Corporate Governance

Flexibility and Proportionality in Corporate Governance

OECD

Corporate Governance

Flexibility and Proportionality in Corporate Governance

OECD
BETTER POLICIES FOR BETTER LIVES

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document, as well as any data and any map included herein, are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Please cite this publication as:
OECD (2018), *Flexibility and Proportionality in Corporate Governance*, OECD Publishing, Paris.
https://doi.org/10.1787/9789264307490-en

ISBN 978-92-64-30748-3 (print)
ISBN 978-92-64-30749-0 (pdf)

Series: Corporate Governance
ISSN 2077-6527 (print)
ISSN 2077-6535 (online)

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Photo credits: Cover © alice-photo / iStock.

Corrigenda to OECD publications may be found on line at: *www.oecd.org/publishing/corrigenda*.

© OECD 2018

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgement of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to *rights@oecd.org*. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at *info@copyright.com* or the Centre français d'exploitation du droit de copie (CFC) at *contact@cfcopies.com*.

Foreword

This report presents the results of a set of thematic peer reviews based on the G20/OECD Principles of Corporate Governance. The theme of the reviews is the availability of flexibility and proportionality measures that can be used when implementing key areas of corporate governance regulation such as company law and securities regulation. The regulatory areas that are covered by the report are 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; disclosure of major shareholdings; takeovers, and pre-emptive rights. The report covers 39 jurisdictions and in-depth case studies of Italy, Japan, Portugal, Sweden, the United Kingdom and the United States.

The report has been prepared by the OECD Corporate Governance Committee under the chairmanship of Masato Kanda. Secretariat support has been provided by Akito Konagaya, Héctor Lehuedé and Serdar Çelik, under the direction of Mats Isaksson, at the Corporate Governance and Corporate Finance Division of the OECD.

The purpose of the Corporate Governance Committee's thematic peer reviews is to facilitate effective implementation of the G20/OECD Principles of Corporate Governance and to help policy makers, regulators and market participants to respond to developments that may influence the relevance and effectiveness of their existing corporate governance framework.

Table of contents

Foreword **3**

Executive summary **11**

Main findings **13**

The composition, committees and qualifications of the board of directors 16
Say on pay and disclosure of remuneration 16
Related party transactions 17
Disclosure of periodic financial information and ad hoc information 17
Disclosure of major share ownership 18
Takeovers 18

Chapter 1. Introduction **21**

Flexibility and proportionality in corporate governance 22
The public policy rationale for flexibility and proportionality 23
Flexibility and proportionality in the G20/OECD Principles of Corporate Governance 30
Notes 31
References 33

Chapter 2. Scope and methodology of the thematic reviews **35**

Research design 36
Responses and interpretation of results 37
Notes 38

Chapter 3. Overview of survey results **39**

Flexibility and proportionality across jurisdictions 40
Flexibility and proportionality by area of regulation 41
Flexibility and proportionality by sectors 46
Flexibility and proportionality by criteria 47
Opt-in and opt-out 52

Chapter 4. Board composition, board committees and board member qualifications **53**

Introduction 54
Survey results 57
Case study: United Kingdom 64
Conclusions 81
Notes 82
References 86

Chapter 5. Say on pay and the detail of disclosure of remuneration 87

Introduction 88
Survey results 96
Case study: Sweden 102
Conclusions 109
Notes 110
References 112

Chapter 6. Related party transactions 115

Introduction 116
Survey results 122
Case study: Italy 128
Conclusions 138
Notes 139
References 141

Chapter 7. Disclosure of periodic financial information and ad-hoc information 145

Introduction 146
Survey results 148
Case study: United States 155
Conclusions 163
Notes 163
References 166

Chapter 8. Disclosure of major shareholdings 167

Introduction 168
Survey results 170
Case study: Japan 175
Conclusions 181
Notes 181
References 183

Chapter 9. Takeovers 185

Introduction 186
Survey results 189
Case study: Portugal 194
Conclusions 208
Notes 209
References 210

Annex A. Survey instrument 211

Survey notes 233

Tables

Table 1. Jurisdictions that reported *at least one* flexibility mechanism in each of the seven areas of corporate governance regulation surveyed ... 14
Table 2. Number of jurisdictions that reported the use of flexibility mechanism and their application across the seven areas of corporate governance regulation surveyed ... 15
Table 2.1. The criteria and dimensions surveyed ... 36
Table 3.1. Jurisdictions that reported *at least one* flexibility mechanism in each of the seven areas of corporate governance regulation surveyed ... 40
Table 4.1. Summary of reform elements and their estimated impacts ... 79
Table 6.1. Ownership structure in selected countries, as a percentage of total, as of end 2016 ... 118
Table 6.2. Regulatory frameworks for related party transactions ... 120
Table 6.3. Use of legal form, maturity of firm and accounting standards criteria for related party transactions ... 126
Table 6.4.Taxonomy of RPTs and applicable disclosure and review/approval provisions ... 132
Table 8.1. Example of disclosure on large volume transfers in a short period ... 181
Table 9.1. Overview of takeovers in Portugal 2007-2017 ... 195
Table 9.2. Derogations in Portugal 2007 – 2017 ... 196

Figures

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 ... 13
Figure 3.1. Number of jurisdictions with *at least one* criterion or optional mechanism in the areas of regulation ... 40
Figure 3.2. Total number of reported criteria for pre-emptive rights ... 42
Figure 3.3. Total number of reported criteria for board composition ... 43
Figure 3.4. Total number of reported criteria for say on pay ... 43
Figure 3.5. Total number of reported criteria for related party transactions ... 44
Figure 3.6. Total number of reported criteria for disclosure of financial information ... 45
Figure 3.7. Total number of reported criteria for major shareholding disclosure ... 45
Figure 3.8. Total number of reported criteria for takeovers ... 46
Figure 3.9. Overall use of criteria per sector ... 47
Figure 3.10. Applications of the *size* criterion and the distribution of the total number of reported *size* criteria between the different areas of regulation ... 48
Figure 3.11. Applications of the *ownership/control* criterion and the distribution of the total number of *ownership/control* criteria between the different areas of regulation ... 49
Figure 3.12. Applications of the *listing/public trading* criterion and the distribution of the total number of reported *listing/public trading* criteria between the different areas of regulation ... 50
Figure 3.13. The distribution of the total number of reported criteria with respect to *maturity of the firm, accounting standards, legal form and "other"* between the different areas of regulation ... 51
Figure 3.14. The overall availability of opt-in and/or opt-out mechanisms and their distribution between the different areas of regulation ... 52
Figure 4.1. Frequency of use of criteria and optional mechanisms per area of regulation ... 57
Figure 4.2. Overall use of criteria across all areas of regulation ... 57
Figure 4.3. Use of criteria for board composition across jurisdictions ... 58
Figure 4.4. Use of the listing/publicly traded criterion for board composition ... 59
Figure 4.5. Use of the size criterion for board composition ... 60
Figure 4.6. Use of the ownership/control structure criterion for board composition ... 62

Figure 4.7. Use of opt-in and/or opt-out mechanisms for board composition...................................... 63
Figure 4.8. Use of flexibility and proportionality in different sectors for board composition 64
Figure 5.1. Say on the remuneration policy across jurisdictions... 90
Figure 5.2. Say on level/amount of remuneration across jurisdictions.. 91
Figure 5.3. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation... 96
Figure 5.4. Overall use of criteria across all areas of regulation... 97
Figure 5.5. Use of criteria for say on pay across jurisdictions 97
Figure 5.6. Use of the listing/publicly traded criterion for say on pay... 98
Figure 5.7. Use of the size criterion for say on pay.. 99
Figure 5.8. Use of opt-in and/or opt-out mechanisms for say on pay 101
Figure 5.9. Use of flexibility and proportionality in different sectors for say on pay 102
Figure 6.1. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation. 122
Figure 6.2. Overall use of criteria across all areas of regulation... 123
Figure 6.3. Use of criteria for related party transactions across jurisdictions 123
Figure 6.4. Use of listing/publicly trading criterion for related party transactions 124
Figure 6.5. Use of size criterion for related party transactions.. 125
Figure 6.6. Use of ownership/control structure criterion for related party transactions..................... 126
Figure 6.7. Use of opt-in and/or opt-out mechanisms for related party transactions 127
Figure 6.8. Use of flexibility and proportionality in different sectors for related party transactions.. 127
Figure 7.1. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation. 148
Figure 7.2. Overall use of criteria across all areas of regulation... 149
Figure 7.3. Use of criteria for disclosure of information across jurisdictions 149
Figure 7.4. Use of the listing/publicly traded criterion for disclosure of information........................ 150
Figure 7.5. Use of the size criterion for disclosure of information.. 152
Figure 7.6. Use of the ownership/control structure criterion for disclosure of information............... 153
Figure 7.7. Use of opt-in and/or opt-out mechanisms for disclosure of information 154
Figure 7.8. Use of flexibility and proportionality in different sectors for disclosure of information.. 155
Figure 8.1. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation. 170
Figure 8.2. Overall use of criteria across all areas of regulation... 170
Figure 8.3. Use of criteria for disclosure of major shareholdings across jurisdictions....................... 171
Figure 8.4. Use of the listing/publicly traded criterion for disclosure of major shareholdings........... 172
Figure 8.5. Use of the size criterion for disclosure of major shareholdings...................................... 173
Figure 8.6. Use of ownership/control structure criterion for disclosure of major shareholdings........ 173
Figure 8.7. Use of flexibility and proportionality in different sectors for disclosure of major shareholdings... 174
Figure 8.8. Timing for filing Reports 176
Figure 8.9. Timing for filing Reports under the Special Reporting System...................................... 178
Figure 8.10. A case which satisfies the conditions of "Large Volume Transfers in a Short Period" . 180
Figure 9.1. Takeover bids rules... 186
Figure 9.2. Jurisdictions with at least one criteria of optional mechanism in the areas of regulation. 189
Figure 9.3. Overall use of criteria across all areas of regulation... 190
Figure 9.4. The use of criteria with respect to takeovers across jurisdictions.................................... 190
Figure 9.5. Use of the listing/publicly traded criterion for takeovers.. 191
Figure 9.6. Use of the ownership/control structure criterion for takeovers....................................... 192
Figure 9.7. Use of the size criterion for takeovers... 193
Figure 9.8. Use of opt-in and/or opt-out mechanisms for takeovers 193
Figure 9.9. Use of flexibility and proportionality in different sectors for takeovers.......................... 194
Figure 9.10. The Portuguese securities market: Case 1... 202
Figure 9.11. The Portuguese securities market: Case 2... 203
Figure 9.12. The Portuguese securities market: Case 3... 203

Figure 9.13. The Portuguese securities market: Case 4 204
Figure 9.14. The Portuguese securities market: Case 5 204
Figure 9.15. The Portuguese securities market: Case study A 205
Figure 9.16. The Portuguese securities market: Case study B 207

Boxes

Box 5.1. Excerpts from OECD (2011) Board practices: Incentives and governing risk 88
Box 5.2. Excerpts from the 2014 amendment proposal for the EU Shareholder's Rights Directive 92
Box 5.3. A critique of the French Say on Pay system 93
Box 8.1. Excerpts from the EU's Transparency Directive (2004/109/EC) 169
Box 9.1. Optional rules under EU Takeover Directive 188

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.

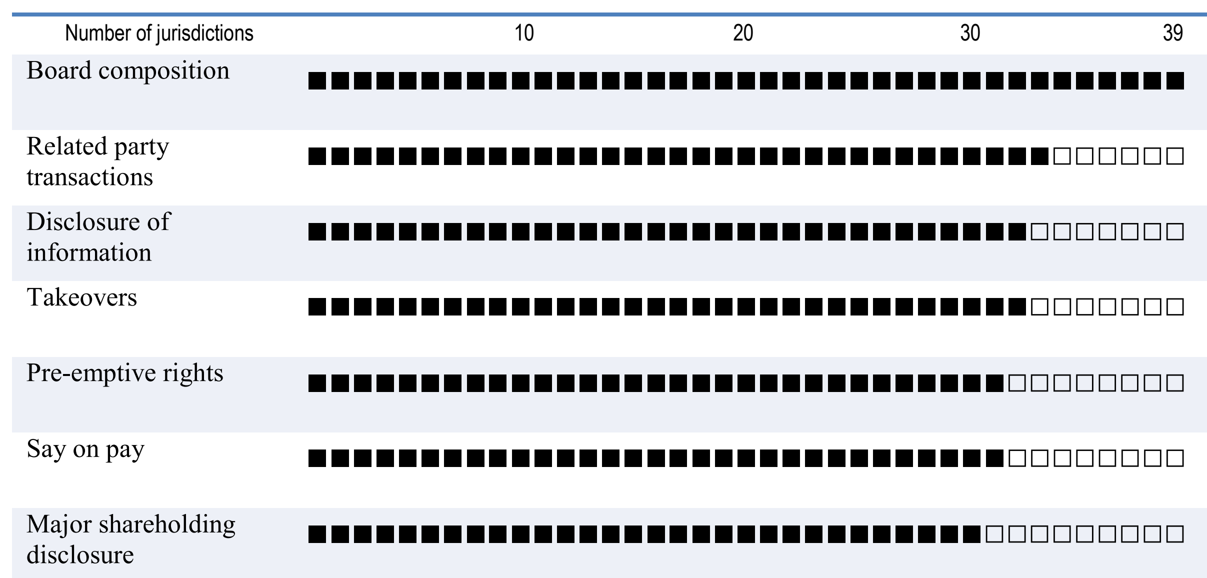
The results from the survey provide a detailed overview of the frequency and application of flexibility and proportionality across the different areas of regulation. And the findings resonate well with a general ambition to take a functional and outcome oriented approach that simplifies effective compliance 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



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.

Chapter 1. Introduction

This section offers an introduction to the topic of the thematic review, describing the background against which the work was conducted. It covers the concepts of flexibility and proportionality; their use in the G20/OECD Principles of Corporate Governance; and describes the rationale for a flexible and proportional approach to corporate governance by offering historical and contemporary examples. It also highlights its applicability to some of the opportunities and challenges that come with current capital market developments.

The purpose of the Corporate Governance Committee's (the Committee) thematic peer reviews is to facilitate effective implementation of the G20/OECD Principles of Corporate Governance (the G20/OECD Principles) and to help policy makers, regulators and market participants to respond to developments that may influence the relevance and effectiveness of their existing corporate governance framework.[1] For this purpose, the Committee decided to conduct a thematic analysis on how flexibility and proportionality can be used when implementing the G20/OECD Principles.

This report presents the results of the review which identifies criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating to selected regulatory areas covered by the G20/OECD Principles. It is structured as follows: This first chapter introduces the overall approach. The next two chapters describe the methodology and present the main results. Then six separate chapters address the results in more detail for the areas of regulation that are reviewed.[2] Each of these six sections also contains a case study to illustrate the reasoning behind proportionality and flexibility provisions and their application in one of the participating jurisdictions. The annex presents the full questionnaire used for the reviews.

