of dimensions, of which the most important are the assets involved in the transaction or the profits attributed to those assets, as compared with the net assets or profitability of the company as a whole, and the consideration for the transaction as a proportion of the company's market capitalization.[19] If the requisite threshold is met on any of these dimensions the rules are triggered.

A clear difference between the disclosure rules for AIM and PS companies is that the threshold for disclosure is set at a significantly higher level on AIM (5%)[20] than under the LR (0.25%).[21] At the 5% level the LR rules require in addition independent shareholder approval,[22] which is never required under the AIM Rules, no matter how large the transaction. Both sets of rules necessarily contain aggregation provisions designed to forestall avoidance of the rules by splitting the transaction up into smaller component parts.[23]

An important feature of both sets of rules is that the thresholds relate to the economic size of the RPT, not to the size of the related party's interest in the transaction. Thus, if a company decides to issue new shares where the consideration to be received exceeds 5% of its existing market capitalization, the transaction will be within both sets of rules even if the related party proposes to acquire only 0.001% of the new shares. The effect of this interpretation of the rules

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[18] The contents of which are prescribed in LR 13.3 and 13.6.
[19] LR 10, Annex 1; ARC, Sch 3.
[20] ARC, Rule 13.
[21] LR 11.1.10.
[22] LR 11.1.7.
[23] ARC, Rule 16; LR 11.1.11.

is that a much larger number of RPT is brought within the rules than if the percentage tests were applied to size of the related party's interest. The overall impact of the rules is somewhat surprising. The exclusion of "small" transactions leads to the non-reporting of transactions which, at least in nominal terms, are quite large. For example, taking the average current market capitalization of the ten largest PS companies, a transaction involving those companies would have to have a value of about £2 billion to be disclosable; on the other hand, once that threshold is crossed, it would make no difference whether the related party's interest in the transaction was £2k or £2m.

The overall picture is set out in Table 1.

Table 1

Trigger Percentages

	Disclosure	Shareholder approval
LR 11	0.25%	5%
AIM	5%	N/A

3. The Incidence of Announcements as between AIM and the Premium Segment

The data for the analysis consisted of 497 announcements by AIM or PS companies for the twelve months starting in June 2019. 407 of these announcements were by AIM companies and 90 by premium listed companies. In gross terms, AIM companies generated 4.5 times more announcements than premium listed companies. This is surprising, given that the AIM announcements needed to pass a higher threshold on the class tests (5%) than did announcements by premium listed companies for disclosure purposes (0.25%).

This distribution might be understandable if there were about four times as many AIM companies as PS companies. However, this is not the case. During the research period there were slightly more companies trading in the PS than on AIM.[24] Thus, in the research period AIM companies had about a 50% chance of having to make an RPT announcement, whilst PS companies had only about a 10% chance.

However, it is possible that part of this difference is explained by the differential composition of the issuers on AIM and in the PS. Besides commercial companies, funds, both open-end and closed-end, which have adopted the corporate form, are traded on both markets. But they are a proportionately greater part of the PS market as compared to AIM. As to open-end funds, the view of the FCA, these funds (typically in the form of Exchange Traded Funds) do not engage in RPT, so their presence in the PR population might explain some of the differential.[25] Certainly, no open-end fund announcements showed up in the data collected in this research.

By contrast, closed-end funds on both AIM and the PS did appear in the announcements investigated in the research. In this case, their greater presence in the PS might help to explain the differential if closed-end funds had a lower propensity to engage in RPT than commercial companies. To control for this, the announcement differential was recalculated, excluding funds from both the populations of traded companies and the number of announcements made in the research period. The result is given in Table 2, based on figures from March 2020. This shows that the rate of announcements increased slightly for PS companies (to 0.13), but remained the same for AIM companies. Thus, only a small part of the differential announcement rates was explained by the differential composition of AIM and PS issuers: the

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[24] London Stock Exchange, *Issuer List*, November 2020 (available at www.londonstockexchange.com/reports?tab=issuers). This list includes all Main Market companies, but allowing for that, the number of PS companies still probably exceeded those on AIM.

[25] FCA, *Open-ended Investment Companies – Proposals for a more proportionate Listing regime*, cp20/05, March 2020, para. 3.8. Consequently, the FCA is currently implementing a move of open-end funds to a listing category to which the RPT rules of the LR do not apply: FCA, *Handbook Notice No. 84*, January 2021 – in force from January 2022.

rate for AIM commercial companies was still nearly 3.7 times that for PS companies. The complete explanation for the greater frequency of reporting by AIM companies clearly has to be found elsewhere than in the composition of the respective populations. (In the subsequent Tables closed-end company announcement are included in the analysis.)

Table 2

Announcement Frequency Commercial Companies

	Premium Segment	*AIM*
Population	472	846
Announcements	63	405
Frequency	0.13	0.48

A further possibility is that the 5% threshold for disclosure by AIM companies is more demanding than the 0.25% for PS companies. This might be because the twenty-times differential between the percentage figures underestimates the difference in economic size between companies on the two markets. For example, if the average AIM company were fifty times smaller than a premium-listed company, a twenty times smaller disclosure threshold might nevertheless operate more severely on AIM companies. However, this does not appear to be the case. The 5% disclosure level for AIM companies seems to have been set so as roughly to replicate in terms of market capitalization the 0.25% disclosure level for premium segment companies. Thus, issuers in the FTSE All-Share Index for premium-listed companies had a median market capitalization of £685m at the end of 2020, while those in FTSE AIM index displayed a median value of £27m, a 25 times differential.[26] At the same time the median capitalization for FTSE 100 companies was approximately £8500m and for the AIM 100 £400m, a 21 times difference.[27]

Nevertheless, as we see below (Table 4 and attached text), the effect of fixing the thresholds at their current levels is, across both markets, to skew their impact towards companies with smaller capitalizations.

A. Variations in the Rules

It is counter-intuitive to seek to explain the over-representation of AIM issuers in the announcements studied on the basis that the AIM rules are more demanding than the LR, since one of the selling points of AIM is that it is a more lightly regulated market than the PS. For example, AIM is not a regulated market in EU terms and its companies are not required to comply with the principles of the UK Corporate Governance Code.[28] Nevertheless, the LR do contain two exemptions from the disclosure obligation which are not in terms available to AIM companies, where the rules apply to "any transaction whatsoever with a related party" which exceeds the threshold.[29]

First, the LR exclude transactions "in the ordinary course of business", no matter what their size.[30] The LR exclusion is potentially a major loop-hole, depending on how closely its use is

[26] Figures from FTSE Russell, *AIM Index Series* (available at research.ftserussell.com/Analytics/FactSheets/temp/847d6dc4-1a05-4786-bce3-5dcaf3ed0aea.pdf) and FTSE Russell Factsheet, *FTSE All-Share Indexes*, as of November 2020.

[27] Figures from FTSE Russell, *AIM Index Series* (previous note) and FTSE Russell *100 Index*, available at research.ftserussell.com/Analytics/FactSheets/#

[28] Contrast LR 9.8.6 for PS issuers.

[29] ARC, r 13.

[30] See LR 11.1.5. The omission of this exemption from ARC r.13 appears deliberate since ARC r.12 (on "substantial" transactions) does contain it.

policed. The research was not designed to capture data on this issue. All that can be noted is that the LR indicate some degree of FCA supervision of the use of the exemption by providing that "In assessing whether a transaction is in the ordinary course of business under this chapter, the FCA will have regard to the size and incidence of the transaction and also whether the terms and conditions of the transaction are unusual."[31] Since there is no requirement for FCA approval before a company takes up the exemption, the question arises as to how the scrutiny would ever occur, at least ex ante. The answer seems to lie in the requirement that a PS company seeking to enter into what might be a RPT must seek the guidance of its sponsor on the application of the LR to the proposed transaction.[32] On the likely effectiveness of the sponsor and nominated adviser in this role, see section 3 below.

The second relevant exemption in the LR covers the receipt of assets or the grant of options under a long-term incentive plan (ltip), which is defined to mean a reward scheme for directors which is conditional on the achievement of performance conditions and operates over more than one financial year.[33] This exclusion is possibly explained by the fact that PS company ltips, but not those of AIM companies, are subject to the shareholder control provisions of the CA.[34] Eleven of the 407 (3%) announcements by AIM issuers in the research period involved the grant of options to directors, which, conceivably, would have fallen under the ltip exemption in the case of a PS company. This suggests the absence of this exemption in the AIM rules generated only a small number of additional announcements.

