Corporate Governance

Flexibility and Proportionality in Corporate Governance

Executive summary and Main findings

OECD

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Executive summary

The quality of corporate governance regulation affects the supply of capital to the real economy. It also influences how well this capital is used in the hands of individual companies. As a consequence, the design of corporate governance regulation has a critical impact on key policy objectives, such as the level of investment, productivity growth, business sector dynamics and financial stability.

In order to achieve these objectives and to strengthen a country's competitive edge, the regulatory framework must be fit for purpose. And in the complex and multifaceted world of business, this means that regulations must be designed to meet the many varying needs of those entrepreneurs, investors and stakeholders who are supposed to use them.

This is why the G20/OECD Principles of Corporate Governance (the G20/OECD Principles) state that policy makers have a responsibility to establish a regulatory framework that is flexible enough to meet the needs of corporations that operate under widely different circumstances. Only then will it provide market participants with the right incentives to exploit new business opportunities that create value and ensure the most efficient use of capital and other corporate resources.

Importantly and in order to support a dynamic business sector, regulations must also be able to accommodate new and innovative business practices. For that reason, the G20/OECD Principles state that when new experiences accrue and business circumstances change, the different provisions of the corporate governance framework should be reviewed and, when necessary, adjusted.

These insights and this approach to regulation are not new. The use of flexibility and proportionality has a long tradition in key corporate governance areas such as company law and securities regulation. And over the years, it has provided entrepreneurs, investors and corporations with a great variety of options when they decide on issues such as the purpose, contractual relations and capital structure of their enterprise.

Flexibility and proportionality is not about less demanding rules or the acceptance of sub-standard practices. On the contrary, a functional and outcome oriented approach to corporate governance will allow regulation to evolve in a way that facilitates implementation and makes enforcement more effective. It will not only improve the ability of entrepreneurs, investors and stakeholders to find arrangements that best fit their needs. It will also meet the recommendations of the G20/OECD Principles that policy measures should be designed with a view to avoid over-regulation, unenforceable laws and unintended consequences that may impede or distort business dynamics.

Policy makers and regulators should also note that flexibility and proportionality must be backed by a solid judicial and supervisory foundation. Institutions must be in place that protect the rights of the different stakeholders and give them access to effective redress if these rights are violated. It also requires effective means of supervision and sanctions that result from public as well as private enforcement. The implementation of these and other core recommendations of the G20/OECD Principles will provide a sound basis on which

it is possible to reap the benefits of a flexible and proportionate regulatory framework that remains focused on the ultimate economic outcomes.

Not surprisingly, this report finds that a vast majority of countries have criteria that allow for flexibility and proportionality at company level in all of the seven areas of regulation that are being reviewed. When it comes to rules about board composition, board committees and board qualifications, all of the 39 jurisdictions included in the survey reported that they had criteria that allowed for flexibility and proportionality. In the other six areas of regulation that were reviewed, between 75% and 85% of the jurisdictions reported that there was scope for flexibility or proportionality in their implementation at company level.

Half of the jurisdictions reported that there was room for flexibility and proportionality in all the seven areas of regulation that were surveyed. This includes jurisdictions with a common law tradition, such as the United States and the United Kingdom as well as jurisdictions with a civil law tradition, such as Germany and France.

Overall, company *size and the listing status* of a firm were reported as the most common reason for allowing flexibility and proportionality. A majority of jurisdictions reported that *listing status* provided scope for flexibility and proportionality across all the examined areas of regulation, except pre-emptive rights and takeovers. Most frequently the criteria *size and listing status* allowed for flexibility and proportionality with respect to regulations on board composition and disclosure of information. Other criteria that frequently provided room for flexibility and proportionality were the company's legal form and its ownership/control structure. Most often these two criteria provided the possibility for flexibility and proportionality with respect to board composition, related party transactions and takeovers.