Flexibility and proportionality in corporate governance

Flexibility and proportionality, as general concepts, form an inherent part of the legal framework of most jurisdictions. In the context of corporate governance, it is manifested in the many options for contractual freedom that company law allows for when establishing a company's governance structure and purpose, as well as in the differential application of elements of legal and regulatory framework to companies depending upon their specific character.

The opposite end of the spectrum from flexibility and proportionality would be a "one-size-fits-all" approach, in which the corporate governance framework (or elements thereof) would be mandated to all companies equally, without taking into account relevant differences among them. Typical flexibility and proportionality considerations reflected in corporate governance frameworks include characteristics such as the size of a company, ownership and control structures, geographical presence, sector of activity, a company's stage of development and/or whether a company's securities are publicly traded.

The main point of departure for applying flexibility and proportionality in practice is to enable the corporate governance framework to accommodate differences in company practices that while achieving desired regulatory outcomes, allow or facilitate companies' individual development and the most efficient overall deployment of their resources. Likewise, flexibility and proportionality prevent the unnecessary adoption of requirements that may impose burdens and restrictions on companies without effectively promoting the overall outcomes.

As a result, flexibility and proportionality rules have been applied in relation to a variety of matters within corporate governance frameworks. Disclosure rules for example are frequently differentiated according to various criteria. Other factors that are commonly subject to a flexibility and proportionality approach are the composition of the board, the establishment of board committees, remuneration practices, shareholder and stakeholder (including employee) rights. Well known national examples of applying flexibility and proportionality in the area of corporate governance include the US JOBS Act[3] and the European Union's Accounting and Transparency Directives.[4] But examples abound.

Within the Italian framework, for example, flexibility and proportionality are provided for SMEs in the Consob regulation and in the listing rules.[5] In Chile, independent directors are only mandated if a company has market capitalisation and a free float above a certain minimum.[6] Similarly, in Sweden, worker representation on the board is mandatory only in companies of a certain size.[7] In the UK, the flexibility and proportionality approach is used in the 2016 Green Paper on Corporate Governance Reform[8] as it seeks to discuss whether the UK's largest privately-held companies –where they are of similar size and economic significance to public companies– should be expected to meet higher minimum standards of corporate governance and reporting than other privately-held firms.[9]

More recently, the European Commission has launched a consultation for "Building a proportionate regulatory environment to support SME listing"[10] that aims to assess the impact of regulation on SMEs incentives to listing so as to "further alleviate the administrative burden on listed SMEs and revive the local ecosystems surrounding SME-dedicated markets, while keeping investor protection and market integrity unharmed" (European Commission, 2017).

The public policy rationale for flexibility and proportionality

In a market economy, the production of goods and services can be organised in a great number of different legal forms. Co-operatives, partnerships, limited liability corporations, joint stock companies, either privately-held or listed, are just a few examples. The reason why our legal systems make all of these different forms available is that the character of economic activities varies, as do the personal preferences of the individuals that are engaged in these activities.

For example, a law firm whose business model requires little fixed capital may be best served by choosing the limited liability partnership form, while a capital-intensive mining venture with an uncertain outcome may opt for the joint stock corporate form. The variety of legal forms also facilitates the pursuit of different objectives that founders and participants may have. Some organisations are established to generate profits, while others are run for social purposes, charity, or the advocacy of special causes.

The G20/OECD Principles do not refer to any specific legal form, since they focus mainly on companies which are "publicly traded" and that, in principle, can include different legal forms. The dominant legal form of publicly traded companies is the joint stock company, but there are examples of publicly traded companies adopting other legal forms, like the limited liability companies in the US or the cooperatives in Italy.

Irrespective of their legal form, publicly traded companies are not a homogenous group. They differ greatly with respect to size, ownership structure, stage of development and the industries in which they operate. This is why the G20/OECD Principles state that policy makers have a responsibility to make sure that the corporate governance framework for listed companies is flexible enough to meet the needs of firms that operate under widely different circumstances.

Just like good corporate governance, the notion of flexibility and proportionality is not an end in itself. And it is by no means a way to weaken the effectiveness of the corporate governance framework. On the contrary, flexibility and proportionality is a necessary prerequisite for creating an effective legal environment that can support the ultimate policy objectives of the G20/OECD Principles, namely to support economic efficiency, sustainable growth and financial stability.

When addressing the issue of flexibility and proportionality, it is essential to think about regulation in economic as well as legal terms. It requires an understanding of the incentives of market participants and how ongoing structural developments in the financial and corporate sectors may influence, or even alter, these incentives. After all, in order to achieve their objectives, laws, regulations and practices must be designed with respect to the economic reality in which they will be implemented.

As a first step, it may therefore be useful to briefly recapitulate the evolution of the corporate form. Why was it established and how has it evolved over time in response to economic events. By doing that, we will find that legislators have never been alien to the concepts of flexibility and proportionality when circumstances change. This is true for differences between corporate forms as well as the ability of publicly traded companies to deviate from the default rules that are provided in the typical company law contract.

Flexibility and proportionality in company regulation

As regards joint stock companies, one of the first flexibility and proportionality reforms took place in Germany almost 150 years ago. The very first German joint stock companies act (*Aktiengesetz*) was introduced in 1870. It applied to all joint stock companies (*Aktiengesellschaft*) and was considered very liberal. Due to abusive use of the liberal regime, the act was replaced in 1884 by a new, more formalistic and restrictive piece of legislation, including mandatory rules on, inter alia, the organizational structure of the company.

Complaints were soon heard against this mandatory approach from small and medium sized businesses. They requested a new form of limited liability company adapted to the, typically, more closed structure of ownership in small firms. Eight years later, in 1892, Germany therefore introduced a separate form of company with limited liability, the *Gesellschaft mit beschränkter Haftung* (GmbH) aimed at smaller businesses, typically with a smaller number of owners.

During the decades to come, equivalents of the GmbH concept spread all over Europe. In France the joint stock company, *Societé Anonyme* (SA), was complemented with the *Société à Responsabilité Limitée* (SARL) in 1925, and in Italy the S.p.a. was complemented with the S.r.l. in 1942. In the UK two categories of the limited liability company, private and public companies, were introduced in 1907. Today, in almost every country in the world there are two major forms of companies with limited liability for the owners or two categories thereof: AG – GmbH, SA – SARL, S.p.a. – S.r.l., Plc – private company, etc.

But flexibility and proportionality in company law reforms did not stop after these developments. In many jurisdictions additional steps have been taken by the legislator. In France, for example, a new company form "in between" the SA and the SARL was introduced in 1994, called *Société par Actions Simplifiée* (SAS).[11] It was introduced to combat certain rigidities in the law governing the SA and the SARL, which could not always be overcome by means of the introduction of special provisions in the company's statutes, or via shareholders' agreements. The SAS was intended to be a flexible legal form combining the advantages of legal personality and a considerable degree of contractual freedom.

In 1999, a decision by the European Court of Justice on the freedom of establishment[12] indirectly triggered a wave of flexibility and proportionality reforms in many EU member states. In Germany, France, and several other jurisdictions, subtypes of the limited

liability company were introduced to make the formation of such companies easier and less risky for entrepreneurs. In Germany the official name of this "mini-GmbH" is *Unternehmergesellschaft* (UG), while in France it is *Entreprise Unipersonelle à Responsibilité Limitée* (EURL). Similar subtypes exist in many other EU member states. A common feature of these limited liability companies is that they may not offer shares for subscription by the public. Hence, while there are exceptions to this rule (cf. publicly traded LLCs in the US), since they cannot be listed, these types of limited liability companies may be considered to be of only limited interest from the perspective of the Corporate Governance Committee.[13]

Regulatory flexibility and proportionality of several kinds exists also among joint stock companies, i.e. companies that may turn to the public to raise capital. Here, proportionality may relate to, inter alia, the size of the company. In such cases certain provisions in the company legislation makes a distinction between companies of different sizes. As mentioned above, employee representation on the board is mandatory in Swedish companies of a certain size. And in Chile, independent directors are only mandated if a company has market capitalisation and a free float above a certain minimum.

A different and typically much more important kind of flexibility and proportionality relates to the distinction between "listed" and "non-listed" joint stock companies. In many jurisdictions, rules with respect to the organisational structure of the company and other issues are stricter, and to a larger extent mandatory, for listed companies than for non-listed companies. But not even this is exhaustive. Within the Italian framework, for example, flexibility and proportionality is provided in the regulation to give more flexibility for, and to improve the corporate governance of, SMEs[14] and in the listing rules (with the aim to improve SMEs corporate governance). And as mentioned above, the UK 2016 Green Paper on Corporate Governance Reform adopts a flexibility and proportionality approach to discuss whether the UK's largest privately-held companies – where they are of similar size and economic significance to public companies– should be expected to meet higher minimum standards of corporate governance and reporting (Department for Business, 2016).[15]

Furthermore, in many countries there are also different categories of market places for trading in shares. In the European Union, a distinction is made between regulated markets and alternative trading platforms (ATPs). EU member states are only bound to apply certain company law directives to the regulation of companies whose shares are admitted to trading on a regulated market. That is, for example, the case with the EU Shareholders' Rights Directive.[16]

In the same vein, we find flexibility and proportionality following from corporate governance codes. In many jurisdictions all listed companies (or only companies listed on regulated markets) must adhere to a corporate governance code on a "comply or explain" basis, while typically no such codes exist for non-listed companies or companies whose shares are traded on ATPs.

Finally, the listing rules of many market places have provisions on corporate governance matters. In some cases this is due to legislative requirements, while in other cases such provisions have been introduced at the initiative of the exchanges themselves, often with the aim to increase confidence in the business of the exchange. Regardless of the rationale, this is another example of regulatory flexibility and proportionality.

To summarise, flexibility and proportionality in the field of company law and corporate governance is nothing new; it has been practised and continued to evolve for a long time. While the flexibility and proportionality concept may indeed be complex, as it relates to different aspects of companies, the common ground is the acknowledgement that "one size does not fit all."

Regulation meets reality

The development of the G20/OECD Principles was informed by a number of special studies that highlighted key developments in both the financial and corporate sectors. They included developments with respect to corporate listings, an analysis of growth companies and the role of institutional investors.

This empirical research, together with the practical experiences of the review group, resulted in a number of changes and amendments to the G20/OECD Principles. It also resulted in a further elaboration of the concept of flexibility and proportionality in the G20/OECD Principles. In addition to acknowledging the need for flexibility and proportionality, the G20/OECD Principles also provide examples of corporate characteristics that may call for flexibility and proportionality, such as size, ownership and control structure, geographical presence, sectors of activity and the company's stage of development. The G20/OECD Principles also recognise that corporations do not operate in a vacuum and that changing circumstances in the financial and corporate sectors over time may call for adjustments in the corporate governance framework.

These observations are of direct relevance to the implementation of the G20/OECD Principles when jurisdictions have to translate its recommendations into laws and regulations. As mentioned above, this requires a good economic understanding of how different legal provisions influence the incentives of market participants, such as shareholders, managers, board members, service providers and stakeholders. But it also requires an empirical understanding of real world developments that over time may influence these incentives and, as a consequence, the effectiveness of existing laws and regulations. In the following sections, three interrelated examples of such developments are discussed. Each of them has triggered a discussion about the merits and the boundaries of flexibility and proportionality in corporate governance frameworks.

The decrease in smaller growth company listings

The use of primary equity markets can be an important source of equity funding for smaller growth companies that want to grow and develop as independent entities. For a company that gets listed, the access to equity funding is not limited to the funds that are raised in the initial public offering (the "IPO"). Equally important is the ability to raise additional equity through a secondary public offering[17] sometime after the listing. As a matter of fact, every year since 2000 such secondary offerings have raised more equity for non-financial companies than the IPOs themselves. We also know that once they are listed, smaller growth companies use this additional source of equity funding at approximately the same rate as larger more established companies (OECD, 2015[(2)]). Moreover, being listed does not only provide access to long-term capital in the form of equity. It also facilitates the use of other forms of capital market based corporate finance, such as corporate bonds (Çelik, Demirtaş and Isaksson, 2015).

Against this background and the documented positive correlation between equity finance and economic growth, concerns have been raised about the marked decline in the listings of smaller growth companies. Globally, the average annual number of growth companies

that made an IPO of less than USD 50M (USD 100M) was 1 373 (1 739) in the period 1996-2000. That number fell to 1 041 (1 179) in the period 2001-2007 and to only 627 (785) in the period 2008-2016. At the same time the share of growth company proceeds from all non-financial company IPO proceeds also declined from 8% (19%) in the period 1996-2000 to 6% (15%) in the period 2008-2016. Again, the fall is particularly marked in advanced economies where the share of smaller growth company IPOs more than halved.[18]

Changes in corporate characteristics and business models

At its origin, corporate ownership and shareholder oversight was mainly relating to the residual claim on fixed assets used in production. Improved access to finance and a boost to competition have eroded the primacy of capital over other relevant corporate inputs. Many of today's largest companies are increasingly dependent on intangible assets and talent from unique human resources. This has given rise to two main discussions with respect to corporate governance arrangements.

The first relates to the relative powers of capital and human resource providers. While the joint stock company is an association of capital, many corporations today depend equally much on key human assets that are not easily appropriated or even monitored.[19] This may, for example, appear in parts of the financial industry where personal networks play an essential role and in companies that still depend heavily on the expertise and strategy of a successful entrepreneur. Under such circumstances, it is not unusual that the company founders will require –and investors agree to cede– certain control rights before an IPO.[20] It may also have implications for remuneration practices where shared ownership in many cases is expected and/or demanded from key corporate personnel.

The second discussion relates to the increased complexity of evaluating corporations, particularly when they are heavily dependent on intangible assets and key human resources. This is a key economic function assigned to capital markets and essential for efficient allocation of capital from household savings to productive investments. Today's concern is that while corporations have become more complex and idiosyncratic, large scale investing has become more indexed, standardised and passive. This mismatch may lead to a situation where smaller growth companies do not necessarily get the attention, access to capital or contractual arrangements that will allow them to develop their full potential as independent entities.

In such cases, smaller growth companies may just remain privately held, which may limit their growth prospects and also deprives a broader public of the opportunity to share in their wealth creation. Alternatively, they may be acquired by larger firms that will integrate them in their current business and/or discontinue their activities which could have developed future competition if remained independent. Furthermore, some may grow to become what is now called a "unicorn;" privately-owned companies with valuations above USD 1 billion that attract a significant amount of investment (often indirectly from pension funds and other institutional investors) via venture capital and hedge funds, while offering only a fraction of the corporate governance requirements expected from listed companies. Hence, giving growth companies the scope for flexibility and proportionality may have long term and economy wide effects on the rejuvenation and dynamics of the business sector (Isaksson and Çelik, 2013).