[31] LR 11.1.5A.
[32] LR 8.2.3.
[33] LR 11, Annex 1(3).
[34] CA Part 10, Ch. 4A and Part 15, Ch 6. Both sets of provisions require the subject company at least to be "traded", ie having its voting shares traded on a UK or EU regulated market.

B. The Structure AIM Shareholdings

A more significant element in explaining the over-representation of AIM companies in the announcements appears to lie in the investment strategies adopted by institutional investors and wealthy individuals when making equity investments in AIM companies[35] whose business models are, overall, less mature and more risky than those of PS companies. There are a number of relevant aspects to this strategy. The first is to fund only identified and immediate projects (rather than placing large amounts of capital at the disposal of the board to promote a general strategy). This results in frequent, but small-scale, fund raisings by AIM issuers. Comparing AIM and Main Market[36] companies, Figure 1 shows the greater reliance by AIM companies on follow-on or "secondary" fund raisings as compared to initial public offerings (IPOs). Whilst the amounts raised have fluctuated, the greater significance of secondary offerings has been a constant feature of the past two decades. Figure 2 shows that nearly 70% of post-IPO share issuances by "growth" companies in the UK raised no more than US$10m per fund-raising event, whilst the bulk of fund raising by listed companies was in the region of $20m to $300m per event.[37] This investment strategy thus translates into a pattern of relatively frequent but small-scale fund raisings by AIM companies.

[35] For an argument which puts this analysis in the broader context of the overall construction of the AIM market, see P Roscoe and P Willman, "Flaunt the imperfections: Information, entanglements and the regulation of London's Alternative Investment Market" (2021) 50 *Economy and Society* 565. AIM has been characterized as an "institution dominated" market with a low level of retail activity (*cf*. S Arcot, J Black and G Owen, *From local to global: the rise of AIM as a stock market for growing companies*, 2007 at 43). While it is true that few retail investors invest directly in AIM, holdings by wealthy external individual investors, founders, members of a founding family (and associated trusts) are significant. Thus, in the sample discussed below there were a total of 207 investors holding ≥10% of the shares, of whom 62 (30%) were individuals (the remainder being institutions or other commercial companies).

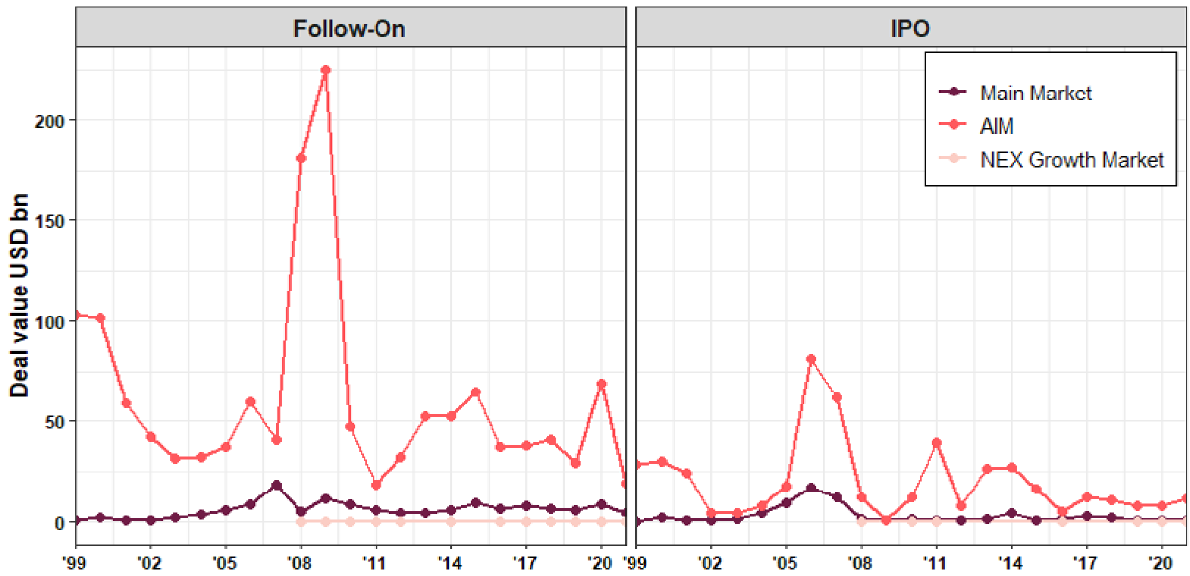
[36] This category includes standard listed companies, but for the reasons given at the beginning of §2, this is very unlikely to alter the general picture presented.

[37] Another figure in this source shows that some 65% of growth companies raised less than £10m on IPO, whilst this was true of only just over 20% of listed companies. The categories of "listed" and "growth" used by the FCA do not exactly parallel the division between AIM and PS companies, since the "listed" category includes standard listed companies and the "growth" category companies listed on NEX Exchange Growth Market. It is unlikely, however, that these additions substantially altered the picture.

This pattern of fund-raising showed up in the research period in a significantly greater number of fund raisings via placings by AIM companies (152) as compared with PS companies (25). Companies have an incentive to use placings, where possible, because they are cheaper than public offerings. For AIM companies the cost advantages are likely to be particularly significant, because AIM is not a regulated market under the Prospectus Regulation, so that the listing of shares on this market does not trigger a prospectus requirement. By astute use of the placing mechanism, essentially by confining the range of offerees,[38] the company can ensure in addition that it does not make a public offer. However, placings have a natural tendency to lead to the emergence, and to maintain the position, of substantial shareholders.

Figure 1

Deal value raised by deal type (Follow-On vs IPO) and market (Main Market, AIM, NEX)



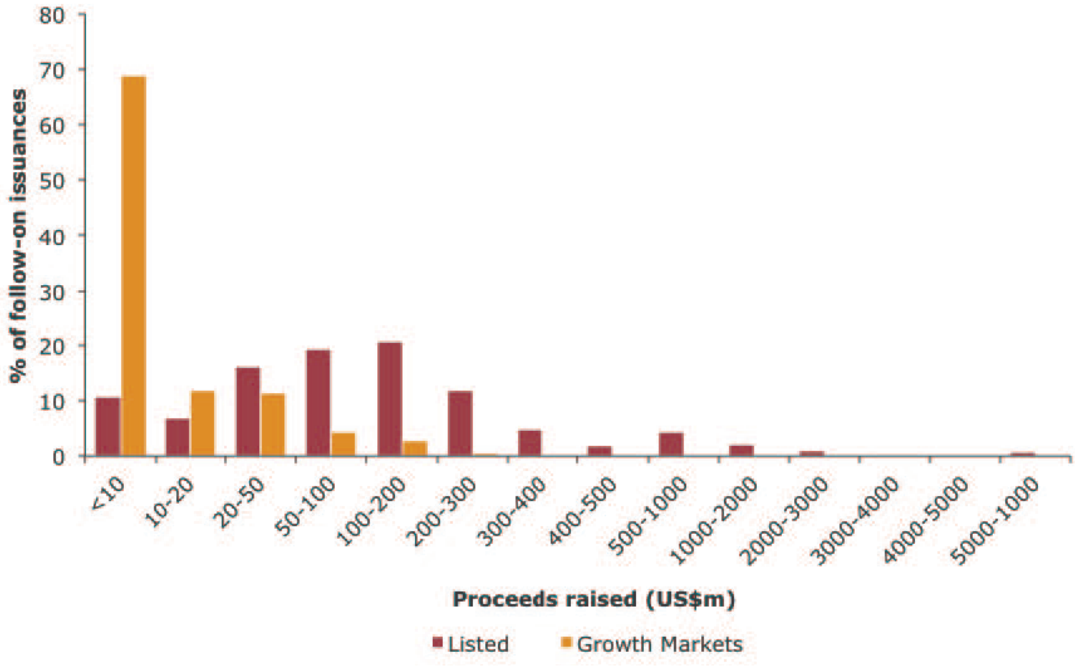
Source: FCA, Primary Markets Effectiveness Review, 2021, cp 21/21, Charts 2 a

The NEX market was not covered in this research because of its relative insignificance. It contains currently some 97 companies.

[38] The offerees need to be brought within exemptions laid out in the Prospectus Regulation (Regulation (EU) 2017/1129) Art. 2(4)) notably those for small numbers of investor and qualified investors.