The results from the survey provide a detailed overview of the frequency and application of flexibility and proportionality across the different areas of regulation. And the findings resonate well with a general ambition to take a functional and outcome oriented approach that simplifies effective compliance and strikes a rational balance between the costs and benefits of regulation. It goes without saying however, that the statistical picture does not, by itself, tell us very much about the quality of the regulation in a specific country. Neither can it be used to rank countries with respect to the quality of their regulatory frameworks. Extensive use of flexibility in a jurisdiction may in principle reflect dysfunctional default rules or regulatory overlap, while the lack of specific flexibility provisions in another jurisdiction may reflect the ability of default rules to accommodate the variety of purposes.

In order to provide a more detailed picture of how flexibility has been used in practice, the report also contains six country case studies covering six different areas of regulation. Each of them gives concrete examples in terms of rationale and regulatory design with respect to the use of flexibility and proportionality.

Main findings

This report finds that a vast majority of countries have criteria that allow for flexibility and proportionality at company level in all of the seven areas of regulation that are being reviewed. Figure 1. below shows that when it comes to rules about board composition, board committees and board qualifications, all of the 39 jurisdictions included in the survey reported that they had criteria that allowed for flexibility and proportionality. In the other six areas of regulation that were reviewed, between 75 and 85% of the jurisdictions reported that there was scope for flexibility or proportionality in their implementation at company level.

Figure 1. Number of jurisdictions that reported that they had *at least one* criterion that allowed for flexibility and proportionality in each of the seven areas of corporate governance regulation surveyed

Number of jurisdictions 10 20 30 39

Board composition

Related party transactions

Disclosure of information

Takeovers

Pre-emptive rights

Say on pay

Major shareholding disclosure

Source: OECD Survey.

Half of the jurisdictions reported that there was room for flexibility and proportionality in all the seven areas of regulation that were surveyed (Table 1.). This includes jurisdictions with a common law tradition, such as the United States and the United Kingdom as well as jurisdictions with a civil law tradition, such as Germany and France.

Table 1. Jurisdictions that reported *at least one* flexibility mechanism in each of the seven areas of corporate governance regulation surveyed

	Board composition	Disclosure of information	Major shareholding disclosure	Pre-emptive rights	Related party transactions	Say on pay	Takeovers
Argentina	●	●	●	●	●	●	●
Australia	●	●	●	●	●	●	●
Austria	●	○	○	○	○	●	●
Belgium	●	●	●	●	●	●	●
Brazil	●	●	○	●	●	●	●
Chile	●	●	●	○	●	○	●
Colombia	●	○	○	●	○	○	●
Czech Republic	●	○	●	●	○	●	●
Denmark	●	●	○	●	●	●	●
Egypt	●	○	○	●	○	○	○
Finland	●	●	●	●	●	●	●
France	●	●	●	●	●	●	●
Germany	●	●	●	●	●	●	●
Hong Kong (China)	●	○	○	●	●	○	○
Hungary	●	●	○	●	●	○	●
Ireland	●	●	●	●	●	●	●
Israel	●	●	●	○	●	●	●
Italy	●	●	●	○	●	●	●
Japan	●	●	●	●	●	●	●
Korea	●	●	●	●	●	●	○
Latvia	●	●	●	●	●	●	●
Lithuania	●	●	●	●	●	●	●
Malaysia	●	●	●	●	●	●	○
Mexico	●	●	●	○	●	●	○
Netherlands	●	○	●	●	●	○	●
Norway	●	○	○	●	○	●	○
Poland	●	●	○	○	○	○	○
Portugal	●	●	●	●	●	●	●
Russia	●	●	●	●	●	○	●
Saudi Arabia	●	●	●	●	●	●	●
Singapore	●	●	●	●	●	●	●
Slovenia	●	●	●	●	●	●	●
South Africa	●	●	●	●	●	●	●
Spain	●	●	●	○	●	●	●
Sweden	●	●	●	○	●	●	●
Switzerland	●	●	●	●	●	●	●
Turkey	●	●	●	●	●	●	●
United Kingdom	●	●	●	●	●	●	●
United States	●	●	●	●	●	●	●
NUMBER OF JURISDICTIONS	**39**	**32**	**30**	**31**	**33**	**31**	**32**

Source: OECD Survey.