Another important corporate development, with potential implications for the implementation of corporate governance rules, is the fact that an increasing number of corporations today actually have a controlling or dominant owner. This is particularly

accentuated in emerging markets, but controlling owners are also common in most advanced economies, including the US and Continental Europe. It has been argued that the conclusions that stem from an analysis of the principal-agency problem that follow from dispersed ownership are of limited help when addressing corporate governance issues in companies that have controlling owners. Their presence is generally assumed to provide strong incentives for informed ownership engagement and to overcome the fundamental agency problem between shareholders and managers. There are also arguments that the incentives for controlling owners to assume the costs for this ownership engagement are weakened by restrictions on the controlling owners to exercise their rights and be properly compensated for their efforts to monitor.

Increase in institutional ownership

In reality, share ownership may differ from the traditional textbook assumptions that shareholder actions are driven by a direct and uncompromised relationship between company performance and the income of a large number of small direct shareholders.

In addition to direct ownership by a company's ultimate beneficiaries, today's advanced economies are characterised by greater ownership by institutional investors. In the United Kingdom, for example, direct ownership by households in 2014 was down to a mere 12 percent with different categories of institutional investors, notably investment funds, being the dominant category of owners. Japan too has seen a marked decrease in the share of equity held by households, from around 30% in 1980 to 17% in 2016. The same is true for the United States, where households, who traditionally have been quite significant owners of public equity during the period 1980-2016 have been replaced by institutional investors as dominant owners of shares in publicly listed companies.[21]

One driver behind the increased importance of institutional investors as corporate owners, such as pension funds and to some extent investment funds, has been the transformation of pension systems towards funded plans and the establishment of mandatory and voluntary private pillars that are intended to complement existing government sponsored pension systems in many countries. As a result, private pension funds in the OECD area have reached significant sizes, representing as much or more than their own economy's GDP. This is for example the case in Australia (124%), Canada (159%), Denmark (209%), Iceland (151%), Netherlands (180%), Switzerland (127%), and the United States (135%).[22]

Another development that has contributed to the growth of institutional investors has been the formation of sovereign wealth funds (SWFs). Many economies, in particular natural resource exporting countries, have created SWFs to serve as pension reserve funds, financial stabilization funds or state ownership agencies. These funds either directly or through cross investments in other institutional investors invest extensively in public equity markets.

Other factors that have contributed to the increase in collective investment vehicles include modern portfolio theory, which increasingly has gained ground as investment strategy followed by investors around the world. As a result, the trend has been to pool capital into large diversified portfolios that can take advantage of any economies of scale and enhance the risk-return relationship. The advances in technology have also facilitated the introduction of new investment vehicles that follow the same diversification principle.

The shift from direct household ownership to institutional investors has inspired several regulatory and voluntary initiatives aiming at increasing the level of ownership

engagement by institutional investors. Some jurisdictions have, for example, decided to impose different requirements for ownership engagement on different types of institutional investors. Alternatively or complementary to such regulatory requirements, some regulators have chosen to rely on investor stewardship codes or other guidelines. For example, in 18 out of 42 jurisdictions covered in the 2017 OECD Corporate Governance Factbook there is a legal requirement for institutional investors to disclose their voting policies and in 12 jurisdictions they are forced to disclose their actual voting record. Similarly, 17 jurisdictions have some form of stewardship code for encouraging the disclosure of their voting policy and 10 for encouraging the disclosure of actual voting records.

The G20/OECD Principles of Corporate Governance recognises that some countries have begun to consider adoption of codes on shareholder engagement (stewardship codes), which institutional investors are invited to sign up to on a voluntary basis. But the G20/OECD Principles also states if shareholder engagement is not part of the institution's business model and investment strategy, mandatory requirements to engage, for example through voting, may be ineffective and lead to a box-ticking approach.

The impact of the new trends on policy making in corporate governance

As illustrated by the examples above, the evolving landscape raises some challenges to policy makers. How to recover the listing gap, in particular for growth companies? How to understand the increasing role of institutional investors and approaches toward corporate governance? How to apply standards and rules for growth companies with idiosyncratic corporate governance patterns?

Addressing these challenges is key for policy makers to maintain capital markets as an effective driver for growth. As a consequence, several initiatives have been taken to analyse and adjust elements of the corporate governance framework. These initiatives have used a flexibility and proportionality approach to target aspects of laws and regulations that may be of particular importance to companies of diverse size and at distinct stages of development.

With respect to growth companies, for example, the US Congress passed the Jumpstart Our Business Start-ups (JOBS) Act, aiming at easing the regulatory process for passing the registration threshold and lowering the costs to remain listed.[23] Another example involves the changes in UK regulations following the Kay Review of UK Equity Markets and Long-Term Decision Making.[24] Other initiatives include regulatory adjustments in Israel to allow for a longer transition period to implement corporate governance rules that are associated with a full IPO and scaling with respect to disclosure requirements for companies under a certain size. In Italy, smaller companies may enjoy differential treatment with respect to issues such as the disclosure of major shareholdings, mandatory bid thresholds and procedures for related party transactions.

Several jurisdictions are also reconsidering their attitude toward the one-share-one-vote principle with a view to allow and/or encourage long-term investments which can be particularly relevant for growth companies and, in general, for all companies which are more dependent on intangible assets and on human capital resources. Examples in this direction are provided by France, where the *Loi Florange*[25] has made the loyalty shares with double voting rights the default standards for listed companies; by Italy, where loyalty shares have been made available to listed companies and the ban for multiple voting rights has been removed for IPOs, and by Singapore, whose stock exchange has

introduced a framework to list companies with dual class shares, along with safeguards against risks that come with such a listing structure.

Furthermore, in several jurisdictions a number of initiatives are in place to adapt the local corporate governance codes to the specific features of small and growth companies, in order to overcome the "large companies" bias which usually characterizes codes.[26] Such bias can prevent investors from fairly understanding and evaluating corporate governance practices by those companies. In some cases the initiatives lead to the elaboration of a specific code for listed SMEs, while in others a single code provides for a differentiation of the standards according to companies size and/or stage of development.

An important aspect of a policy making inspired by the flexibility and proportionality approach is the use of the policy tools to create a more flexible framework. This includes a variable combination of "scaled" rules and standards for different categories of companies identified ex-ante, and a larger room for individual companies to deviate from default rules and to make use of contractual freedom to define corporate governance arrangements. While "scaled" rules and standards can be more effective in reducing the burdens on targeted companies, the individual company approach can avoid the problems connected with arbitrary ex-ante identification of different classes of companies and of differentiated regimes and allow companies to define their own model on the base of their specific features and of the desired relationship with stakeholders.

Flexibility and proportionality in the G20/OECD Principles of Corporate Governance

The G20/OECD Principles are strongly aligned with the concept of flexibility and proportionality. Chapter I of the G20/OECD Principles states that the corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources, and that it should be consistent with the rule of law and support effective supervision and enforcement. It further says that the corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives that it creates for market participants and the promotion of transparent and well-functioning markets.

Chapter I recognises that the corporate form of organising economic activity is a powerful force for growth, and that the regulatory and legal environment within which corporations operate therefore is of key importance to overall economic outcomes. The G20/OECD Principles further highlight that policy makers have a responsibility to put in place a framework that is flexible enough to meet the needs of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources.

The annotations add that, where appropriate, corporate governance frameworks should allow for flexibility and proportionality, in particular with respect to the size of listed companies, but also with respect to other factors such as the company's ownership and control structure, geographical presence, sectors of activity, and the company's stage of development. The annotations further state that in the design of the regulatory framework, policy makers should remain focussed on ultimate economic outcomes and, when considering policy options, they should undertake an analysis of the impact on key variables that affect the functioning of markets. For example, in terms of incentive structures, the efficiency of self-regulatory systems and when dealing with systemic conflicts of interest.

Last but not least, the Methodology for Assessing the Implementation of the G20/OECD Principles of Corporate Governance (OECD, 2017 (1)) notes that the views of the corporate sector with respect to how they rate the flexibility of the corporate governance framework (e.g. is it regarded as too much "one size fits all" and as not addressing the specific needs of business), are useful in forming an assessment of the quality of the regulatory framework.

In conclusion, flexibility and proportionality are at the centre of some of the most significant trends shaping corporate governance frameworks and can be an effective policy tool to address some of the regulatory challenges ahead. The next two sections of this report will describe the research conducted by the Committee to take stock of the use of flexibility and proportionality within the corporate governance frameworks of jurisdictions participating in the Committee.

Notes

[1] The Committee has produced six thematic peer reviews until this date: Risk Management and Corporate Governance; Supervision and Enforcement in Corporate Governance; Board Member Nomination and Election; Related Party Transactions and Minority Shareholder Rights; The Role of Institutional Investors in Promoting Good Corporate Governance, and Board Practices: Incentives and Governing Risks.

[2] The area of pre-emptive rights was not chosen for an in-depth analysis.

[3] See more online at: www.sec.gov/spotlight/jobs-act.shtml.

[4] The EU's Accounting Directive (2013/34/EU) which regulated accounting requirements for firms within the Union, aims at doing so "designing and delivering regulation of the highest quality whilst respecting the principles of subsidiarity and proportionality and ensuring that the administrative burdens are proportionate to the benefits they bring". For that, it defines different categories of companies (micro undertakings, small, medium, or large undertakings/groups) based upon criteria such as balance sheet size, net turnover, and average number of employees during the financial year. Similarly, one of the stated aims of the EU's Transparency Directive (2013/50/EU) was "to make the obligations applicable to listed small and medium-sized enterprises more proportionate, whilst guaranteeing the same level of investor protection".

[5] Concerning listing rules, Borsa Italiana established a listing segment dedicated to midsize companies who voluntarily adhere to and comply with high transparency and high disclosure requirements, high liquidity (minimum 35% of free float), and corporate governance in line with international standards.

[6] Article 50 Bis of the Chilean Stock Company Law states that listed companies must appoint at least one independent director when they have a market capitalisation equivalent to or greater than USD 85 million (measured in a peso-denominated unit) and at least 12.5% of its issued voting shares are held by investors that individually control or hold less than 10% of such shares.

[7] Under the 1987 Act on Board Representation for Employees in Private Employment, Swedish employees have the right to elect 2 board members in almost all companies with more than 25 employees and 3 board members in companies with more than 1 000 employees which operate in several industries.

[8] See more about the UK's Green Paper on Corporate Governance Reform online at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf.

[9] The UK's Kay Review of Equity Markets and Long-term Decision Making touched upon flexibility and proportionality issues as well, arguing that the government and regulatory policy should aim to ensure there are no unnecessary disincentives to using equity markets, either for companies or investors. See more online at: www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making.

[10] See more about this consultation online at: https://ec.europa.eu/info/consultations/finance-2017-barriers-listing-smes_en.

[11] This "simplified joint-stock company" was the first hybrid legal form enacted under French law and was based on common law principles with a structure similar to a limited liability company under United States Delaware Law. The firm has a single controlling person (Président or chairperson) and no board, and may have a separate Directeur Général for the operation of the company, but this is not required. See: www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000000727529&categorieLien=id.

[12] As stipulated in the Treaty on the Functioning of the European Union (as reinforced by the European Court of Justice case-law), the freedom of establishment and the freedom to provide services guarantee mobility of businesses and professionals within the EU. According to this, self-employed persons and professionals or legal persons within the meaning of Article 54 of the Treaty who are legally operating in one Member State may carry on an economic activity in a stable and continuous way in another Member State. This implies eliminating discrimination on the grounds of nationality and, if this freedom is to be used effectively, the adoption of measures to make it easier to exercise, including the harmonisation of national access rules or their mutual recognition. See more online at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A61997CJ0212.

[13] For a review of the use of contractual freedom in the governance arrangements of publicly traded LLCs in the US, see "The Governance of Publicly Traded Limited Liability Companies".

[14] Concerning regulation, differential treatment for "small companies" is provided with respect to major shareholdings disclosure, takeover rules, and related party transactions.

[15] The recent answer from the UK government to the green paper agrees to explore this policy (Department for Business, Energy & Industrial Strategy, 2017).

[16] See more online at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2014%3A213%3AFIN.

[17] These include sales of shares by the founders.

[18] See OECD Equity Market Review of Asia 2017

[19] In "In Search of New Foundations", Zingales highlights the evolution of the corporation that emerged after the second industrial revolution towards that of our times. About the first one, he describes its main features as: i) It was asset intensive (which required great access to a limited offer of financing); ii) The size of the investment needed to enter the market created a huge barrier for competition, which therefore was low; iii) It was vertically integrated (managed all parts of the production and commercialization process internally); iv) It had high control over employees (there was no outside market for specialized workers as the firm was dominant in their market), and v) Power was concentrated at the top, creating an agency risk due to separation of ownership and control. According to his analysis, this model gave us the corporate governance approach focused on shareholder control, investor protection, accountability and transparency. But that model evolved overtime and the XXI century firm has developed away from its predecessor: i) Physical assets are less unique and as a result of better legal protection, intellectual assets are generating more value; ii) It is less dependent on financing to enter the market (also financing has become more accessible) and it is subject to significant competition which demands more innovation and efficient management of costs; iii) It is no longer vertically integrated (to the point

it is hard to determine the contours of the firm itself due to varying degrees of association and/or cooperation within the supply chain), iv) It has less control over employees (there is a great outside market of competitors and financing for leaving employees), and v) Control from the top is diluted, leading to a challenge to establish power to keep the firm from the risk of disintegration.

[20] SNAP, the parent company of the start-up behind the popular phone application 'Snapchat' conducted its IPO in 2017 where it offered investors only shares without voting rights, a first for an IPO in the US. See more online at: www.reuters.com/article/us-snap-ipo-investors-idUSKBN1685R0.

[21] Source: Japan, Flow of Funds, Bank of Japan; United Kingdom, Ownership of UK quoted shares, Office for National Statistics; United States, Financial Accounts, L. 223 Corporate Equities, Federal Reserve.

[22] Source: OECD Global Pension Statistics, Pension Markets in Focus 2017, Figure 2. Total private pension assets include pension funds and other providers of retirement products in 2016.

[23] The US JOBS (Jumpstart Our Business Startups) Act, as defined by the Act itself, aims "to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies." The act defines emerging growth companies as those with total gross revenue of less than USD 1.07 billion and offers them reduced regulatory and reporting requirements for a period of up to five years from their IPO. These include scaled financial reporting requirements for prospectuses and scaled executive compensation disclosure and auditor attestation of internal control over financial reporting. The act also raised from USD 5 million to USD 50 million the limit of the small issue offering exemption from Securities and Exchange Commission ("SEC") registration requirements within any 12-month period, as well as increased the shareholder threshold to register a class of equity securities with the SEC from 500 to 2 000 persons (or 500 or more persons who are not accredited investors).

[24] The UK's Kay Review touched upon flexibility and proportionality issues as well, arguing that the government and regulatory policy should aim to ensure there are no unnecessary disincentives to using equity markets, either for companies or investors.

[25] The *Loi Florange* was promulgated in March 2014 and aims to support long-term shareholders by permitting the generalization of double voting rights for registered shareholders holding their shares for more than two years before a vote. See more online at: www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000028811102&categorieLien=id.