Figure 2

Percentage of follow-on issuances raising US$m 2010-2016



Source: FCA, Review of the Effectiveness of Primary Markets, 2017, dp 17/2, Appendix 1

Taking a substantial stake in an AIM companies has two further advantages for institutional and wealthy in individual shareholders. In corporate governance terms, a substantial shareholding puts the investor in a stronger position to protect that investment, should the risks attached to the company's business model eventuate and necessitate a change in the company's strategy. This may be particularly valuable given the lower governance standards to which AIM companies are held, in particular the absence of a requirement for independent directors, who may be expected to be more sensitive to the interests of shareholders.[39] One suggestive datum from the research was that in the research period 65% of the AIM cases revealed a director as

[39] See text attached to n 28 above. For evidence that non-managerial blockholders improve firm value by monitoring the managers of AIM companies see M Mortazian et al, "Large Shareholding and Firm Value in the Alternative Investment Market (AIM)" (2019) 26 *Asia-Pacific Financial Markets* 229.

a related party, whereas this was true of only 24% of the PS cases. Whilst a number of explanations of this difference are possible, a plausible view is that the independent directors of PS companies constrained the involvement of directors in RPT.

In addition, investment in a risky business generates an incentive for shareholders to spend resources on monitoring the management of the company, but continuous monitoring is expensive. Monitoring costs are easier for the investor to bear if they are spread over a substantial investment in monetary terms. Given the small scale of AIM company equity fund-raisings, any particular amount of investment will translate on average into a larger percentage holding in an AIM as compared with a PS company.

An entirely separate factor supporting the presence of substantial shareholders in AIM companies is the fact that many of them are recent (sometimes very recent) arrivals on the public markets and, further, relatively recently created businesses, driven in some cases by the "idiosyncratic vision" of a founding entrepreneur. Such entrepreneurs are likely to wish to continue to hold a significant shareholding in the company, directly or indirectly via the shareholdings of other family members or associated trusts. However, founding entrepreneurs are likely also to be directors and so trigger an announcement in that capacity.

Table 3, constructed on the basis of a random but systematic sample of PS and AIM companies as of December 2020,[40] confirms the hypothesis that AIM companies are more likely to contain a substantial shareholder at the 10% level than a PS company. Looking at row 1, columns 1 and 2 (PS and AIM companies as a whole), PS companies were nearly twice as likely as AIM companies to have no substantial shareholder. Looking at the matter the other way around, an

[40] The population sampled was that given by FTSE All-Share Index Ranking (unofficial guide) available at www.stockchallenge.co.uk/ftse.php. The sample consisted of approximately one third of the PS and AIM companies ranked.

AIM company was twice as likely to have two or more substantial shareholders present than a PS company (cols. 1 and 2, rows 3 and 4).

Table 3

	No. of ≥10% shrhldrs	1 All PS	2 All AIM	3 Large* AIM	4 Small* AIM	5 FTSE 100	6 FTSE 250	7 Small Cap
Row 1	**0**	42	23	38	19	61	37	35
Row 2	**1**	36	33	38	32	32	44	30
Row 3	**2**	13	27	21	29	5	15	17
Row 4	**3**	9	17	3	20	2	4	19

*A "large" AIM company is one which would have been included in the FTSE 250 (or higher) had it been in the premium segment. Only two AIM companies would have made the FTSE 100. A "small" AIM company is one which would not have been so included.

The Table also suggests that a crucial association was between the number of substantial shareholders and the economic size of the company. Thus, just over 60 percent of FTSE 100 companies had no substantial shareholders whilst for PS companies as a whole the figure as just over 40 per cent (row 1, cols. 1 and 5). In the same way, the substantial shareholder percentages for FTSE 250[41] companies and AIM companies which would have been classified as in the FTSE 250 if listed in the PS were similar (cols 3 and 6). However, the majority of AIM companies were not "large" in the sense of meeting the FTSE 250 criteria. Of the 373 AIM commercial companies on the All Share list in December 2020, only 38 qualified as large, so that nearly 90% of the AIM companies would have fallen with the below the FTSE 250, if

[41] The FTSE 250 are the 250 largest PS companies outside the FTSE 100. When referring to both groups together it is conventional to use the term "FTSE 350". Below the FTSE 350 are the "Small Cap" and "Fledgling" sections of the PS market.

they had traded in the PS. This category of AIM companies ("small" AIM companies) showed a much larger incidence of substantial shareholders than the FTSE 250 category (cols 4 and 6) and, even, a larger incidence than companies in the Small Cap segment of PS (cols 4 and 7)

Some further evidence of the association between announcement frequency and economic size (assessed by reference to market capitalization) comes from an analysis of the actual announcements made by AIM companies in the investigation period. Table 4 shows that the frequency of announcements by the largest AIM companies was substantially lower than that by the AIM population as a whole and significantly lower among the largest 50 AIM companies than among the largest 100 AIM companies.

Table 4

Frequency of Announcements by Size of AIM Company[42]

	All AIM	AIM 100	AIM 50
Frequency	0.5	0.1	0.06

Once one or more substantial shareholders has emerged, the company and the investors have an incentive to continue to transact with each other over equity fund raising, the investors to maintain their relative positions and companies to reduce the costs of fund-raising, as we have noted. It has been remarked that "AIM is actually only a secondary market, with the primary market component operating as a private placement."[43] However, the incentive for substantial shareholders and AIM companies to transact with one another is not limited to

[42] AIM 50 and 100 constituents from www.londonstockexchange.com/indices/ftse-aim-uk-50-index/constituents/table?lang=en&page=3 and www.londonstockexchange.com/indices/ftse-aim-100-index/constituents/table?lang=en.*

[43] J Armour, M Bengtzen and L Enriques, *Investor Choice in Global Securities Markets*, ECGI Law Working Paper 371/2017, p 44. "Secondary" in this context refers to trading among investors, not to fund raising by companies.

equity fund raisings. A substantial shareholder is likely to have better "soft"[44] information about the company and so be more likely to lend or to lend on more favourable terms (or to guarantee an external loan) than an external financial institution, which, in its relative ignorance, will assume the near-worst case outcome when making lending decisions.

In summary, the interests of both investors and companies on AIM conduce to the emergence of substantial shareholders and to continuing interactions with them. Thus, while some 110 announcements (27%) by AIM commercial companies in the investigation period involved participation by existing substantial shareholders in placings, a further 76 (19%) concerned loan deals with substantial shareholders (including the modification of an existing loan arrangement and conversion of an existing loan into equity). Substantial shareholders may also be prepared to provide facilities to the company, for example, renting premises or other assets to the company. This is not to argue that substantial shareholders in PS companies will not participate significantly in fund raisings by their companies, but simply that there were many fewer such exercises in the research period. As noted, substantial shareholders appeared as related parties in 25 equity fund raisings by PS companies. In line with the data on the skewed distribution of substantial shareholders in PS companies, only 3 of these cases concerned FTSE 100 companies and over half of the total were companies in the Small Cap or Fledgling sections of the market.

4. The Operation and Potential Reform of the Disclosure Rules

A. The Operation of the Current Rules

Disclosure is the only regulatory technique used by the AIM rules and the dominant one in the LR. Thus, the impact of the Exchange rules on RPT turns very heavily on the effectiveness of

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[44] Cf M Bengtzen "Private Investor Meetings in Public Firms: The Case for Increasing Transparency" (2016) 22 *Fordham Journal of Corporate and Financial Law* 33; M Becht et al "The Benefits of Access: Evidence from Private Meetings with Portfolio Firms" ECGI Finance Working Paper 751/2021.

the disclosure provisions. Whether disclosure will achieve its objectives will depend, in large part, on how salient the information disclosed is to the judgement the market, shareholders and others have to make.[45] That judgement is actually quite a complex one. Disclosure of the mere existence of an RPT does not demonstrate unfairness to the company and the non-related shareholders. Under current UK law no RPT are prohibited since the related party may be the only or most favourable source of the good or service for the company.[46] The question for the market is whether the *terms* of the transaction are weighted in favour of the related party and against the company. To make this assessment the market needs not only information about the terms of the transaction but also some mechanism for assessing the fairness of those terms. It is submitted that both the AIM Rules and the LR do a poor job of putting the market in a position to judge the fairness of the transaction.

The LR require disclosure of:

"i) the identity of the related party;

(ii) the value of the consideration for the transaction or arrangement;

(iii) a brief description of the transaction or arrangement;

(iv) the fact that the transaction or arrangement falls within LR 11.1.10 R;[47] and

(v) any other relevant circumstances."

[45] It also depends on the sophistication of investors. There is not space to investigate that issue here. I assume that the London market is sophisticated as a result of the heavy presence of institutional investors and (in AIM companies, at least) blockholders.

[46] Under the pre-2006 law in the UK loans to directors by the company were prohibited, but no longer. Prohibition is a rational technique for controlling RPT only if excluding fair RPT of the particular type imposes low or no costs on the company and the proportion of unfair RPT is likely to be high.