Overall, company *size* and *the listing status* of a firm were reported as the most common reasons for allowing flexibility and proportionality (Table 2.). A majority of jurisdictions reported that *listing status* provided scope for flexibility and proportionality across all the examined areas of regulation, except pre-emptive rights and takeovers. Most frequently the criteria *size and listing status* allowed for flexibility and proportionality with respect to regulations on board composition and disclosure of information. Other criteria that frequently provided room for flexibility and proportionality were the company's legal form and its ownership/control structure. Most often these two criteria provided the possibility for flexibility and proportionality with respect to board composition, related party transactions and takeovers.

Table 2. Number of jurisdictions that reported the use of flexibility mechanism and their application across the seven areas of corporate governance regulation surveyed

	Board composition	Disclosure of information	Major shareholding disclosure	Pre-emptive rights	Related party transactions	Say on pay	Takeovers
Accounting standards	0	4	0	0	4	1	0
Maturity of firm	4	2	0	1	3	3	1
Ownership/ control structure	12	4	6	7	10	2	14
Legal form	16	7	5	9	6	9	6
Size	29	17	9	3	11	11	9
Listing/publicly traded	28	27	24	7	21	25	16

Source: OECD Survey.

The results from the survey provide a detailed overview of the frequency and application of flexibility and proportionality across the different areas of regulation. And the findings resonate well with a general ambition to take a functional and outcome oriented approach that simplifies effective compliance and strikes a rational balance between the costs and benefits of regulation. It goes without saying however, that the statistical picture does not, by itself, tell us very much about the quality of the regulation in a specific country. Neither can it be used to rank countries with respect to the quality of their regulatory frameworks. Extensive use of flexibility in a jurisdiction may in principle reflect dysfunctional default rules or regulatory overlap, while the lack of specific flexibility provisions in another jurisdiction may reflect the ability of default rules to accommodate the variety of purposes.

In order to provide a more detailed picture of how flexibility has been used in practice, the report also contains six country case studies covering six different areas of regulation. Each of them gives concrete examples in terms of rationale and regulatory design with respect to the use of flexibility and proportionality. While the survey covers seven areas of regulation, the limited total number of criteria for flexibility and proportionality reported with respect to pre-emptive rights resulted in the OECD Corporate Governance Committee agreeing not to undertake any country case study with respect to pre-emptive rights.

The composition, committees and qualifications of the board of directors

The composition, committees and qualifications of the board of directors is an area where a great variety of practices exist, both across and within jurisdictions. Examples include requirements with respect to the size of the board; the terms of office for directors; the establishment of specialised committees and independent directors. These differences may not come as a surprise, since the composition and work of the board of directors in several ways need to reflect the specific needs of the company they serve and the context in which they operate. In many countries, the statutory requirements with respect to the board's composition, committees and qualifications are therefore quite limited.

This is well illustrated by the case study of the United Kingdom where the Companies Act provides companies with a large degree of freedom to compose their boards in a manner that fits their business model. As a consequence, it does not contain any substantive provisions regarding the qualifications and composition of the board. Neither does the legislation address definitional issues, such as the distinction between executive and non-executive directors. Instead, the main guidance relating to the composition, workings and qualifications of the board is found in the UK Corporate Governance Code, which is a legislative requirement for companies with Premium listing of equity shares. The Code is considered to allow for both flexibility and proportionality as it expects companies to either comply with its recommendations or explain why they have chosen a different arrangement. With respect to the appointment of independent non-executive directors, the Code also has a special exemption with respect to company size, providing less extensive recommendations for smaller companies that are subject to the Code.