[26] For more information on the use of corporate governance codes see 2017 OECD Corporate Governance Factbook.

References

Çelik, S., G. Demirtaş and M. Isaksson (2015), "Corporate Bonds, Bondholders and Corporate Governance", OECD Corporate Governance Working Papers, No. 16, OECD Publishing, Paris, http://dx.doi.org/10.1787/5js69lj4hvnw-en

Çelik, S. and M. Isaksson (2013), "Institutional Investors as Owners: Who Are They and What Do They Do?", OECD Corporate Governance Working Papers, No. 11, OECD Publishing, Paris, http://dx.doi.org/10.1787/5k3v1dvmfk42-en

European Commision (2014), "COM 2014/213 EU Shareholders' Rights Directive Propossal", http://eur-lex.europa.eu/resource.html?uri=cellar:59fccf6c-c094-11e3-86f9-01aa75ed71a1.0003.01/DOC_1&format=PDF

European Commission (2017), Consultation Document - Building a Proportionate Regulatory Environment To Support SME Listing, https://ec.europa.eu/info/sites/info/files/2017-barriers-listing-smes-consultation-document_en.pdf.

Isaksson, M. and S. Çelik (2013), "Who Cares? Corporate Governance in Today's Equity Markets", OECD Corporate Governance Working Papers, No. 8, OECD Publishing, Paris, http://dx.doi.org/10.1787/5k47zw5kdnmp-en.

OECD (2015)(1), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, https://doi.org/10.1787/9789264236882-en.

OECD (2015)(2), Growth Companies, Access To Capital Markets And Corporate Governance: OECD Report To G20 Finance Ministers And Central Bank Governors, http://www.oecd.org/g20/topics/framework-strong-sustainable-balanced-growth/OECD-Growth-Companies-Access-to-Capital-Markets-and-Corporate-Governance.pdf.

OECD (2017)(1), "Methodology for Assessing the Implementation of the G20/OECD Principles of Corporate Governance", https://doi.org/10.1787/9789264269965-en.

OECD (2017)(2), "OECD Corporate Governance Factbook 2017", http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.

OECD (2017)(3), "OECD Equity Markets Review: Asia 2017", http://www.oecd.org/corporate/oecd-equity-markets-review-asia.htm.

UK Department for Business, Energy & Industrial Strategy (2016), "Corporate Governance Reform Green Paper", http://www.gov.uk/beis.

UK Department for Business, Energy & Industrial Strategy (2017), Corporate Governance Reform: The Government response to the green paper consultation, http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640470/corporate-governance-reform-government-response.pdf.

Chapter 2. Scope and methodology of the thematic reviews

This section presents the methodology and the process for conducting the thematic reviews, including an online questionnaire to take stock of the use of flexibility and proportionality in corporate governance frameworks across jurisdictions. It also addresses some issues with respect to the interpretation and use of the data.

Research design

To conduct the thematic reviews, the OECD Corporate Governance Committee decided to use an online questionnaire. The questionnaire surveyed the criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating to the seven different areas of regulation that were subject to review.

The survey focused mainly on the mandatory elements of the corporate governance framework; typically company law, securities law and listing requirements. Codes of corporate governance, which are indeed important in many frameworks, are often applied on a voluntary comply-or-explain basis (that in itself is a flexibility and proportionality tool). For this reason, respondents from jurisdictions where following the code is voluntary (including 'comply-or-explain' regimes) were in their responses invited to consider only the flexibility and proportionality features explicitly included in the text of the code recommendations themselves.[1] The Committee also opted to exclude any other voluntary source beyond national codes, including any self-regulatory arrangements, voluntary commitments, and business practices.

In order to limit the scope of a potentially extremely extensive data collection exercise covering all aspects of the corporate governance framework, seven areas of regulation were chosen to be reviewed:

- 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
- Takeovers
- Pre-emptive rights

The questionnaire offered a list of possible criteria that may motivate and allow for flexibility and proportionality with respect to the implementation of rules that relate to the regulatory areas listed above. For some of the criteria, the survey also offered a subcategory of more detailed criteria (for example size can be used in relation to size of market capitalisation, size of equity, size of workforce, etc.) that for the purpose of the survey are referred to as "dimensions" of the different criteria.

Table 2.1. The criteria and dimensions surveyed

Size	Ownership/control structure	Listing/publicly traded	Maturity of the firm	Accounting standards used	Legal form
Size of equity	Controlling shareholder	Listing level			
Size of sales	Blockholders	Listing venue			
Size of revenues	Free float	Debt only listing			
Size of assets	Subsidiaries of listed companies	Cross-listing			
Size of debt	Private placements	Trading in alternative trading platforms			
Size of work force	Large privately owned firms				
Size of market capitalisation					

Source: OECD Survey.

For each of the reviewed areas of regulation, the survey asked jurisdictions to identify the criteria (and in some cases also the dimensions within each criterion) that are used to motivate and allow flexibility and proportionality. Respondents could select more than one criterion and if an area of regulation had flexibility and proportionality provisions motivated by other criteria than those listed in the questionnaire, respondents were asked to add it by choosing the answer "other" and explain the criteria. If there were no criteria allowing for flexibility and proportionality in an area of regulation, they were invited to respond "none".

The survey also inquired about the use of "opt-in" and "opt-out" mechanisms in the corporate governance framework. This question aimed at identifying flexibility mechanisms within the laws and regulations that enable companies to "opt-in" or "opt-out" of some practice, right or obligation that in the absence of that option would not be mandatory for them (in the case of the opt-in) or would be the default mandatory rule (in the case of the opt-out). Respondents were invited to identify the use of such mechanisms in the seven areas of regulation and to offer a brief description of its scope.

Respondents were also invited to explain how the criteria and mechanisms allow for flexibility and proportionality when they are applied and a reference to the law, regulation or other rules that contain the relevant provisions.

Finally, the survey included questions regarding the presence of flexibility and proportionality criteria or mechanisms tailored for special sectors of activity (e.g. the financial sector) or for specific types of firms (e.g. state-owned enterprises) in each jurisdiction. The Committee opted to exclude them from the previous more detailed questions as to avoid extending the scope of the exercise too broadly.

Responses and interpretation of results

Respondents were invited to respond to the survey during the month of July 2017 and submitted their answers via the internet (see the annex for the full questionnaire). The response rate was high, with the following 39 jurisdictions responding to the questionnaire: 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, and United States.

A detailed analysis of the responses showed that there was room to improve the comparability and quality of some of the data collected, as jurisdictions with quite similar rules and settings sometimes responded to questions in different manners. This is of course an inherent problem of interpretation which the research design could not fully overcome. The Committee delegates were therefore invited to review their answers during December 2017 when some jurisdictions did modify their responses.

Despite the attempts to improve the comparability of the data, the interpretation of the findings presented in this report entails some challenging aspects that the Committee agreed should be presented clearly in this section of the report. This aims to prevent that the results are read in ways that could lead to wrong conclusions about the relative strength or weakness of the frameworks of different jurisdictions, or to how flexible or proportionate their rules are, which was not the point of the exercise.

First, national delegates responding the survey at times interpreted the scope of the exercise in different manners. Some of them narrowed the scope of the flexibility and proportionality rules and practices they reported to those mostly applied to listed companies, while others also included rules and practices relevant to all companies.[2] This means that in some instances it may be that some jurisdictions may have the same degree of flexibility, but the answers provided may differ in scope causing the appearance that their frameworks has more or less flexibility or proportionality provisions.

Second, the survey listed a number of criteria and dimensions to assess the use of flexibility and proportionality, and also asked jurisdictions to name and describe any other relevant criteria the may use but were not included in the survey list. Many responses included these under "other criteria" and they are presented in the report data, but due to their heterogeneity, this report may not fully capture the full range of flexible and proportionate practices available in some jurisdictions.

Third, the fact that any given jurisdiction uses more or less interventions to introduce flexibility and proportionality may also have to do with the design of the regulatory framework. Within a framework of extensive use of hard law to set mandatory rules for everyone, it would be expected to find more evidence of interventions to introduce flexibility and proportionality than in a framework where the principles are inverse, and only a few rules are made mandatory for specific subjects under a set of given circumstances, and everything else is subject to contractual freedom.[3] This means that a country that does not use any of the criteria listed in the report can nonetheless allow for a great degree of flexibility and proportionality.

For these reasons, the Committee encourages the reader of this report to make use of these findings in line with the ultimate objective of the research, which is to map actual practices and facilitate the implementation of better corporate governance rules and practices in line with the recommendations of the G20/OECD Principles. The expectation is that the findings presented here will enable policymakers, stakeholders and businesses to gain insight into the corporate governance rules and arrangements of a wide range of jurisdictions that use flexibility and proportionality as an approach to functional and outcome oriented regulation

Notes

[1] This means that respondents were asked to avoid offering responses related to the myriad of existing or hypothetical "explanations" that companies under unique circumstances may provide for deviations from the code by applying higher or alternative practices. For example, if the code says that companies with boards comprised of more than five directors should have a remuneration committee, respondents were invited to select only the criteria "Size", and then to add the dimension "Size of the board". Of course, there may be an unlimited number of explanations why a specific company at a specific point in time chooses to "explain" a deviation from the code. But this follows logically from the nature of the "comply or explain" code as a "flexibility" instrument in its own right, so delegates were not asked to provide information about such "explanations".

[2] For example, delegates from the Netherlands interpreted the questionnaire to deal with listed companies only. This means that, in the responses from the Netherlands to the questionnaire, no distinction was made between listed and non-listed companies.

[3] The Delegates from Norway expressed this view about their framework.

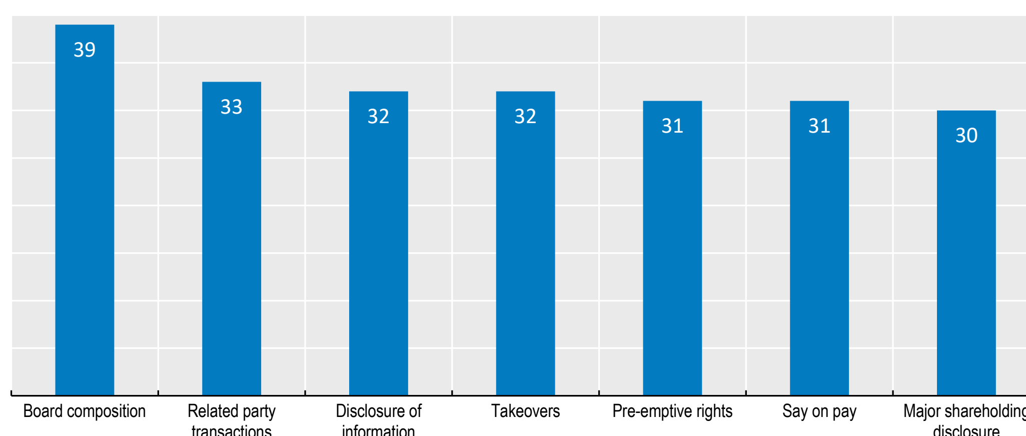
Chapter 3. Overview of survey results

This section presents an overview of the results of the survey that was conducted to take stock of the use of flexibility and proportionality in corporate governance frameworks across jurisdictions.

Flexibility and proportionality across jurisdictions

The survey shows that for all the areas of regulation that were reviewed, a vast majority of jurisdictions had at least one criterion or mechanism that allowed for flexibility and proportionality (Figure 3.1.). In the area of regulation of board composition, board committees and board member qualifications all of the 39 jurisdictions reported that they had criteria and mechanisms that allowed for flexibility and proportionality. In the remaining areas of regulation more than 75% of the jurisdictions reported that they had proportionality and flexibility criteria in place, with major shareholding disclosure being the regulatory area where the lowest number of jurisdictions reported that they had criteria that allowed for flexibility and proportionality.

Figure 3.1. Number of jurisdictions with *at least one* criterion or optional mechanism in the areas of regulation



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 3.1.). 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 3.1. 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	●	○	●	●	○	●	●

	Board composition	Disclosure of information	Major shareholding disclosure	Pre-emptive rights	Related party transactions	Say on pay	Takeovers
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**

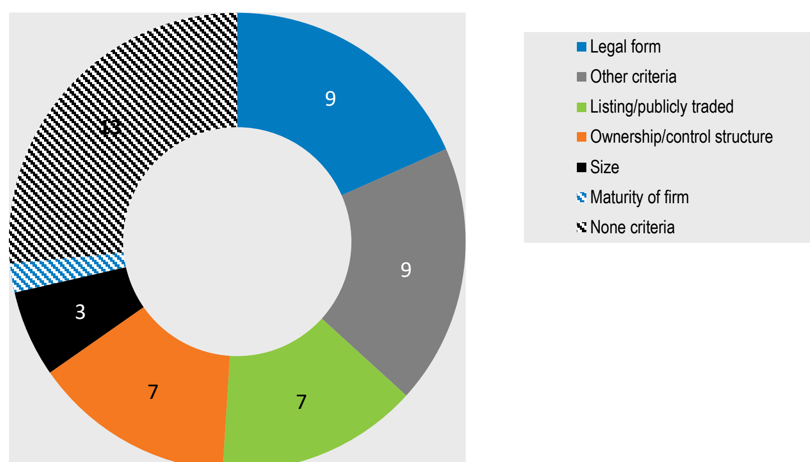
Source: OECD Survey.

Flexibility and proportionality by area of regulation

Pre-emptive rights

In the area of pre-emptive rights, 31 out of the 39 jurisdictions reported that they had criteria that allowed for flexibility and proportionality. Some of the jurisdictions reported more than one criterion. The most frequent criteria were the *ownership/control structure* and the *listing/publicly trading* and *legal form,* which accounted for about 75% of the responses (Figure 3.2.). *Ownership/control structure* is mentioned as a criterion in about half of the responses within the OECD area and in none of the jurisdictions outside of the OECD area, where instead *listing/publicly trading* is the most reported criterion for flexibility and proportionality with respect to pre-emptive rights.

Figure 3.2. Total number of reported criteria for pre-emptive rights



Source: OECD Survey.