[47] This means the issuer has to state specifically that the transaction is not subject to the shareholder approval requirement. If it is, the disclosure obligations arise in relation to the circular required to be sent to the shareholders convening the meeting to consider the transaction. See further below.

The AIM rules,[48] which contain ten items for disclosure, are somewhat more explicit, partly because these requirements apply to a range of transactions, not just RPT. In addition to the items mentioned in the LR, the AIM rules require, inter alia, disclosure of:

- a description of the assets which are the subject of the transaction, or the business carried on by, or using, the assets;
- the profits (or if applicable, losses) attributable to those assets;
- the effect of the transaction on the AIM company;
- any other information necessary to enable investors to evaluate the effect of the transaction upon the AIM company.

Even if the information disclosure exercise is faithfully carried out, the market is still not necessarily in a position to make the fairness assessment of its related-party aspect. What is needed is some way of judging the overall balance of the consideration provided and received by the company or, more broadly, the overall balance of the costs and benefits to the company of the transaction. It is noticeable that none of the disclosure items, except possibly the "sweeping up" item and even then not explicitly, require information which focusses directly on the fairness of the transaction. The announcement presents the deal, but leaves fairness assessment wholly to the market. The attitude embodied in the rules can be characterized, without excessive parody, as: "there it is, you decide whether you like it."

To be sure, in some cases, the market may be in a position to make the fairness assessment on the basis of the facts required to be disclosed. This will be the case, for example, where there is an established and easily ascertainable market price for the good or service for which the company has contracted with the related party, so that the only fact investors need to know is the price paid by the company. Even in this case, there may be good reasons, not

[48] Set out in Schedule 4.

visible to outsiders, for the company to over-pay for the good or service in a particular case, but the existence of a market price extrinsic to the company will incentivize the board to explain in its disclosure why this is so. Or the information disclosed may by chance suggest fairness, as where it reveals that substantial numbers of non-related parties participated in the transaction on the same terms as the related parties.

Nevertheless, across RPT announcements as a whole, it cannot be guaranteed that the data provided in the disclosure will themselves enable a reliable assessment to be made of the fairness of the transaction or that, alternatively, an external standard will be readily available to assess the data disclosed. Apparently, this problem was recognized by those who drafted the Exchange Rules, who required inclusion in the announcement of what is can be referred to as a "fairness opinion" or a "fairness certificate" (the terms are used interchangeably in this paper). This is provided in two, apparently slightly different, ways under the LR and AIM rules.

Under the AIM rules the fairness opinion, which is termed a "statement", is a statement by the directors, other than any "involved in the transaction", that they consider the transaction fair and reasonable as far as its shareholders are concerned. Before giving this opinion the directors must consult the company's nominated adviser (or "nomad") – and state that they have done so.[49] The nomad is an adviser, usually a financial institution, which the AIM rules require companies always to have in place.[50] The function of the nomad is to guide the company on its compliance with the rules and to provide assurance to the LSE that compliance is in place. In effect, the nomad system constitutes a partial contracting out by the LSE to the nomads of its supervisory functions. However, the LSE necessarily acquires in consequence a supervisory

[49] ARC r 13.
[50] ARC r 1.

role in relation to the nomads, crucially by placing a financial institution on or removing it from the list of approved advisers.[51]

The AIM rule makes it clear that the announcement is not just a disclosure. It is also a statement by the non-involved directors that they approve of the transaction as a beneficial one for the company. Thus, not only are the provisions of the AIM rules engaged in the announcement, but so also are the core legal duties of the directors, to act with due care and loyally when approving the RPT. In addition, it is impossible to see how the consultation process can have significance unless the adviser as well carries out an appropriate assessment of the fairness of the transaction. In fact, in a small number of cases in the research period where there were no uninvolved directors, the fairness opinion was attributed to the nomad. Thus, the nomad's obligations to the LSE to advise the issuer appropriately are engaged by the rule,[52] as, in all likelihood, are its contractual duties to the company under the terms of its engagement by the company.

The LR rules formally put the obligation the other way around in the case of "smaller" RPT, ie those requiring disclosure only. The fairness opinion (referred to in the LR as a "confirmation") is required to be that of the company's sponsor. The directors must obtain "written confirmation from a sponsor that the terms of the proposed transaction or arrangement with the related party are fair and reasonable as far as the shareholders of the listed company are concerned."[53] A sponsor performs broadly the same role in relation to PS companies as nomads do in relation to AIM, though the sponsor, at least of large PS companies, is usually a much grander institution, often an international investment bank. Naturally, the sponsor's relationship is with

[51] London Stock Exchange, *AIM Rules for Nominated Advisers*, 2021.
[52] *AIM Rules for Nominated Advisers*, 2021, rr 16 and 17,
[53] LR 11.1.10(2)(b).

the FCA rather than the LSE.[54] Nevertheless, the directors of a PS company cannot consistently with their legal duties to the company announce a transaction to which they are committing the company unless they themselves think it will promote the interests of the company and its shareholders take it forward. In this respect, it is not enough that the sponsor thinks the transaction is fair; the directors must address their minds to the issue as well and conclude that it is fair (for which they are able to rely on the sponsor's reasoning to the extent that is appropriate).

The up-shot, it is submitted, is that under both sets of rules the corporate law duties of the directors and the regulatory and contractual duties of the adviser will require both directors and advisers to form a view that the transaction is fair and reasonable from the point of view of the shareholders of the company when it is announced to the market.

Despite the range of legal duties involved in the announcement, the fairness opinion as it operates in practice does not take the market much further forward in forming its own view of the fairness of the transaction, so that the effectiveness of the disclosure obligation remains in doubt. It is particularly striking that the reasoning underlying the fairness conclusion is not required by the rules to be disclosed in the announcement (either in whole or in part) nor is the substance of any discussions between the directors and the sponsor/nomad over this issue. Even more important, it is apparently not the practice of companies to reveal this information. The fairness statements in the announcements examined were invariably pure boilerplate. AIM announcements examined invariably followed the formula that "the [non-involved directors, naming them] consider, having consulted with [X], the Company's nominated adviser, that the terms of the [transaction] are fair and reasonable insofar as the Company's shareholders are

[54] A sponsor needs the approval of the FCA under s.88 of the Financial Services and Markets Act 2000 (FSMA). A PS company is not required always to have a sponsor in place after it has been listed, but for present purposes that is not important since LR 11 requires the involvement of a sponsor.

concerned." Similarly, for PS companies, the typical formula was along the following lines. "[The company] has obtained written confirmation from its sponsor, [naming it], in accordance with the requirements of LR 11.1.10(2) (b), that the terms of the proposals are fair and reasonable as far as shareholders are concerned." In only one of the announcements examined did the board take the opportunity to address the substance of the fairness issue.[55]

We now turn to two proposals to make disclosure to the market a more effective tool, the first relating to the information to be disclosed and the second to the independence of the directors who provide the information.

B. Disclosure of the Fairness Assessment

A straightforward reform would be to require publication of the reasoning underlying the fairness conclusion – or at least of specified elements of these views.[56] The focus of the disclosure should be on the methodology or methodologies used to conclude that the price was fair, including disclosure of possible criticisms of the methodology used. For the reasons given above, the reasoning of both directors and adviser should be revealed, at least in their fundamental elements, though it appropriate cases the directors might simply say that they adopted the adviser's analysis. Requiring both disclosures would have the advantage of flushing out any differences of opinion between the directors and the adviser, which under the current rules can be obscured. Above all, however, this additional disclosure would place the

[55] See Hummingbird Resources plc (AIM), announcement of June 4, 2020, where the company, developing a gold mine, entered into an "earn-in" agreement with third party, in which three of the company's directors were significant investors. The announcement sought to justify this choice of earn-in partner on both substantive and procedural grounds: the capabilities and commitment of the third party as against other candidates and the exclusion of the interested directors from negotiations with the third party.

[56] This technique is recognized but not required under the new Art.9c(3) of the Shareholder Rights Directive (OJ L132/1 (2017)). Member States may require the announcement "to be accompanied by a report assessing whether or not the transaction is fair and reasonable . . . and explaining the assumptions it is based upon together with the methods used."

market in a stronger position to evaluate the fairness of the terms of the transaction as currently disclosed.