Companies with a Standard listing on the London Stock Exchange benefit from wider flexibility. The requirement is limited to producing a Corporate Governance Statement in the Annual Report and disclose whether and to which extent they comply with a specific code. Companies listed on the Alternative Investment Market (AIM) are also required to apply a recognised corporate governance code but are allowed the flexibility to choose between the UK Corporate Governance Code and the Quoted Companies Alliance (QCA) Corporate Governance Code.

Say on pay and disclosure of remuneration

Regulations with respect to say on pay and disclosure of remuneration are usually not targeting the setting of remuneration, including the absolute level of remuneration and severance payments caps. Instead, the focus is to give shareholders an opportunity to assess the cost of the remuneration package and the extent to which it is aligned with the longer term interests of the company. For this purpose, jurisdictions increasingly provide shareholders with an opportunity to exercise either binding or advisory votes on executive pay. These may include voting only on the remuneration policy (its overall objectives and structure) or be extended also to include the amount/level of remuneration.

The Swedish case study provides an example of how flexibility and proportionality is introduced with respect to say on pay in companies that are listed in a regulated market. The rules include a mix of statutory requirements, comply or explain code and ad-hoc rulings by the self-regulatory body, the Securities Council. The statutory provisions are mainly concerned with the decision making process, giving shareholders control of the cost. In the interest of flexibility the board may still deviate from the remuneration guidelines agreed by the shareholder's meeting if there are particular reasons to do so. The Swedish comply or explain code expands beyond the cost and recommends an explanation of the link to

performance criteria and the alignment with shareholder's interests. But again, these provisions include flexibility in terms of comply or explain. The Securities Council has also established rulings with respect to the use of synthetic options, board participation in equity schemes and information requirements to the general meeting. When formulating these rulings, the Securities Council applies a flexible and functional approach that allows criteria such as company size, international expanse and competition to be taken into account.

Related party transactions

In the area of related party transactions the main flexibility mechanisms have emerged with respect to the approval procedures aiming at protecting the interest of the company and its shareholders and at the same time allowing companies to engage in economically beneficial transactions with related parties. In recent years, countries have typically tried to achieve these objectives by strengthening shareholder's rights and empowering the shareholder meeting. In most jurisdictions, independent directors have also been given a key role in the review and approval processes of material related party transactions. In many cases where there is a requirement for shareholder or board approval various quantitative criteria – such as thresholds based on market capitalisation, annual turnover and total assets - have also been adopted allowing for proportionality.

The flexibility and proportionality mechanisms in the Italian regulatory framework for related party transactions are embedded in the design of a three-layer system: the Civil Code provides the legal framework and the general objectives, the Securities Regulator (Consob) establishes the principles for achieving the objectives of the Code and the companies define their own steps to be followed when dealing with related parties. The disclosure requirements, for example, in the Consob principles are proportionate with respect to the materiality of the transactions in the sense that only transactions that exceed certain thresholds must be disclosed. With respect to approval procedures, a primary role has been given to independent directors. At the same time, the Italian regulatory framework provides a proportionate approach by also defining stricter rules with respect to, for example, the company's structure, such as different materiality thresholds for pyramidal group companies (2.5% instead of the general 5% rule).

Disclosure of periodic financial information and ad hoc information

A common rationale for flexibility and proportionality with respect to disclosure of periodic information and ad hoc information is striking a reasonable balance between the overall cost and the key objective of providing market participants with information that is of material importance to their investment decisions. One way to achieve this goal is to use flexibility and proportionality mechanisms in a way that scales disclosure requirements for certain types of companies, in particular for smaller companies, while maintaining appropriate investor protection. When scaling disclosure requirements, policy makers typically choose either to exempt companies from disclosure itself, to reduce the frequency of reporting, or to exempt companies from disclosing certain items or documents. Strengthening disclosure requirements for certain type of companies, such as large companies and group companies, is also used as flexibility and proportionality tools.