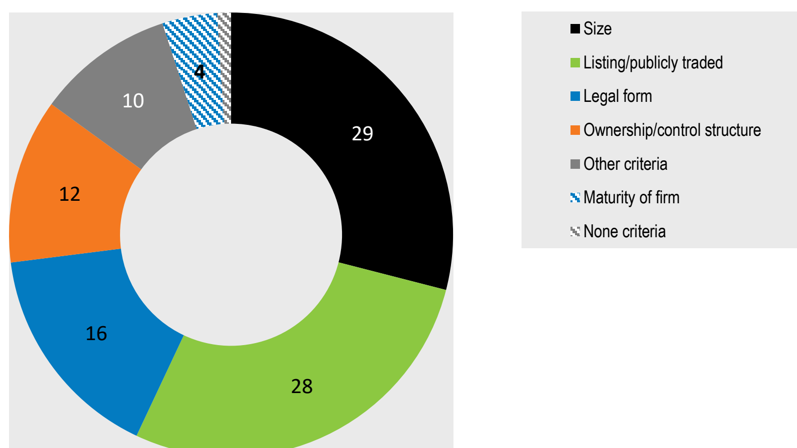
As seen in Figure 3.2., jurisdictions also reported the use of 9 *"other"* criteria (or other dimensions of certain criteria) than those that were provided as options in the survey questionnaire. Examples include the UK that reports that the articles of association of a company or shareholders' agreements may adopt specific pre-emptive regimes for a company. In Germany, the application of the rules may depend on the price of the newly issued shares. In Hong Kong, China, a general or specific mandate needs to be obtained from shareholders pursuant to listing rules, while in Ireland those listing rules allow for exceptions with respect to certain rights issues. In Portugal, a flexible treatment may be conditional on the type of share capital increase while in the Netherlands it may depend on the share class.

Board composition, board committees and board member qualifications

With respect to *board composition, board committees and board member qualifications*, 39 out of the 39 jurisdictions reported that they had criteria that allowed for flexibility and proportionality. Some of the jurisdictions reported more than one criterion. By far the most frequently reported used criteria were *size* (*size of workforce*) and *listing/publicly trading* (*listing level*), followed by *legal form* and *ownership/control structure* (Figure 3.3.).

Examples of the 10 "*other*" reported criteria for flexibility and proportionality with respect to board composition, board committees and board member qualification include the number of shareholders (Belgium), the independence of the board's chairman (Singapore), the size of a company's board (the Netherlands and France); the size of its balance sheet (Portugal and the Netherlands); the size of its net turnover (Latvia and the Netherlands); the type or nature of the company's activity (Lithuania and France); whether it has its operations mainly abroad (Israel); and the rank of the company relative to the rest of the listed market segment (the UK and Australia), among others.

Figure 3.3. Total number of reported criteria for board composition

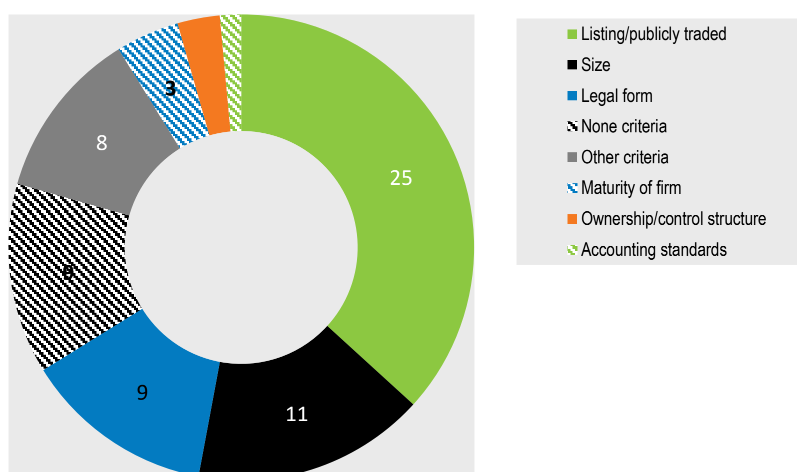


Source: OECD Survey.

Say on pay and the detail of disclosure on remuneration

In the area of *say on pay and the detail of disclosure on remuneration*, 31 out of the 39 jurisdictions reported that they had criteria that allowed for flexibility and proportionality. Some of the jurisdictions reported more than one criterion. Two third of the jurisdictions reported that they used *listing/publicly traded* (*listing level* and *listing venue*) as criteria for flexibility and proportionality, followed by *size* (*size of revenues* and *size of asse*ts) and *legal form* (Figure 3.4). Outside of the OECD area, the *listing/publicly traded* criterion was reported by more than half of the jurisdictions.

Figure 3.4. Total number of reported criteria for say on pay



Source: OECD Survey.

Examples of *among the 8 "other"* criteria that are used to allow flexibility and proportionality with respect to say on pay and disclosure on remuneration include the adoption of a shareholders resolution (UK); options available at the time of listing or registration and issuer status, such as emerging growth company, smaller reporting

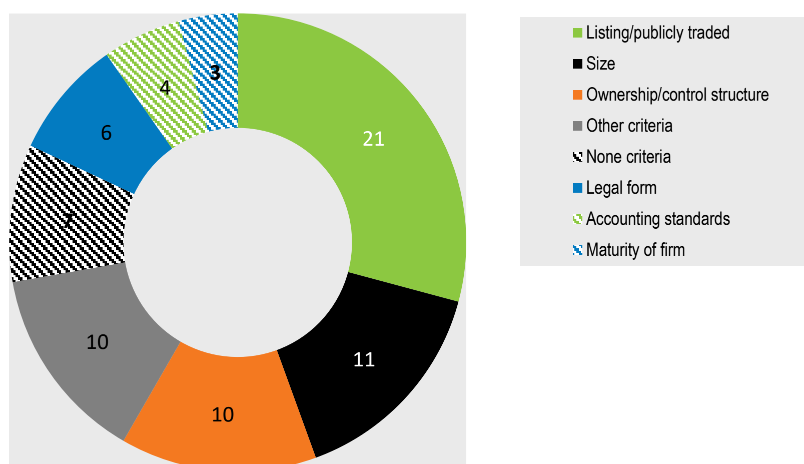
company, or foreign private issuer (U.S.); the company's net turnover and balance sheet total (Germany); the existence of a takeover bid (Ireland); the number of shareholders; the amount of stated capital (Japan); and the qualification of the company as a public interest entity (Portugal).

Related party transactions

In the regulatory area of *related party transactions*, 33 out of the 39 jurisdictions reported that they had criteria that allowed for flexibility and proportionality. Some of the jurisdictions reported more than one criterion. The most frequently reported criteria were *listing/publicly trading* (*listing venue* and *listing level*) and *size* (*size of assets* and *size of revenues*) (Figure 3.5.).

Ten "*other"* criteria were reported including the size of any given transaction (Brazil; Hong Kong, China; Singapore; and the US), the character of the transaction (Singapore); the number of shareholders and the amount of stated capital (Japan). Regulatory exceptions depending on the nature of the offering (U.S. and UK) are also among the "other" criteria for flexibility and proportionality with respect to related party transactions.

Figure 3.5. Total number of reported criteria for related party transactions



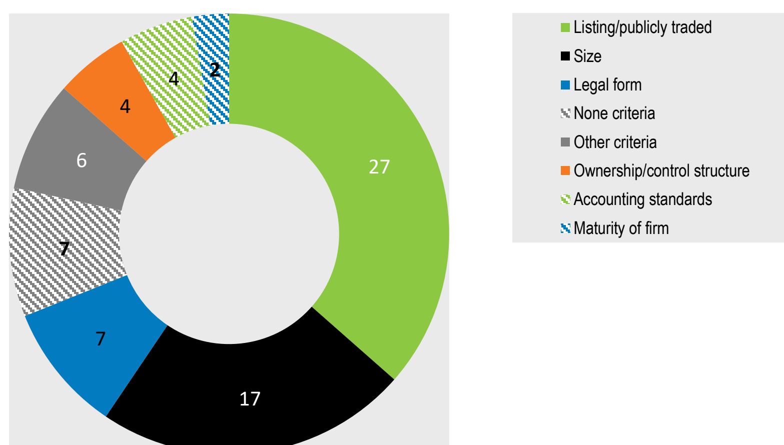
Source: OECD Survey.

Disclosure of periodic financial information and ad-hoc information

Regarding *disclosure of periodic financial information and ad-hoc information*, 32 out of the 39 jurisdictions reported that they had criteria that allowed for flexibility and proportionality. Some of the jurisdictions reported more than one criterion. The most frequently reported criteria for flexibility and proportionality were *listing/publicly trading* (*listing level* and *listing venue*) and *size* (*size of assets* and *size or revenue*s) (Figure 3.6.).

Examples among the 6 "*other"* criteria that jurisdictions reported in this area include the net turnover and balance sheet total of the company (Germany); the number of shareholders (Russia), and a choice by the company made at the time of an offering or registration, as well as size of the offering (U.S.).

Figure 3.6. Total number of reported criteria for disclosure of financial information

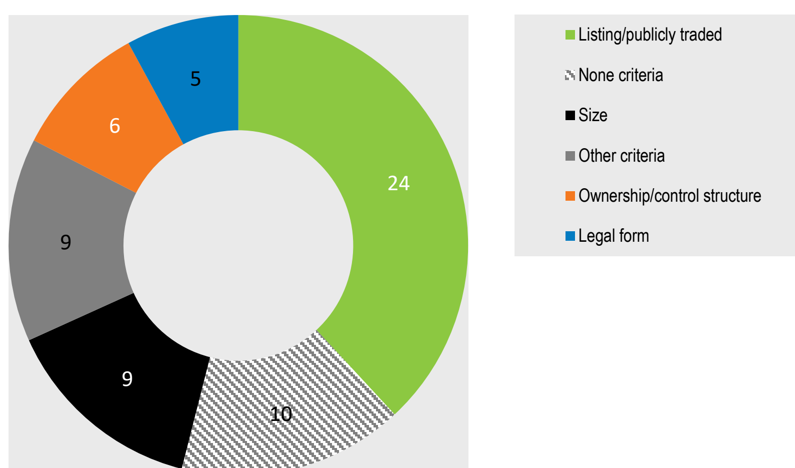


Source: OECD Survey.

Major shareholding disclosure

Within the regulatory area of *major shareholding disclosure*, 30 out of the 39 jurisdictions reported that they had criteria that allowed for flexibility and proportionality. Some of the jurisdictions reported more than one criterion. The most frequently reported criteria for flexibility and proportionality with respect to major shareholding disclosure were *listing/publicly trading* (*listing level* and *listing venue*), *size* and *ownership/control structure.* (Figure 2.7.).

Figure 3.7. Total number of reported criteria for major shareholding disclosure



Source: OECD Survey.

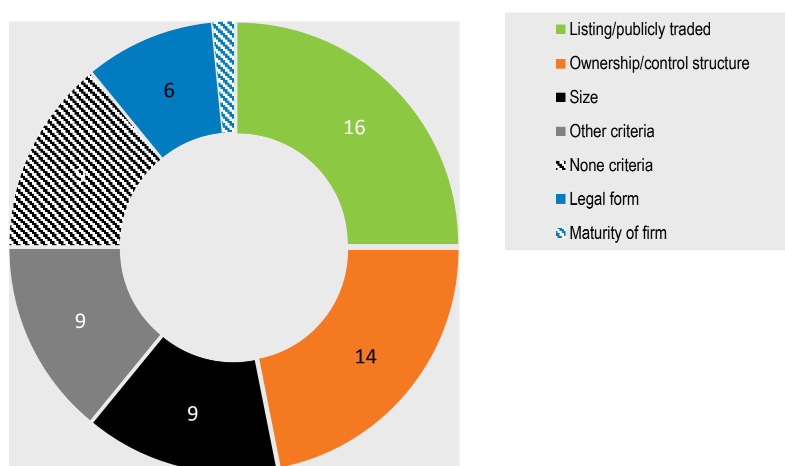
Examples among the 9 "*other*" criteria that were reported include the nature of the investor, including if they are asset managers, private equity and venture capitalist (Italy and Spain); both the number of shareholders and the amount of stated capital (Japan); the

number of shareholders combined with the size of the company's assets, the voting rights and some available exemptions and regulatory options upon making an offering (U.S.).

Takeovers

With respect to *takeovers* 32 out of the 39 jurisdictions reported that they had criteria that allowed for flexibility and proportionality. Some of the jurisdictions reported more than one criterion. The two criteria *listing/publicly trading* (*listing venue* and *listing level*) and *ownership/control structure* (*controlling shareholder*, *blockholders*, *privately owned*) are each reported as criteria for flexibility and proportionality in about one quarter of the responses, followed by *size* (Figure 3.8.).

Figure 3.8. Total number of reported criteria for takeovers



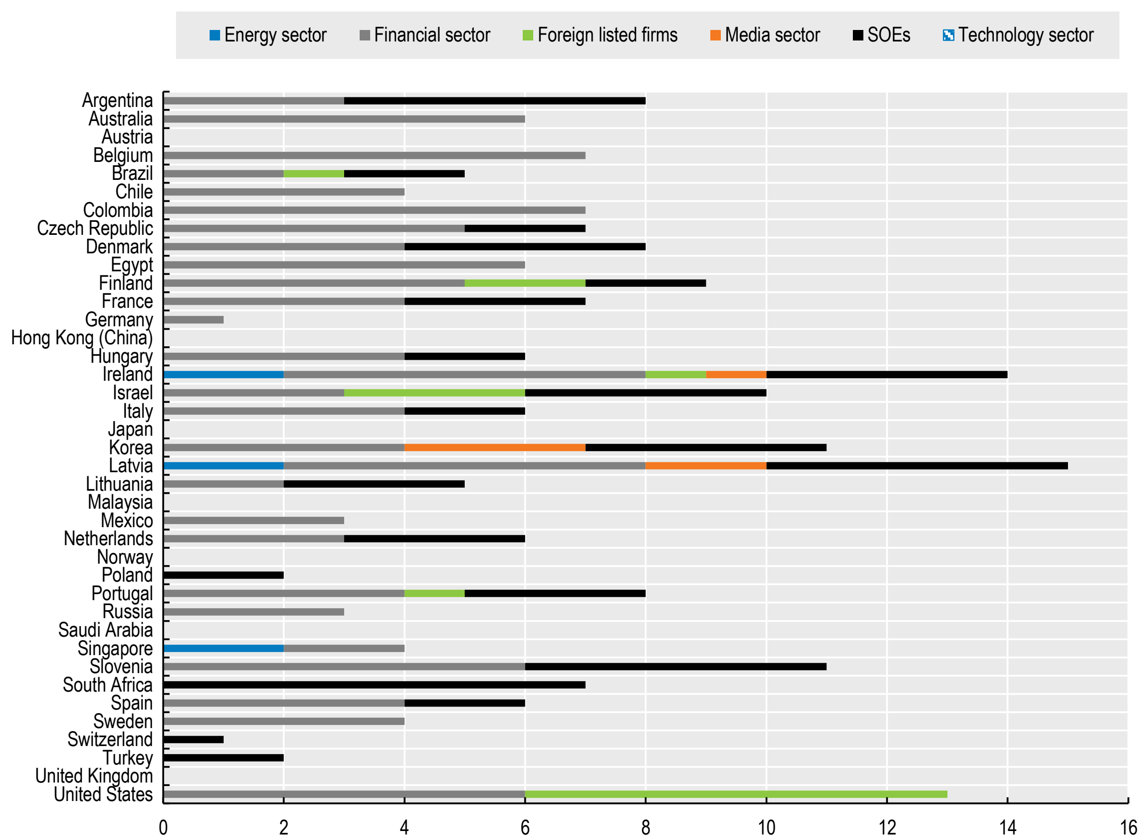
Source: OECD Survey.