Disclosure of the underlying fairness reasoning would have one additional benefit, certainly in relation to advisers and probably in relation to directors as well, of encouraging their loyalty to the company. As to the former, the sponsor/nomad's position is conventionally analysed in the literature as that of a "gatekeeper", ie someone whose consent is necessary for a transaction to proceed, but who is paid for by the person promoting the transaction.[57] There is an inherent conflict of interest here: the gatekeeper's remuneration is in the hands of the corporate insiders but its role is to protect the interests of corporate outsiders. The gatekeeper naturally has an incentive to please the payer (the company), which the non-disclosure practice facilitates. It is probably safe to assume that the sponsor/gatekeeper will not approve egregiously unfair transactions, for fear that this will eventually become clear to the FCA or LSE and lead to the removal of the sponsor/nomad's approved status. This is a severe sanction, for the adviser will no longer be able to act on share offerings, which constitute a greater revenue stream than the modest remuneration the gatekeeper role attracts. Even if the adviser is only reprimanded by the regulator, it may find it cannot discharge its role in share offerings effectively, because it has lost the trust of potential investors. Nevertheless, in cases where the fairness of the transaction is open to debate, a sponsor/nomad may conclude that it has little to lose by leaning routinely in favour of the view of the insiders, if its reasoning is not open to market scrutiny.

As to the directors, there is a risk that even directors not involved in the transaction[58] will favour related parties who are in a position to influence the management of the company (other directors and substantial shareholders), either because they expect similar treatment in the

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[57] See the analysis in J Coffee, *Gatekeepers*, 2006.

[58] ARC 13 excludes directors involved in the transaction from attaching their names to the announcement; the LR in the case of RPT requiring announcement only do not even go this far. The company's articles may go further, of course. The Model Articles for public companies (reg. 16) create a default rule of exclusion of the interested director from voting on an interested transaction but not from being present and, indeed, speaking.

future in relation to their RPT[59] or because they wish to avoid creating enmities which might making the discharge of their own functions more difficult in the future. Consequently, it would seem valuable to require the directors not simply to describe the transaction but explicitly to identify and evaluate, as they see them, the related party risks to which the transaction gives rise. This rule would require the non-involved directors explicitly to address the balance of risk and benefit to the company of the transaction. At a minimum it would prevent easy acceptance of the RPT by the non-involved directors.

The main grounds for objection to this proposal are likely to be the cost of providing an enhanced announcement and the potential additional liability of the directors and advisers (to the company) and of the company (to the market) for inaccurate statements. Since AIM companies have a one in two chance of having to make an RPT announcement in any one year, this argument is likely to be strongly made in relation to such companies. As to the cost argument, it has little weight. If advisers and directors are currently producing adequate assessments, the publication of the bases of those assessment should incur little additional cost. What is proposed is the publication of (elements of) the fairness opinion, not its creation. If fairness opinions are in fact currently inadequately prepared, then either the requirement of a fairness opinion should be withdrawn on the grounds that they are potentially misleading to the market or, as proposed here, an incentive to prepare fairness opinions properly should be provided. The latter is what disclosure of the reasoning underlying them would provide.

As to liability risk, it is true that publication of the reasoning underlying fairness opinions may provide evidence to support litigation that did not previously exist. However, the litigation risk

[59] In the case of Union Jack Oil plc, an AIM company, three out of four directors were granted options over the company's shares which grant was approved by the remaining director of the company (announcement of 19 July, 2019). Less than three weeks later (announcement of 6 August 2019) the approving director under the previous transaction was granted options on exactly the same terms, the grant being approved by the grantees under the earlier grant. The oddity of this is reduced by the fact that it appears to be the practice that, where there are no independent directors at all for a particular transaction, the fairness certification is provided by the nomad alone.

is unlikely to be substantially increased. The company's liability to the market requires proof of fraud or recklessness which is unlikely to exist (and if it does exist, liability is appropriate).[60] The liability of advisers and directors to the company is based on negligence, which, in the absence of evidence hindsight bias in UK courts' application of the reasonableness standard or of the extension of the range of claimants beyond the company as a separate person, seems again an appropriate basis for inducing care.[61]

Nevertheless, it might be thought to be redundant to make fairness opinions by both sponsor/nomads and directors mandatory. It might be enough to make explicit the requirement for a directors' opinion on the fairness of the transaction and leave it to them to decide whether to commission an opinion from the sponsor/nomad or some other third party. However, if such a report were commissioned, it would be required to be disclosed along the lines indicated above. This would avoid the costs of an expert report where the directors took the view that the related party aspects could be explained effectively to the market without a report and where they did not feel the need to reduce their liability risk by commissioning such a report. International experience suggests that, even where fairness reports are not mandatory, they are often produced for significant transactions which require director approval.[62]

C. Enhancement of Independence Requirements

Given the unlikelihood of litigation, compliance with the proposed fairness disclosure rule relies for its effectiveness on its impact on the reputational incentives of the directors who approve the transaction. Directors, it is said, will be reluctant to associate themselves with

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[60] FSMA s 90A and Sch. 10A. And see Simmons and Simmons, *The Dismissal of the Tesco Litigation* (available at: www.simmons-simmons.com/en/publications/ckf84jlxkafpd0a79jeoav3xu/the-dismissal-of-the-tesco-litigation)

[61] The empirical evidence suggests that the risk of litigation against directors of public companies by the companies themselves or through derivative claims is close to the vanishing point: J Armour, B Black, B Cheffins, R Nolan "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States" (2009) 6 *Journal of Empirical Legal Studies* 687.

[62] See L Enriques, above n 15 at 22.

shoddy or unconvincing fairness arguments, for fear that a damaged reputation will harm their future careers. The force of this argument turns on how the directors in question envisage their careers. An executive director who contemplates remaining in the company may take the contrary view that his or her career chances will be enhanced by supporting the RPT of corporate insiders. This raises the question whether it is possible to confine approval of the RPT on behalf of the company to a group of directors who are exposed to the full force of the reputation argument. It is suggested that this could be done by strengthening the independence requirements for the directors who approve the transaction. As has been said, genuinely independent directors "will not personally profit from actions that disproportionately benefit the firm's management or controlling shareholders, and hence are expected to be guided more strongly by conscience and reputation in making decisions."[63]

At present, the AIM rules and the LR in cases where shareholder approval is required adopt an independence requirement for directors who put forward the RPT, but the definition of independence used in the current rules is a limited one, ie the exclusion of directors involved in the transaction.[64] As we have noted above, this definition fails to capture elements of bias arising from factors outside the deal at issue. These may range from mutual back-scratching to a simple desire for a quiet life by not up-setting other corporate insiders. This limited definition, which reflects the CA, may have seemed an obvious choice when the AIM and LR were formulated in the early 1990s, but since then the UK Corporate Governance Code (CGC) has developed a more demanding definition of independent directors. This excludes from the definition of independence those with current or recent business ties with the company or its

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[63] R Kraakman, J Armour, P Davies et al, *The Anatomy of Corporate Law*, 3rd ed, 2017, p 35 (with a fn referring to various studies of the adverse consequences for independent directors of poor decisions). For some evidence that independent directors constrain manipulative share repurchases see A Grosman and M Amore, *Share Repurchases and Board Independence* (available at ssrn.com/abstract=3928335).

[64] ARC r 13; LR 13.6.2 – excluding directors and associates who are related parties or directors of related parties from being signatories to the shareholder circular. However, the announcement to the market under the LR is made by the board as a whole.

management or who represent significant shareholders. Its default rule is that companies should normally appoint one half of the board on this basis.[65] The exposure of such directors to reputational sanctions is likely to be significant, since a damaged reputation will make it more difficult for the director to obtain an independent position in a higher-status and better-paying company.[66]

It would be straightforward in the case of PS companies to confine approval of both RPT announcements (in all cases) and of circulars to shareholders (where shareholder approval was sought) to directors who were independent in the CGC sense of the term. Since PS companies, both those incorporated in the UK and outside, are already required to abide by the Code's Principles and, on a comply-or-explain basis, its Provisions, they already have the board structure in place which would facilitate this step.[67] The reform would exclude non-involved executive directors from approving the announcement or circular and also exclude non-executive directors who represented substantial shareholders or who had ties with the management of the company. We have already noted that there is some evidence that the presence of independent directors in PS companies reduces the incidence of RPT by directors.[68] The proposed reform would strengthen this trend by harnessing the reputational incentives of independent directors to do a good job to the specific task of reviewing RPT and explaining their reasoning to the market and other interested parties. It would be clear that they, and they alone, had approved the transaction as being in the company's interests.