In the case study of the United States, this is illustrated by the scaled disclosure provisions that facilitate access to the public capital market for emerging growth companies, with total annual gross revenues of less than USD 1.07 billion. The scaled

requirements apply both to disclosure at the time of the initial public offering and for a defined period after the company's listing. The U.S. Securities and Exchange Commission (SEC) has also adopted scaled disclosure requirements for smaller reporting companies, that generally are companies that are below certain threshold with respect to the amount of public equity float or total annual revenues. The scaled disclosure requirements permit smaller reporting companies to include, for example, less extensive narrative disclosure than required of other publicly listed companies, particularly in the description of executive compensation. The US federal securities laws also provide a certain degree of flexibility and proportionality as they relate to certain foreign private issuers and companies that offer and sell securities based on exemptions from registration. As mentioned above, it is important to recall that these requirements are complemented by both public and private enforcement actions and the SEC staff's selective review of certain types of company filings.

Disclosure of major share ownership

Disclosure of major share ownership is typically motivated by the fact that the composition of shareholders may influence the valuation of the company, impact the free float and the strategic direction of the company. In virtually all jurisdictions, this has resulted in reporting requirements with respect to shareholdings above a certain thresholds and of significant changes in the size of existing shareholdings. Some scope for flexibility and proportionality still exist, for example with respect to the size and the purpose of the shareholdings. The rationale for such flexibility can be linked to the administrative burden for certain types of shareholders and to maintain incentives for shareholders to identify and build a portfolio of what they may consider being an undervalued stock.

The Japanese case study provides a number of examples of flexibility and proportionality. The most important criterion for exception relates to changes in ownership by certain financial institutions for which the rules are relaxed in terms of the frequency of reporting and the deadlines for filings. The rationale is that strict adherence to the default rules would result in excess paperwork and impede smooth transactions of listed stocks. There are two important qualifications for using this exemption; the institution is not allowed to use its ownership to influence the company's business in any important way and the ownership cannot exceed 10% of the company shares. Other exemptions from the general reporting requirements include the disclosure of treasury shares held by listed companies, since they do not carry any voting rights.

Takeovers

Takeovers and the market for corporate control play an important role for business sector dynamics. Therefore, it is important that proper rules and procedures are in place. One important aim of such rules is to define the rights and the duties of the bidder, the target company board etc. during the process. Another objective is to address the fairness of the offer. Some jurisdictions, notably the United States, leave it to the bidder's discretion how to approach the takeover process and do not require a mandatory bid regime. A majority of jurisdictions assess the fairness of the offer. A majority of jurisdictions have also established a mandatory bid regime.

As the case study of Portugal illustrates however, even within a national statutory framework, several provisions for flexibility and proportionality are typically applied.

Some of them are of principal interest. First is the fact that the Portuguese Securities Commission (CMVM) has discretionary power to make an independent assessment of whether a change in control actually has occurred when an owner reaches the formal threshold for a mandatory bid, which is one-third of the voting rights. Circumstances that may influence the judgment on actual control include the specific shareholder structure (including the presence of shareholder agreements) and the target company's free float. Other examples include instances where someone gains control as a consequence of a voluntary bid, a merger or as the result of a financial recovery plan.

Corporate Governance

Flexibility and Proportionality in Corporate Governance

This report provides an assessment of the flexibility and proportionality arrangements available within corporate governance frameworks that relate to seven areas of regulation: pre-emptive rights; board composition, board committees and board member qualifications; say on pay and the detail of disclosure on remuneration; related party transactions; disclosure of periodic financial information and ad-hoc information; major shareholding disclosure, and takeovers. It covers 39 jurisdictions, including in-depth case studies of the United Kingdom; Sweden; Italy; Japan; the United States of America, and Portugal and is based in part on a questionnaire to which all participating jurisdictions in 2017 responded.

Consult this publication on line at ***https://doi.org/10.1787/9789264307490-en***.

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