Examples among the 9 "*other*" criteria that jurisdictions reported include the number of shareholders (Singapore and Australia); the size, objective and potential impact of the acquisition (Brazil); the rules in the articles of incorporation (France); the number of participants in a non-publicly traded entity, such as cooperative (Italy); the application of exemptions or voting caps (Portugal); the type of consideration offered, the structure of the transaction, and the amount of the equity being sought by the acquirer (U.S.).

Flexibility and proportionality by sectors

An analysis of the responses regarding the use of flexibility and proportionality with respect to different sectors of activity shows that, in line with expectations, most jurisdictions apply flexible and proportional rules for the financial sector (Figure 3.9.). The State-owned sector is also subject to special rules in several jurisdictions. Ireland, Latvia and the United States are the countries that report the most frequent use of criteria for flexibility and proportionality with respect to sectors of activity.

Figure 3.9. Overall use of criteria per sector



Source: OECD Survey.

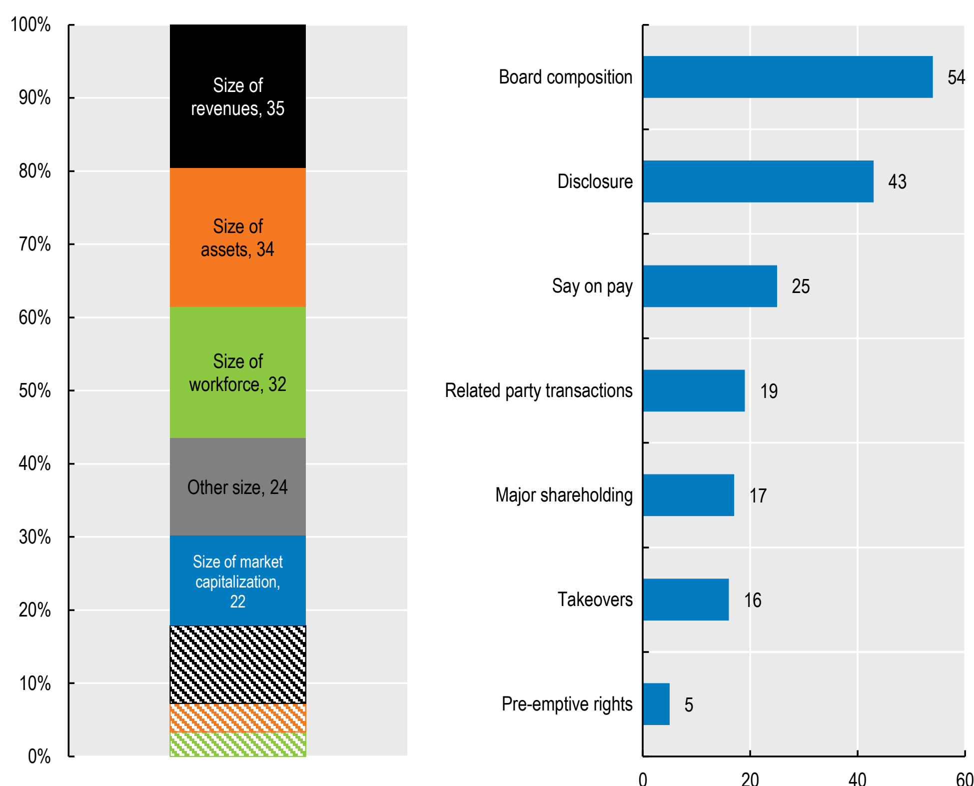
Flexibility and proportionality by criteria

As mentioned above, several jurisdictions have reported more than one criteria for flexibility and proportionality with respect to each of the different areas of regulation that has been surveyed. Jurisdictions have also been asked to report how the different criteria, for example size, are defined. This section provides an overview of how the total number of criteria are defined and how frequently they are used in the different areas of regulation.

Size

Size is the second most frequently reported criterion for flexibility and proportionality. As shown in the left hand panel of Figure 3.10., the most common definitions of size are *size of revenues, size of assets* and *size of workforce*, followed by *size of market capitalisation.*

Figure 3.10. Applications of the *size* criterion and the distribution of the total number of reported *size* criteria between the different areas of regulation



Source: OECD Survey.

Jurisdictions that share EU membership form a group where the use of *size of revenues* and *size of market capitalisation* are about 10 percentage points more commonly used than in the other jurisdictions, most likely because of EU Directives that are implemented in national their regulations. Beyond the EU area other dimensions are more frequently reported, particularly *size of equity*.

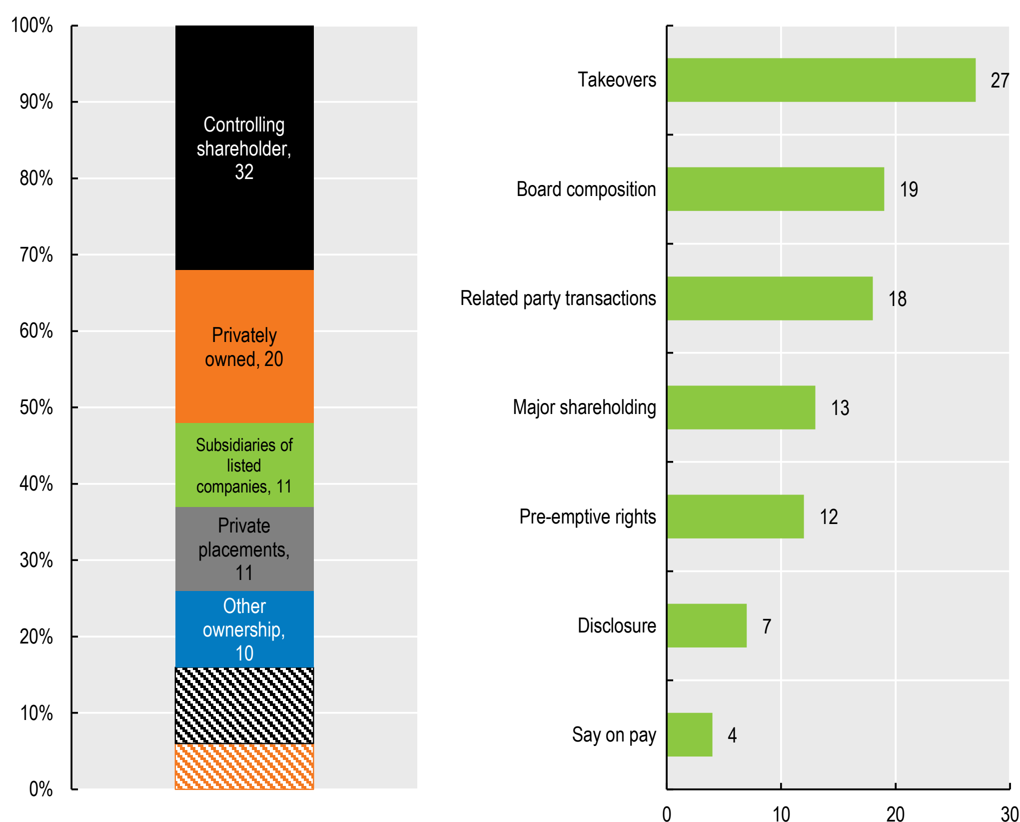
The panel on the right hand side in Figure 3.10. shows how the total number of reported size criteria are distributed between the different areas of regulation. It reveals that the *size* criterion for flexibility and proportionality is most frequently applied with respect to *board composition, board committees and board member qualifications* and to the area of *disclosure of periodic and ad-hoc information*, while it is rather ignored in the area of *pre-emptive rights*.

Ownership/control structure

The *ownership/control structure* is the third most frequently reported criterion for flexibility and proportionality. Figure 3.11. shows that in about half of the responses, it relates to the presence of a *controlling shareholder* and when the firm is *privately owned*. Ownership criteria related to *blockholders* and *free float* were not reported by any non-OECD jurisdictions, while the EU-area jurisdictions use the *controlling shareholder* dimension about 10% more often than other jurisdictions.

The right hand panel of Figure 3.11. shows that the *ownership/control structure* criterion is most often used with respect to *takeover* regulation and for *board composition, board committees and board member qualifications*. Its use for regulation of *say on pay and the detail of disclosure of remuneration* and *disclosure of periodic financial information and ad-hoc information* is rather limited.

Figure 3.11. Applications of the *ownership/control* criterion and the distribution of the total number of *ownership/control* criteria between the different areas of regulation



Source: OECD Survey.

Listing/public trading

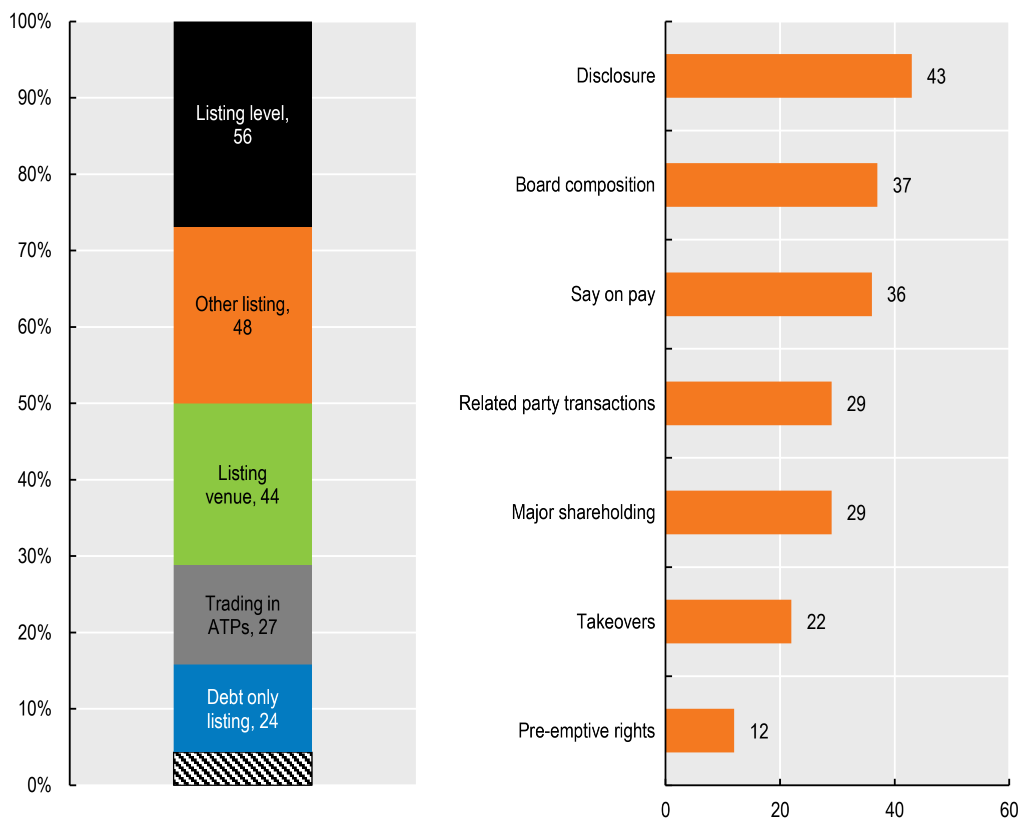
As mentioned above, the *listing/public trading* is the most commonly reported criterion for flexibility and proportionality. The left side panel in Figure 3.12. shows that it is most frequently used in relation to the *listing level* and the *listing venue* of the firm. The results also show that *trading in ATPs* is an almost irrelevant criterion outside the OECD area. Within the EU area, *listing level* is reported by half of the jurisdictions, while outside the EU area it is reported by one third of the jurisdictions. The frequency with which the listing/public trading criteria relates to *listing venue* is basically the same in all areas.

It should be noted that a more detailed analysis of the responses shows that in many instances the *listing/publicly traded* criterion was selected by respondents to indicate that the regulations were applicable only to listed companies. The questionnaire design failed to fully capture this in the default dimensions for the *listing/publicly traded* criterion that were provided (see also Chapter 2). A few respondents took the opportunity to report this

distinction as "other" while most respondents opted to select the *listing level* or *listing venue* dimensions instead, even if it was not necessarily the most relevant answer.

Per area of regulation, the *listing/public trading* criterion is most frequently used with respect to *disclosure of periodic and ad-hoc information* and with respect to requirements for *board composition, board committees and board member qualifications*, closely followed by *say on pay* and the *detail of disclosure of remuneration* (Figure 3.12.).

Figure 3.12. Applications of the *listing/public trading* criterion and the distribution of the total number of reported *listing/public trading* criteria between the different areas of regulation



Source: OECD Survey.

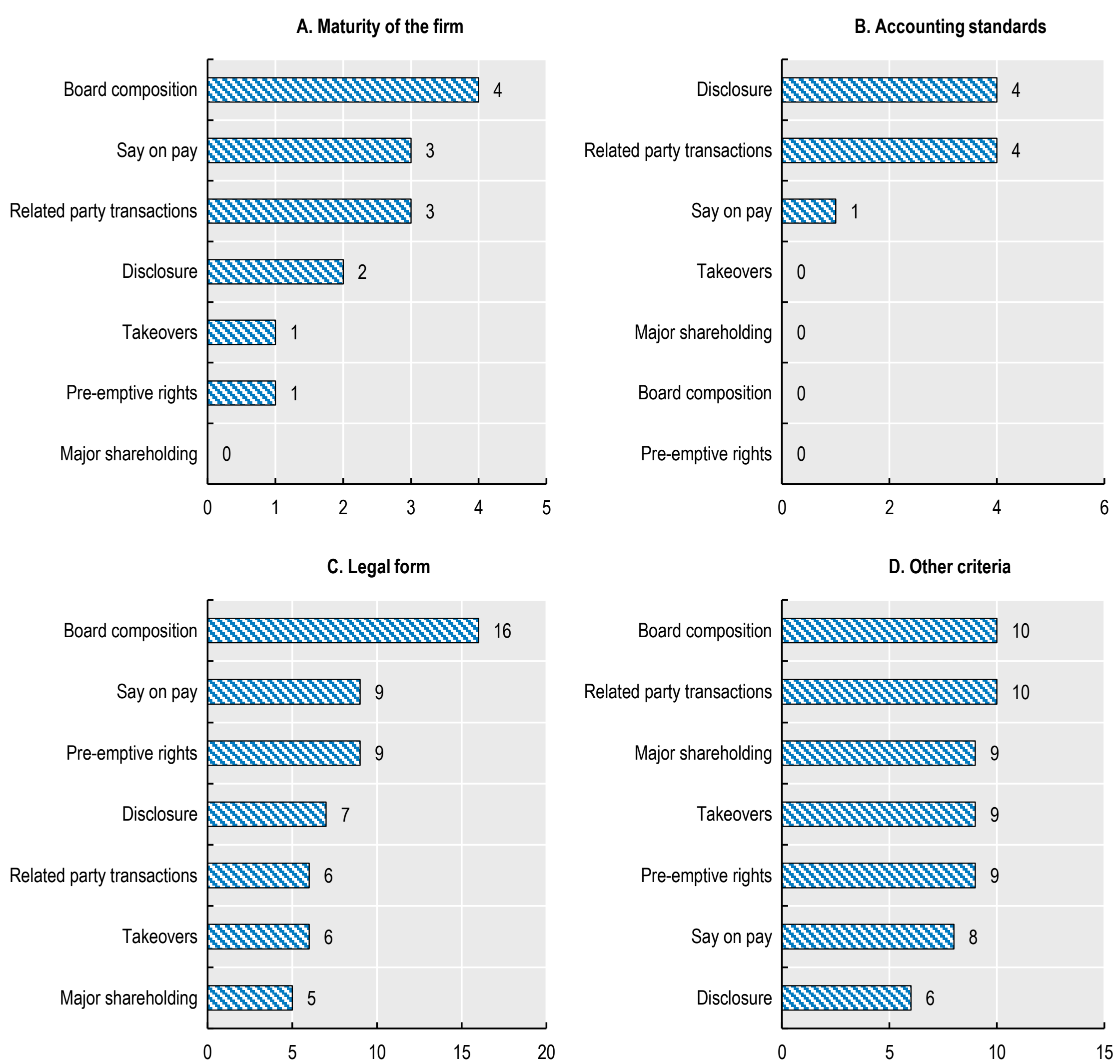
Maturity of the firm

The *maturity of the firm* is one of the criteria included in the review that seem to be less used across the different areas of regulation and across jurisdictions with a total of only 14 criteria being reported (Figure 3.13.A.). Only France, Hungary, Israel, Italy, Korea, Latvia, and the United States reported the use of this criterion. Mostly with respect to *related party transactions* and *board composition, board committees and board member qualifications*, but also for some aspects of disclosure. It should be noted that the *maturity of the firm* criterion to some extent may overlap and serve similar purposes as some of the flexibility and proportionality criteria that are reported with respect to *listing/public trading*.