The proposal to enhance the independence requirements for the directors who approve RPT on behalf of the company is not out of line with the requirements of exchanges in other countries. The Rules of the New York Stock Exchange require related party transactions to be subject to

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[65] FRC, UK Corporate Governance Code 2018, Principle G and Provisions 10 and 11.
[66] See R Masulis and S Mobbs, "Independent director incentives: Where do talented directors spend their limited time and energy?" (2014) 111 *Journal of Financial Economics* 406.
[67] LR 9.8.6(5)(6) and 9.8.7.
[68] See text attached to n 39.

prior review and approval by the company's audit committee "or another independent body of the board of directors". All the members of the audit committee are required to be independent in the CGC sense of the term.[69] In Europe, the rules of Consob[70] – the Italian market regulator – in the case of "transactions of greater importance"[71] require a committee of directors independent in the CGC sense to be involved in the negotiation of the transaction. The board may not proceed with a transaction contrary to the advice of the committee, unless the board obtains the approval of the shareholders. Where the transaction is approved by the board, a public statement must be issued within seven days, to include, amongst other things, the views of the independent directors.[72]

In relation to AIM companies the proposal for enhanced independence requirements faces the difficulty that the AIM Rules do not require adherence to the UK CGC, though they do require AIM issuers to apply a relevant governance code.[73] For UK-incorporated companies an obvious choice for adoption is the Wates Code, sponsored by the Financial Reporting Council (FRC), which, however, has only weak provisions on independent directors. "Companies should consider the value of appointing independent non-executive directors to offer constructive challenge."[74] By contrast, the Quoted Companies Alliance, a private representative organization for smaller companies, does recommend in its Code of Corporate Governance that companies should have at least two independent non-executive directors.[75]

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[69] Rules of the NYSE, §§314.00, 303A.02 and 303A.06.

[70] See Consob, *Regulations containing provisions relating to transactions with related parties*, Arts 5,7, 8 and Annex 3 (available at www.consob.it/web/consob-and-its-activities/laws-and-regulations/documenti/english/laws/reg17221e.htm).

[71] Essentially a 5% threshold. In the case of transactions of lesser importance approval is required of a committee composed of "unrelated, non-executive directors, mostly independent".

[72] So that the reasoning underlying the fairness conclusion is publicly revealed, as proposed in Section 4B above.

[73] ARC, r 2 and sched. 1(p).

[74] FRC, *The Wates Corporate Governance Principles for Large Private Companies*, December 2018, p 14.

[75] QCA, *Code of Corporate Governance*, 2018, discussion of the application of Principle 5, "Maintain the board as a well-functioning, balanced team lead by the chair".

Indeed, a recent study by the QCA claimed that nearly 90% of AIM companies had decide to base themselves on the QCA Code.[76]

5. Shareholder Approval Requirements and Information Disclosure

Shareholder approval has two facets which need to be examined separately. First, and most obvious, it is a more demanding regulatory technique than disclosure at the time the transaction is entered into. This is not the same as saying that it is a regulatory technique of which more use should be made. That is examined below in Section 6. The second role it performs is inducing greater disclosure of information via the circular which is sent to shareholders in advance of the approval meeting than is produced when only disclosure to the market is required. We begin with this issue, since it has the potential to qualify the suggestions put forward in the previous section for enhanced disclosure. However, as we shall see, those suggested reforms are not rendered redundant by the operation of shareholder approval rules.

A. Shareholder Approval Requirements under the Exchange Rules

Approval of the RPT by a majority of the independent shareholders is very much the second-string among the regulatory techniques deployed in the Exchange Rules. Only 16 (or 18%) of the 90 PS transactions required shareholder approval and, necessarily, none of the AIM transactions. So, only 3% of the total number of RPT examined in the research period involved shareholder approval.

As with a transaction below 5%, shareholder approval is preceded by notification to the market "as soon as possible after the terms of a . . . transaction have been agreed."[77] The information required to be given in this announcement goes somewhat beyond the disclosure requirements

[76] Quoted Companies Alliance, "Which corporate governance codes do AIM companies apply?" 13 December, 2018 (available at theqca.com/email/news/briefs/175536/whichcorporate-governance-codes-do-aim-companies-apply-.thtml). I am grateful to Jonathan Chan for this reference.

[77] LR 11.1.7(1) and 10.4.1. The RPT notification requirements piggyback here on the notification requirements for "Class 2" transactions, which are a category of "large", but not necessarily related-party, transactions.

for sub-5% transactions and approximates what is required under the AIM rules. More important than the announcement, however, is the requirement that the shareholder meeting must be preceded by a circular to shareholders from the board, for which the information disclosure requirements are much more extensive, including, for example, the adoption of some heads of disclosure from the Prospectus Regulation.[78] In addition, the circular has to be approved by the FCA.[79] As we noted above, in this case the fairness opinion is required to be included in the circular (rather than the announcement) and is attributed to the non-involved directors. Those directors are required to report that they have been advised by the sponsor that the transactions is fair, along the lines required for AIM company announcements.[80] The opinion also must be lodged with the FCA. However, the basis upon which the directors and sponsor have concluded that the transaction is fair and reasonable is still not required to be disclosed in the circular nor, apparently, to the FCA, though the sponsor is likely to have strong reputational reasons for not getting on the wrong side of the FCA.[81]

However, the circular put out by the company will typically deal with the fairness of the proposed transaction and its implications for the non-involved shareholders in considerable detail. These disclosures are driven, clearly, by the need to obtain the consent of the independent shareholders to the transaction A cursory examination of shareholders circulars put out by companies in these cases suggests that, in contrast to announcements, circulars are substantial documents, rarely shorter than 10 pages and sometimes much longer. Their centrepiece is a letter from the chair of the board or from the independent directors, if the former is conflicted, making the case for the transaction. Indeed, practice appears to have developed a standardization of the format in which information is presented to shareholders in

[78] LR 11.1.7(2) and 13.6. Also relevant are some general rules applying to all circulars to shareholders stated in LR 13.3.
[79] LR 13.2.1(2).
[80] LR 13.6.1(5).
[81] See text attached to n 57.

circulars (in relation to all shareholder decisions), which is helpful both in encouraging comprehensive disclosure and for comparative purposes. Accepting that the information will always be presented so as to put the best possible gloss on the board's position, nevertheless the more extensive and helpful disclosures found in shareholder circulars significantly assist the market in forming a view of the utility of the transaction to the company.

An example of how these incentives play out in relation to RPT circulars required by the LR can be found in the notification and circular put out by PPHE Hotel Group Ltd in February 2020.[82] The company, a developer and operator of hotels, proposed to build a new hotel in London. The resolution for which shareholder approval was sought was to employ a particular contractor (Gear Construction) to build the hotel. This was a related party transaction because Gear was controlled by the non-executive chair of the company and his sons and he was also PPHE's largest shareholder (being interested in nearly one third of its shares). So, the chair was a related party (both as director and as substantial shareholder), Gear was an "associate" of the related party because the related party controlled it, and the proposed transaction was between the company and the associate.[83] The circular, some ten pages long, went to considerable lengths to describe the tender process, conducted by an independent third party, through which Gear had eventually been selected for the contract and the reasons for that selection; the terms of the proposed construction contract; and the terms of the "relationship agreement"[84] entered into under LR 6.5 between the controlling shareholders (and their companies) and PPHE. Although there might still have been some hidden biases in the transaction in favour of the related party, the information disclosed appeared adequate for the

[82] RIS Announcement of 27 February and Circular of the same date. Available at www.pphe.com.
[83] So the shares in which the chair was interested could not be voted on the resolution. In addition, the CEO of the company held indirectly nearly 11% of the company and he and the companies through which the shareholdings were held were parties to a shareholders' agreement with the chair and his companies to vote in line with the latter's decisions. So, this wider range of shares was excluded from voting on the resolution as being held by associates (being persons accustomed to act as the related party directed).
[84] See LR 9.2.2.

market and the minority shareholders to form an assessment of whether the terms of the contract fell within the range of acceptable arrangements. Shareholder consent was given.

B. Shareholder Approval Requirements under Non-Exchange Rules

Thus, in the small number of cases where the LR required shareholder approval, the quantity and quality of the information disclosed dramatically improved. In the light of this, a further striking feature to emerge from the analysis of RPT announcements in the research period was the extent to which shareholder approval was required under rules other than LR11 or AIM r 13 ("non RPT rules"). Some of these approval requirements were contained in other parts of the LR or AIM rules, but most came from sources outside these two rule-books. These additional approval requirements enormously increased the proportion of RPT in which shareholder approval was sought and, in particular, spread the shareholder approval requirement into the AIM category. In over 30% of AIM announcements shareholder approval was sought even though that element is entirely lacking in the AIM RPT rules (Table 5, row B, col. 5). The Table also shows that the number of shareholder approvals required for PS companies was doubled as a result of the application of the non-RPT rules. Indeed, only 5 of the 16 cases requiring shareholder approval under LR 11 would not have been subject to shareholder approval in its absence (row A, col. 2). Overall, just over 30% of both AIM and PS transactions were subject to shareholder approval, once the non-Exchange rules are taken into account.