Accounting standards

Accounting standards as a criterion for flexibility and proportionality received the least responses in the survey, with Denmark, Germany, Lithuania, Portugal, South Africa, the Netherlands, the United Kingdom, and the United States reporting it. In most cases, the criterion was used to provide flexibility and proportionality with respect to *related party transactions* and for some of the regulatory areas related to disclosure (Figure 3.13.B.).

Figure 3.13. The distribution of the total number of reported criteria with respect to *maturity of the firm, accounting standards, legal form and "other"* between the different areas of regulation



Source: OECD Survey.

Legal form

The *legal form* of the firm as a criterion for flexibility and proportionality is reported to be used more often than the *maturity of the firm* and *accounting standards*, but less than all the other criteria. It is reported to be used with respect to all areas of regulation, but is

most often associated with flexibility and proportionality in the areas of *board composition, board committees and board member qualifications* (Figure 3.13.C.).

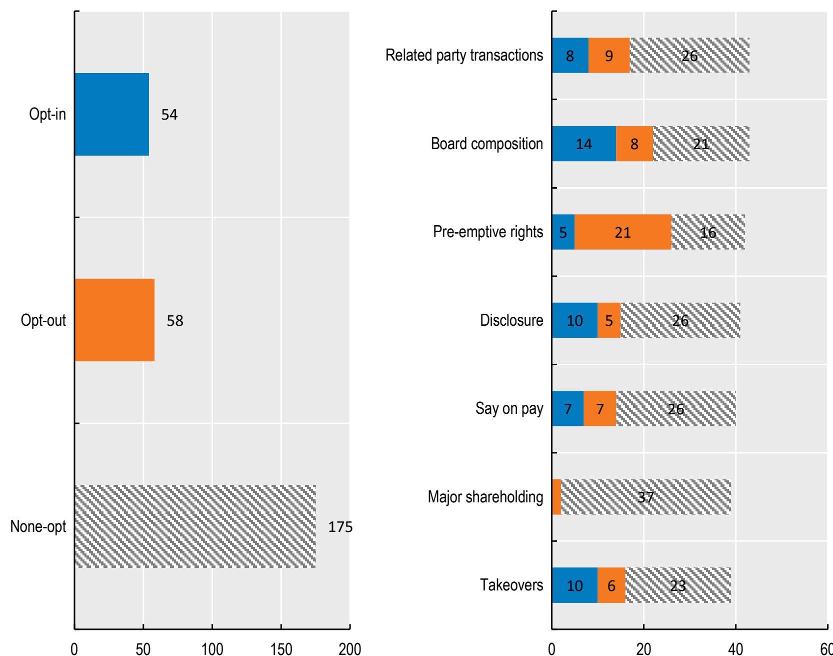
"Other" criteria

Overall the reporting of "*other*" criteria that were not explicitly listed in the survey questionnaire is not negligible. The responses also present a significant variation when it comes to their application and the regulatory areas to which they are applicable. This makes it less meaningful to interpret the aggregated results (Figure 3.13.D.). A more extensive and detailed overview of these additional criteria is therefore provided in respective thematic chapters.

Opt-in and opt-out

The availability of *opt-in* and *opt-out* mechanisms that allow for flexibility and proportionality in the implementation of national corporate governance frameworks is reported for about 40% of the areas of regulation that were surveyed and across almost all 39 jurisdictions. The two possibilities of *opt-in* and *opt-out* were used in similar proportions (Figure 3.14.). EU-area jurisdictions use these mechanisms the most.

Figure 3.14. The overall availability of opt-in and/or opt-out mechanisms and their distribution between the different areas of regulation



Source: OECD Survey.

The use of opt-in and opt-out mechanisms is evenly distributed among the different areas of regulation, with the exception of *disclosure of major shareholdings*, where it is almost not used at all, and the area of *pre-emptive rights*, where it is most common to find *opt-out* mechanisms

Chapter 4. Board composition, board committees and board member qualifications

This chapter presents the results of the review in the area of board composition, board committees and board member qualifications. It takes stock of the criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating to the area across the 39 jurisdictions that responded the survey used for the reviews. It also includes a case study of the British corporate governance framework in the area submitted by Widad Chhibi and Ilaria Miller from the UK Department for Business, Energy and Industrial Strategy (BEIS).

Introduction

Board regulations: background and context

The OECD Corporate Governance Factbook tracks board regulations and practices across the 47 jurisdictions included in its latest edition, noting the different national models of board structures found around the world. Although one-tier boards remain the most common structure (in 19 jurisdictions), a growing number of jurisdictions (12) offer the choice of either single or two-tier boards, consistent with EU regulation for European public limited-liability companies (Council Regulation (EC), 2013). Ten jurisdictions have exclusively two-tier boards that separate supervisory and management functions into different bodies.[1]

Thirty jurisdictions require or recommend a minimum board size of 3 or 5.[2] Seven jurisdictions set forth a maximum board size ranging from 5 to 21, while the others leave it to the company's discretion. For management boards in two-tier systems, only the People's Republic of China (China) and France establish a maximum size requirement, while 10 jurisdictions set a minimum size requirement.

The maximum term of office for board members before re-election varies from one to six years (most commonly 3 years). There are no compulsory limits on the number of re-elections of board members in any jurisdiction. Annual re-election for all board members is required or recommended in 7 jurisdictions but it is more prevalent among companies in many jurisdictions that do not require or recommend annual re-elections.[3]

The recommendation for boards to be composed of at least 50% independent directors is the most common voluntary standard, while two to three independent board members are more commonly subjected to legal requirements. Some jurisdictions link the board independence requirement with the ownership structure of a company.[4] National approaches on the definition of independence for independent directors vary considerably, particularly with regard to maximum tenure and independence from a significant shareholder.

China and 12 European countries have requirements for employee representation on boards, fixing a minimum share of employee representation which varies from one member to half the board members, with one third being the most common. Jurisdictions that require employee board members usually have 2-tier boards or allow for one and two-tier board structures.

Nearly all jurisdictions require an independent audit committee, while the remaining jurisdictions recommend it in corporate governance codes. A full or majority (comprising the chairperson) independence requirement is common.[5] Nomination and remuneration committees are not mandatory in most jurisdictions, although many recommend these committees to be established and to be comprised wholly or largely of independent directors.[6] A majority of jurisdictions require audit committees to have an independent chairperson. Independent chairs are rarely required in nomination and remuneration committees.

In almost all jurisdictions, shareholders can nominate board members or propose candidates. Some jurisdictions set a minimum shareholding requirement for a shareholder to nominate, usually at the same level as the shareholders' right to place items on the agenda of general meetings. A wide variety of voting practices can be observed, with most jurisdictions having established majority voting requirements for board elections,

usually for individual candidates (i.e. not for list) and around half allowing cumulative voting. Seven jurisdictions have special voting arrangements to facilitate effective participation by minority shareholders.[7]

A majority of jurisdictions set out general requirements or recommendations for board member qualifications. Some jurisdictions give more emphasis to the balance of skills, experience and knowledge on the board, rather than on the qualifications of individual board members.[8] About half of jurisdictions require or recommend that some of the candidates go through a formal screening process, such as approval by the nomination committee. Requirements for disclosure of information to shareholders on candidate qualifications is lacking in many jurisdictions, with significant variations regarding more specific requirements.

Issues and trends

The well-functioning of boards and their capacity to steer companies towards long term profitability has been considered an evolving challenge that not only has to manage the changing landscape at company level, but also national and global trends. New issues, technological developments and societal attitudes constantly introduce new risks and opportunities that boards need to understand and manage when serving the interest of the company and its shareholders.

The ownership landscape for companies has also significantly changed, so boards more often have to interact with controlling or block holding shareholders than dispersed owners. Institutional investors, in turn, have also concentrated and amassed large stakes in many firms that make them relevant counterparts, even if they hold those assets on behalf of thousands of retail investors or future pensioners (Çelik and Isaksson, 2013).

As the case study of the UK shows, these developments have put boards under strong scrutiny. In some jurisdictions there is a perception that they have neglected their broader legal and fiduciary responsibilities, particularly vis-à-vis stakeholders, and have somehow lost control of the link between executive pay and the performance of the company that they are to ensure.

Boards have been encouraged to engage more in dialogue with employees, customers, suppliers, and wider stakeholders to improve their decision-making and build confidence. This is part of an ongoing trend towards an increased professionalisation of the board duties linked to an ever increasing level of responsibility and accountability. Some argue that boards need to perform these functions to ensure the company is in compliance with the expectations, while others claim that it may also be distracting them from performing the long term stewardship functions discussed above.

And if this debate is taking place in the context of listed companies, subject to the scrutiny of the market and regulators, the concerns about the behaviour of large, privately-owned companies, is in some cases even larger. In the absence of transparency about their practices, which may be as consequential for stakeholders as those of a listed firm, some have proposed that large privately-held companies should also adhere to minimum corporate governance requirements.

The view of the G20/OECD Principles

The G20/OECD Principles devote an entire chapter to the responsibilities of the board, which are defined as ensuring the strategic guidance of the company and the effective monitoring of management, while remaining accountable to the company and the

shareholders. The annotations refer to the diversity of board structures illustrated in the preceding paragraphs, but clarify that they are intended to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management.

The G20/OECD Principles state that the board should be able to exercise objective independent judgement on corporate affairs. This independence and objectivity usually requires that a sufficient number of board members will need to be independent of management, and that objectivity and independence in single tier boards may be strengthened by establishing a separation of roles between the chief executive and the chairperson. The designation of a lead director is an alternative good practice, which is often complemented by the appointment of a company secretary. But the objectivity of the board may also require independence from a dominant shareholder. In this case, the G20/OECD Principles recommend that they must remain faithful to their fiduciary responsibility to the company and to all shareholders, including minority shareholders.

Setting up specialised committees to support the board in performing its functions, particularly in respect to audit, and, depending upon the company's size and risk profile, also in respect to risk management and remuneration is another relevant consideration. When committees of the board are established, the G20/OECD Principles state that their mandate, composition and working procedures should be well defined and disclosed by the board.

Employee representation on the board is another area covered by the G20/OECD Principles recommendations. Without taking a position as whether it should be mandated by law or collective agreements or not, they recommend that where present, employee representation should be supported by information and training mechanisms. Those mechanisms will facilitate that workers' representatives at the board can have a real opportunity to contribute to the enhancement of board performance, by improving independence, competence and information. Employee representatives should have the same duties and responsibilities as all other board members, and should act in the best interest of the company.

Flexibility and proportionality with respect to board composition

The ability of the corporate governance framework to facilitate the formation of boards that are fit for the individual firm they serve, but that can also handle these changing landscapes, is necessarily an exercise of flexibility and proportionality. That is one of the reasons why many jurisdictions have adopted flexibility and proportionality mechanisms in their governance frameworks to determine important rules like the size or the board, the number or independent directors in it, and the committees they should sit on. The most common of these is the use of codes of corporate governance. When set up under a comply or explain system, they provide enough room for companies to find the parameters that best solve the needs they have, while demanding a reasonable explanation if they depart from what is regarded best practice.

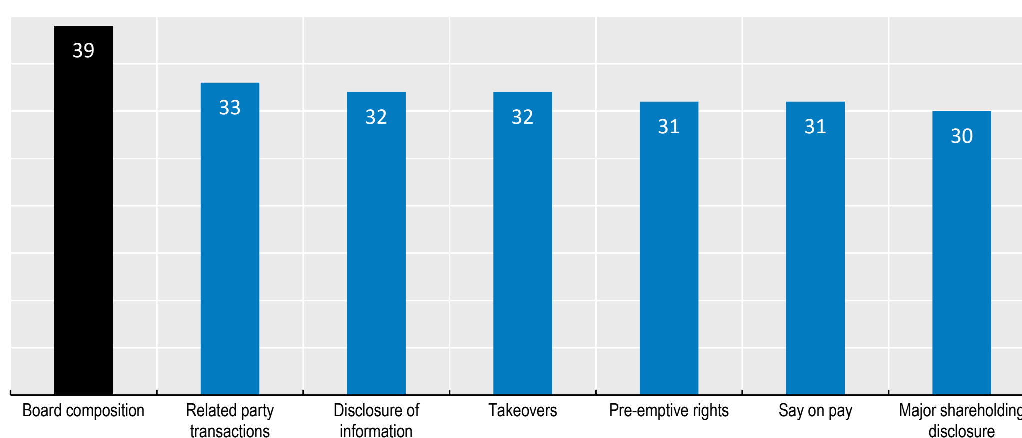
Even in jurisdictions with a long tradition of well-functioning boards, with good guidance as to what best practices are and high levels of compliance with Code's recommendations, such as the UK case study shows, boards are under scrutiny. There is a perception that the expectations of shareholders, regulators and society are intermittently not met by prominent corporate governance failures and that may erode trust in businesses.

Pressure mounts in such cases towards the introduction of new requirements for the board to comply with, setting additional levels of accountability, or expanding the reach of some rules, either by escalating their coverage or making them mandatory. These interventions may or may not have the capacity to achieve the results desired – as corporate governance may not be the best tool for fixing some of the problems (ICSA: The Governance Institute, 2017) – but a flexible and proportional approach may be key to ensure that reforms can be successful with the least possible unintended consequences over the corporate governance framework as a whole.