Table 5

Announcements by Market and Approval Requirements

Market	**1** Announcements (Number)	**2** Number (%) of Announcements requiring RPT approval only	**3** Number (%) of Announcements requiring non RPT approval only	**4** Number (%) of Announcements requiring both approvals	**5** Total Number (%) Shr Approval
A. Premium-listed	90	5 (5.5)	16 (17.7)	11 (12.2)	32 (35.5)
B. AIM	407	N/A	129 (32)	N/A	129 (32)
C. Both markets	497	5 (1.0)	145 (29)	11 (2.2)	161 (32)

Equally striking, however, was the concentration of non-RPT shareholder approval requirements on a single topic. By far the most common reason for seeking non-RPT shareholder approval, across both markets, was to obtain authority for the directors to issue new shares and/or to issue them on a non-pre-emptive basis (hereafter "issuance rules"). 110 (69%) of the approval announcements were based on one or other of or, usually, both these requirements.[85] There were multiple other rules under which shareholder approval of a RPT might be required, but the incidence of their operation was low: only one of the other ten identified reasons for seeking shareholder approval reached double figures – and then only just (Table 6).

Table 6

Non-RPT Shareholder approval requirements

Provision	**Number of Instances**	**AIM/Premium Division**	**Substance**
Takeover Code r 9	9	9 A	Avoidance of Mandatory Bid Rule
AIM Rule 14	3		Large Reverse Takeovers
AIM Rule 15	4		Fundamental Change of Business
AIM Rule 41	4		Delisting
CA 2006 s.618	5	4 A; 1 P	Share split
CA 2000 s.694	2	2P	Share repurchase
CA 2006 s 190	6	5 A; 1 P	Substantial property transaction with director
CA 2006 s 200	1	1 A	Loan to director
CA 2006 s 78	7	6 A; 1 P	Change of name
CA 2006 s 21	11	9 A; 2 P	Change of articles
Waiver of corporate rights	9	3 A; 6 P	Deed of release (usually for improperly paid dividends)
Issuance rules	110	98A; 12P	Authority to issue or waive pre-emption

[85] The percentage of AIM announcements indicating the need for issuance authority was nearly twice that for PS companies (24% vs 13%), a statistic consistent with the data on the frequency of AIM fund raisings (above figures 1 and 2)

Under the UK Companies Act directors normally need shareholder approval by an ordinary resolution to issue shares[86] and by special resolution (three quarters of those present and voting) to issue "equity securities" for cash on a non-pre-emptive basis (ie not offering them pro rata to the existing shareholders).[87] Removal of the pre-emption requirement will be needed for a placing (as opposed to a general offer to all shareholders). Although both statutory provisions appear relatively unconstraining because approval may be given for periods of up to five years and for any percentage of the company's existing capital, the institutional shareholders have adopted a much tougher set of policies in relation to pre-emption in particular. Institutional shareholders will not normally vote for disapplication of pre-emption rights for periods of more than on one year at a time and for amounts more than 5% of the existing share capital or 7.5% over three years, unless disapplication is sought in relation to a particular project, which will be considered on its merits.[88] Consequently, a significant fund-raising via a placing is likely to require shareholder approval at the time the new issuance is proposed.

These rules apply, of course, only to British registered companies and significant numbers of issuers on the London markets are incorporated elsewhere.[89] However, in some of the popular foreign jurisdictions for London issuers similar issuance rules apply, notably Ireland,[90] or there are rules requiring shareholder approval for equity issuance under the rules of a foreign exchange on which the issuer is also listed.[91] In others, such as Jersey or Guernsey, whose

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[86] CA 2006, s.549, subject to an exception for private companies.
[87] Ibid. Part 17, Ch.3, thus applying to convertible debt and warrants to subscribe as well as to shares.
[88] Pre-emption Group, *Disappyling Pre-Emption Rights: Statement of Principles*, 2015. Between April and November 2020 the principles were relaxed so as to permit larger non-preemptive fund raisings on a case-by-case basis, but the requirement for shareholder approval was not relaxed.
[89] As of the end of 2020, taking both the Main Market and AIM together, nearly 30% of issuers were incorporated elsewhere than the UK (LSE, *Issuer List*, available at www.londonstockexchange.com/reports?tab=issuers.)
[90] Companies Act 2014 (Ireland), ss 1021-1023.
[91] In 8 cases approval was sought under Rule 7.1 of the Australian Stock Exchange (approval required for issuance of 15% or more of its issued share capital within a one-year period).

corporate laws do not contain similar issuance provisions, companies may adopt them in their articles and are likely to do so if listing on the London markets, in order to make themselves more attractive to institutional investors.

In addition, 61 instances of non-RPT requirements for shareholder approval were found which did not derive from the above issuance requirements. However, their impact on the total number of transactions requiring shareholder approval was somewhat less because two (or even three) approval requirements might operate in relation to a single RPT. For example, there might be a need for Takeover Panel waiver of the mandatory bid rule in relation to a proposed share issuance which also involved a waiver of pre-emption rights. Or the shareholder approval requirements in Table 6 might overlap with one another. For example, a share split to avoid the rule against issuing shares at a discount to their nominal value[92] might also involve alteration of the articles to create a new class of (worthless) shares into which the "surplus" shares were shifted. In only 36 of the 61 (59%) cases, the non-RPT, non-issuance rules generated a requirement for shareholder approval where none would not have been called for under the RPT or issuance rules.[93]

The circulars issued to shareholders for approval meetings required by the non-RPT rules followed the formats used under the RPT rules, and for the same reasons. The imperative of persuading the shareholders to vote in favour of the resolution led to more detailed and justificatory statements by the directors. The significant question than arises whether the reforms to produce more extensive disclosures, advocated above in §4, in relation to RPT announcements are in fact unnecessary in the light of the extensive non-RPT approval requirements which in fact catching many RPT. The answer, it is suggested, is in the negative,

[92] CA 2006, s.580.

[93] The most common cases were: a deed of release of the company's rights where the board had carried out a transaction incorrectly, normally the payment of a dividend (7); a requirement imposed by the (foreign) law of incorporation or a foreign stock exchange (6); a substantial property transaction with a director (5); and a decision to delist (5).

for two main reasons. First, while the incidence of non-RPT shareholder approval requirements was a striking result of the investigation, nevertheless over two-thirds of RPT remained uncovered by any approval rule. In those two-thirds of the transactions the information disclosed to the market would continue to remain inadequate if the reforms suggested above are not implemented. Second, as clearly shown in Table 6, the coverage of RPT by the non-RPT rules is skewed in favour of fund-raisings and other types of share issuance because of the dominance of the authority and pre-emption provision in the practical impact of those rules. This means that the coverage by the non-RPT rules of debt funding by companies or the sale or purchase of corporate assets is limited. Thus, in the investigation period there were 151 announcements by AIM companies of placings, of which 78 (52%) required shareholder approval (on whatever ground). The remaining 68 approval requirements were spread across 257 transactions, a coverage rate of 26%.[94]

6. Enhanced Shareholder Approval Requirements?

A. Premium Segment Companies

Despite the reputation which the London market has that it requires independent shareholder approval for RPT as a central part of its regulatory structure, the evidence of the period examined shows that this is not the case. In the research period, the LR required shareholder approval in only 16 cases, representing 18% of the announcements by PS companies in the period. Equally striking was the skewed impact of the shareholder approval requirement. No announcement concerned a company within the FTSE 100 and only one a company within the

[94] There are also various technical respects in which the non-RPT rules may be less demanding than the RPT rules. For example, not all of them require independent shareholder approval as opposed to approval by the whole body of the shareholders. On the other hand, the "whitewash" approval provisions of the Takeover Code are more demanding than the AIM rules and the LR.

FTSE 350.[95] Thus, the shareholder approval requirement is close to being non-operative over large swathes of the PS. Only companies in the Small Cap and Fledgling sections of the PS (representing only 3% of the overall market capitalization) face a significant likelihood that they will have to obtain shareholder approval for a RPT. The question thus arises whether there is a case for reducing the percentage levels at which the shareholder approval requirements operate for PS companies.

The shareholder approval requirements for the Main Market appear not always to have had such a restricted scope of application in relation to RPT. The current format of the rules was introduced in 1993. The consultation document[96] preceding this change proposed that shareholder approval should be required at the 2% level (measured on an asset basis). Without public disclosure of the reasons, the figure adopted in 1993[97] was 5% (but with that figure to be assessed on more than just an asset basis). One can guess that there was push-back from listed issuers against the initial proposals but the bases upon which the opposition was placed are not clear.

Before the reforms of 1993, shareholder approval appears from the rules to have been an even more extensive requirement. Thus, in the 1970s the Exchange required listed companies proposing to buy from or sell to a present or past director or substantial shareholder a business or asset to inform the Exchange in advance and "the Council [of the Stock Exchange] will *normally require* a circular to be sent to shareholders . . . and that their prior approval of the transaction be sought in general meeting." (emphasis added).[98] Interested directors and shareholders were excluded from voting. At this time, then, the default rule, admittedly only

[95] Domino's Pizza (April 2020) - sale of controlling interest in Norwegian subsidiary to the existing minority shareholder (approved).

[96] London Stock Exchange, *Consultation Document 1992*, Ch 11. See Paul Davies, "Related Party Transactions: the UK Model" in L Enriques and T Tröger (eds), *The Law and Finance of Related Party Transactions*, 2019, p 385. At this time the rules for listed companies were still set by the Exchange rather than the FCA.

[97] London Stock Exchange, *Listing Rules 1993*, Ch. 11

[98] London Stock Exchange, *Admission of Securities to Listing*, 1973, Ch 4, para 8.

for a specific, but common, type of RPT, was shareholder approval, though it is not clear how widely the Council exercised its power not to require shareholder approval.

Does this little history constitute a case for introducing more extensive shareholder approval requirements into the LR? Shareholder approval is not without its costs to the company as a whole. It cannot be obtained quickly or without publicity. Therefore, it will slow down the conclusion of the deal and possibly make the company a less attractive counterparty than other potential contractors not subject to the approval constraint. In addition, the directors may worry that they may not be able to convey effectively to shareholders, who will be less well informed than insiders, the value of the transaction to the company, and so some transactions will be forgone rather than put up for approval. Finally, it is far from clear that independent shareholder approval (which is relatively uninformed because the approvers' lack soft, inside information about the company) is better at accurately identifying the company's interests than independent board approval (with its risk of bias towards the interests of related parties).[99]

In the face of these uncertainties, it seems inappropriate to advocate a return to the pre-1990 approach of routine shareholder approval of RPT for PS companies, if indeed this is an accurate characterization of the then operative system. However, two more modest proposals can be advanced as worthy of investigation which would counteract the very small impact the shareholder approval requirement on FTSE 350 companies. The first reform which would extend the reach of the LR in relation to RPT would be to reduce the threshold for shareholder approval to that suggested in the early 1990s by the Exchange itself, ie 2%. The data captured in the research did not permit an estimate to be made of the impact of this reform in the research

[99] See Z Goshen and R Squire, "Principal Costs: A New Theory for Corporate Law and Governance" (2017) 117 *Columbia Law Review* 767, who remark: "The same factors that lead investors to delegate authority—lack of expertise and information, conflicts of interest, and collective action problems—will lead them to incur principal costs when they use control rights to police managers in the exercise of that authority." See also A Gözlügöl, "Majority of the Minority Approval of Related Party Transactions: the Analysis of (Institutional) Shareholder Voting" (2021) *European Company and Financial Law Review* 820.

period. All that can be said is that the number would have lain somewhere between 16 (the number of approvals required at the current 5% level) and 90 (the total number of PS announcements in the period triggered at the 0.25% level). It is intuitively likely that the 2% level would have its impact in the lower part of this range, because small transactions are more common than larger ones. The impact of this reform on commercial companies is likely to be even smaller, since 8 of the 16 cases identified in the research period were within the RPT rules solely because the related party was the manager of a fund. This category of related party does not exist in commercial companies.[100]

An alternative or additional reform is to introduce a threshold linked to the cash value of the transaction. Thus, the 1992 consultation document[101] from the Exchange proposed shareholder approval if the transaction had a value of at least £250,000, whether or not it exceeded the proposed 2% level. What the appropriate level is today would again be matter for discussion – though it would clearly be significantly higher than that proposed in 1992.

B. AIM Companies

Turning to AIM companies, a shareholder approval requirement for RPT would be a novelty under the AIM rules. Both RPT and substantial transactions are currently subject only to disclosure.[102] On the other hand, shareholder approval is not an unknown technique under the AIM rules: it is used for substantial changes in the business (including reverse takeovers) and de-listing decisions.[103] The central issue appears to be whether the investment strategies currently adopted by investors in AIM companies[104] provide sufficient protection for them or whether more extensive regulation of RPT would encourage more investors into the AIM

[100] See LR 15.5.4 for the extension of the definition of a related party to an investment manager (and associates) of a closed-end fund.
[101] Above n.98.
[102] ARC rr 12 and 13.
[103] ARC rr 14, 15 and 41.
[104] See above §3B.

market or lead to higher valuations of the shares of AIM companies. In any event, a shareholder approval requirement for AIM companies should be triggered only at a significantly higher threshold than the 5% level used for disclosure of RPT transactions by AIM companies.

A radically different reform would be to remove the shareholder approval requirement from the LR (and, logically, not introduce it into the AIM Rules), on the grounds that it has little impact on companies in the FTSE 350 (unless it could be shown that there was a particular risk of unfair RPT in the Small Cap and Fledgling sections of the PS). This would not leave shareholders without a voice in relation to some RPTs, because of the requirements for shareholder approval arising outside LR 11.[105] However, it would have to be accepted that the impact of these rules on RPT would be somewhat arbitrary: some categories of RPT would remain subject to frequent shareholder approval, whilst others would rarely be.

7. Conclusions

Reverting to the title of this article, it can be said that the research carried out has revealed that neither disclosure to the market (required by both the AIM rules and LR11) nor shareholder approval (required by LR11) work well in their current formats as techniques for regulating RPT.[106] Shareholder approval under LR11 is heavily weighted towards companies below the FTSE 350 (and, of course, is inapplicable to AIM companies). Disclosure under both LR11 and the AIM rules normally fails to mandate the disclosure of all the information which the market needs to assess the fairness of the transaction. However, where shareholder approval is

[105] There is probably a good case for retaining the requirement for shareholder approval at the 5% level for arrangements with the managers of closed-end funds. Equally, the provision of LR11 may need to be retained where they operate as the sanctioning mechanism for breaches of the "controlled company" requirements (see LR 11.1.1A-E).

[106] Contrary to the opinion often held about them. See A Gözlügöl, above, n 6.

required, whether under LR11 or under other operative rules, the level of disclosure is better, perhaps even good.

One reform one could derive from the above is to make shareholder approval requirements coterminous with those for disclosure. However, the costs of shareholder approval put such a reform outside serious consideration, though it has been suggested in §6 that some cautious proposals for more frequent shareholder approval should be modelled. The main reform proposal (see §4) is to improve the operation of the disclosure rules by requiring revelation of the main elements of the reasoning supporting the fairness conclusion. This requirement should be applied to the directors who commit the company to the transaction and to other certifiers of the reasonableness of the transaction, if the directors choose to use them. In addition, the directors who commit the company to the transaction should be required to be independent in the CGC sense of the term.

Appendix 1

The data base was constructed by exploring the RNS Announcements made by companies in the 12 months staring on June 10, 2019. A primary search was made against the term "related party" in the announcements as held on the InvestEgate website. From the resulting "hits" the following were discarded.

(i) Historical reporting of RPTs, usually in companies' annual or half-yearly reports (unless the historical report was of transactions which should have been reported at the time). In line with SRD II the focus was thus on contemporaneous reporting of RPT.

(ii) Contemporaneous reporting required by the law of the company's place of incorporation (where this was outside the UK).

(iii) Contemporaneous reporting required only by a foreign exchange on which the company had its primary listing or was cross-listed. This was in line with the aim of assessing the impact of the UK rules.

(iv) Reporting required by NEX.

(v) Where the company had voluntarily adopted the Listing Rules requirements, as sometimes happens with funds listed on the Specialised Fund segment of the London Stock Exchange.

(vi) Announcements by standard listed companies, which before June 10, 2019 were not subject to any RPT rules and were subject to them during the year examined only as their financial years began within the year examined.

Since the focus of interest was reportable events, rather than the number of announcements per se, multiple announcements about a single event (for example, an announcement about a proposed fund-raising and later an announcement of its results) were treated as a single data point. This set of eliminations led to a data base of 497 reported RPT in the year in question. 407 announcements were by AIM companies and 90 by companies premium listed on the Main Market. Where the RPT announcement was associated with a circular to the shareholders, the full text of the circular was examined in most cases (the text being obtained from the web-site of the company in question).

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