Survey results

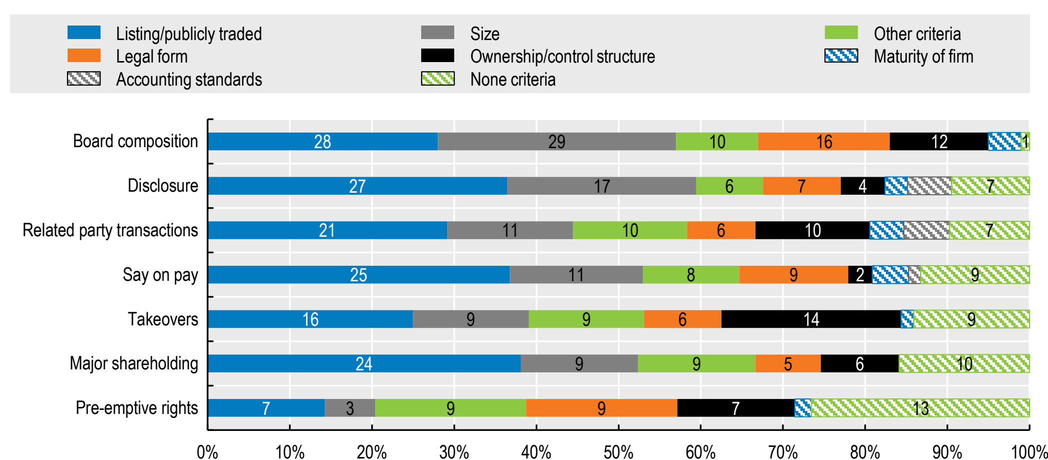
All of the 39 jurisdictions included in the survey reported at least one criteria or optional mechanism that allow for flexibility and proportionality in the area of board composition, board committees and board member qualifications (Figure 4.1.).

Figure 4.1. Frequency of use of criteria and optional mechanisms per area of regulation



Source: OECD Survey.

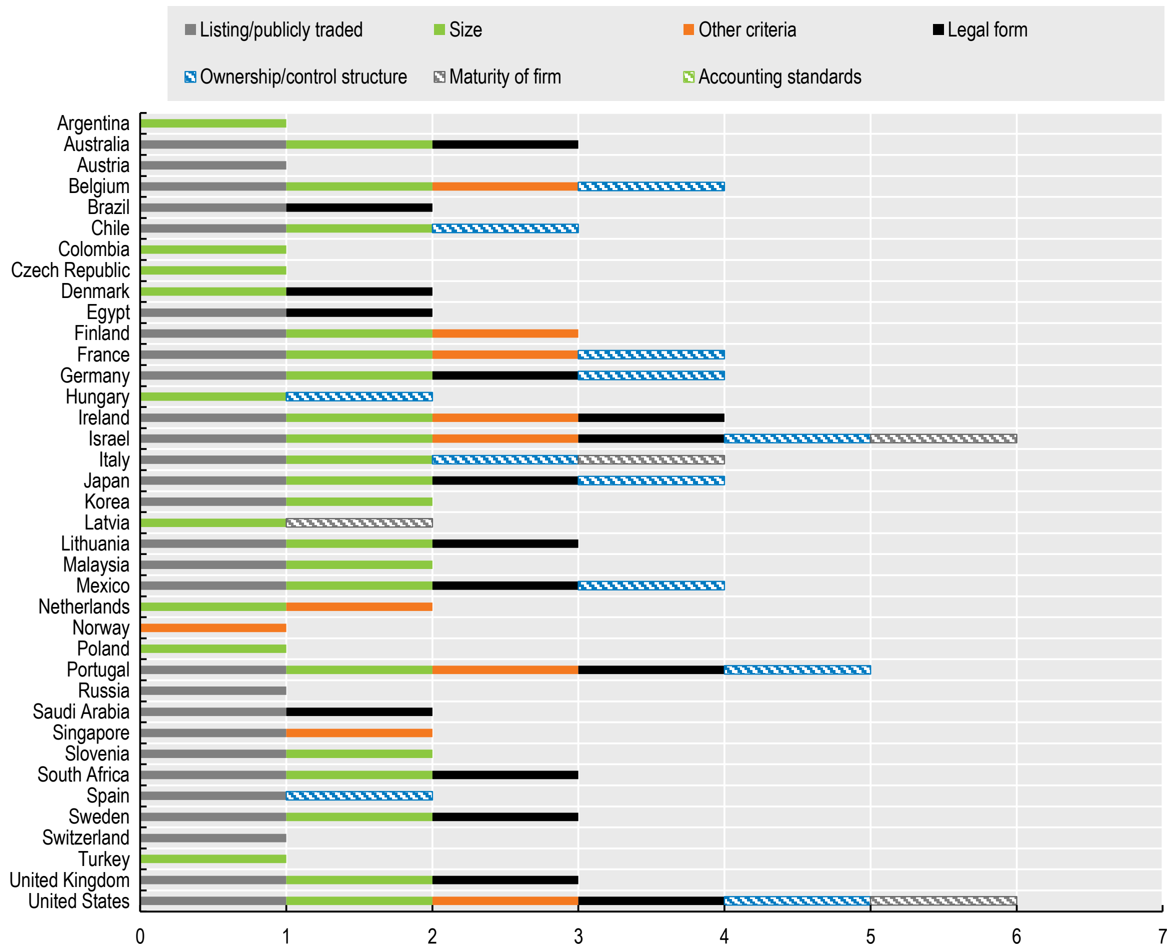
Figure 4.2. Overall use of criteria across all areas of regulation



Source: OECD Survey.

As described in the main chapter of this thematic review, among all the criteria that jurisdictions employ to promote flexibility and proportionality in their corporate governance frameworks, the criterion of *listing/publicly trading* and the criterion of *size* are by far the most used when considering all areas of practice (Figure 4.2.). This is also the case in the area of board composition, board committees and board member qualifications. Figure 4.3. shows the frequency and distribution among different types of criteria that jurisdictions have reported, on a jurisdiction by jurisdiction basis.

Figure 4.3. Use of criteria for board composition across jurisdictions



Source: OECD Survey.

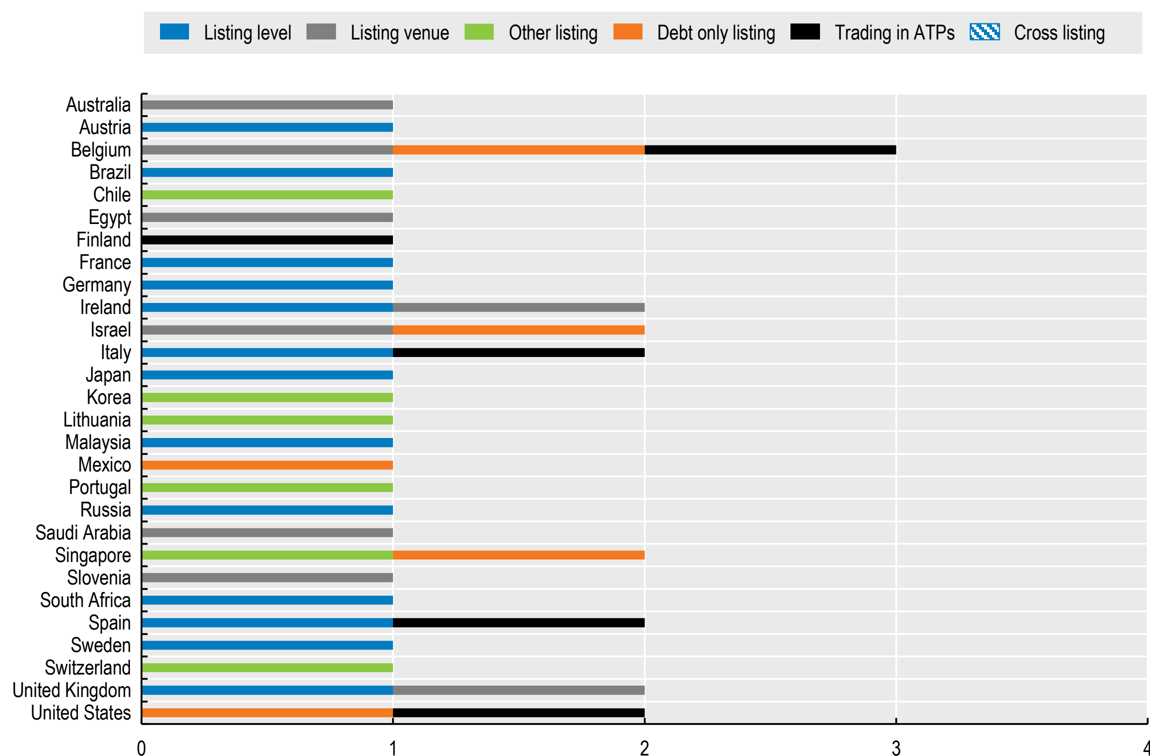
The use of listing/publicly traded as criterion for flexibility and proportionality

Listing/publicly traded is used as criterion for flexibility and proportionality in the regulatory area of board composition, board committees and board member qualifications, by all but 11 jurisdictions and is present in the corporate governance framework in several dimensions, with the *listing level* being the most commonly used tool. (Figure 4.4.).

Most jurisdictions report that they use *listing/publicly traded* as a flexibility and proportionality criterion in the sense that non-listed companies are not subject to the same

rules for board composition as listed ones. This is the case in Austria, Belgium; Chile; Denmark; France; Hungary; Lithuania; Singapore; Sweden; Switzerland; the UK, and the US, among others.

Figure 4.4. Use of the listing/publicly traded criterion for board composition



Source: OECD Survey.

Some jurisdictions differentiate between *listing levels*, often with more stringent requirements for the percentage of board members that are expected to be non-executives or independents; the need to establish certain committees (and comply with rules about their composition), and reporting on board practices. That is the case in Brazil; France; Germany; Italy; Malaysia; Russia, and Saudi Arabia. In Italy, firms listed on the STAR segment have additional requirements issued by the exchange that enhance independence and control.[9] In Malaysia, the firms included in the LEAP segment, foreseen for SMEs, do not have requirements on independent directors and the formation of committees by the board. In Russia, the listing level demand diverse percentages of independent members for the board and the formation of only an audit committee or also the formation of remuneration and nominations committees. In Saudi Arabia, firms included in the NOMU listing segment are only encouraged to adopt voluntarily the mandatory requirements for board composition set for the Main market.

Whether the firm is traded in a regulated market or not, and the trading of its securities in alternative trading platforms (ATPs) is also a relevant consideration used to introduce flexibility and proportionality in a number of jurisdictions. That is the case in Italy, Slovenia and Sweden. In Italy and Slovenia, listing in regulated markets triggers rules on board composition that are not applicable for trading in ATP, while in Slovenia, this also

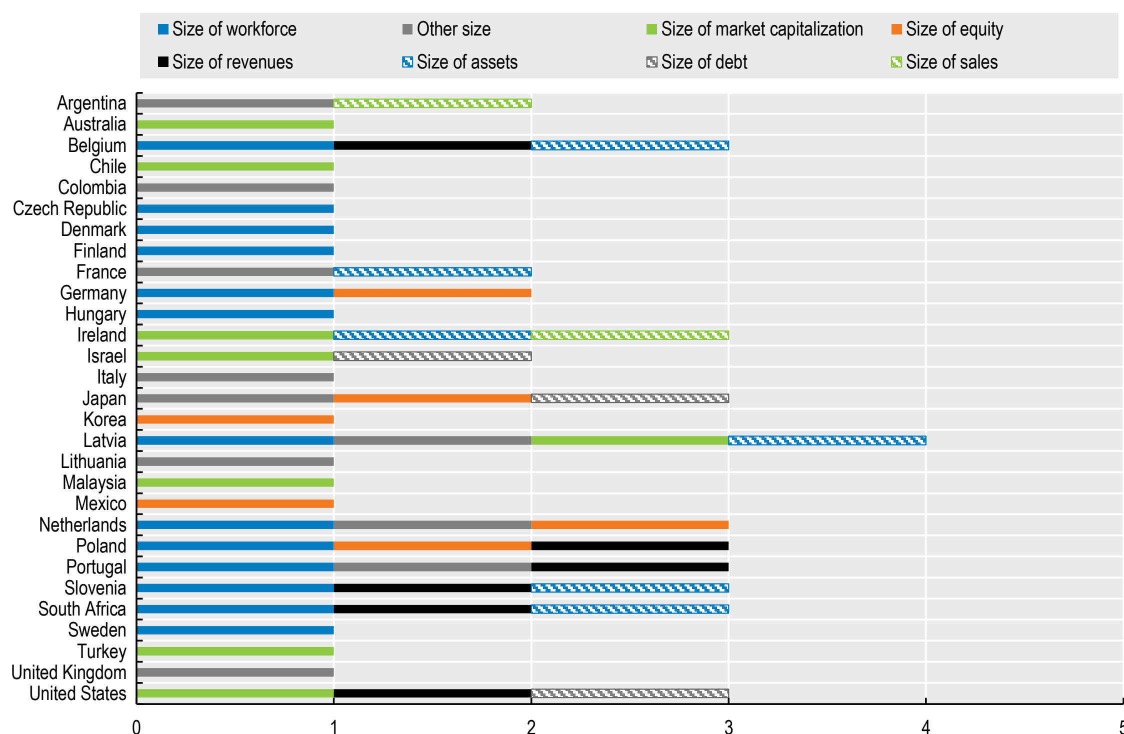
triggers regulations on the composition of the audit committee that are not applicable to other firms (except if they have employee board participation). In the United States, in turn, non-listed firms that trade their securities in the over-the-counter market are not subject to the standards established by the Exchange Act for audit and compensation committees.

Other dimensions of the *listing* criterion used include a consideration for *debt only listings*, as in Mexico and Singapore where no requirements on board composition apply to firm that only list debt instruments, in the United States, where debt-only and preferred listings are exempt from some, but not all, corporate governance listing standards, and in Argentina, where no requirements on the audit committee apply to these firms. *Cross listings* are also considered, and Israel waives the fitness requirements applicable to independent directors for Israeli companies with no controlling shareholders listed in NYSE or NASDAQ (only the fitness requirements according to those exchanges rules apply), for example.

The use of size as criterion for flexibility and proportionality

Size is the most used criterion for introducing flexibility and proportionality regarding board composition, board committees and board member qualifications. Twenty-nine jurisdictions report using it in different dimensions. *Size of workforce and size of market capitalization* are the more frequently used dimensions (Figure 4.5.).

Figure 4.5. Use of the size criterion for board composition



Source: OECD Survey.

The *size* criterion is often used to introduce flexibility and proportionality for SMEs, using the dimensions of *size of balance sheet*, *size of revenues*, *size of market capitalization* and *size of workforce* as the most common definition of a small or medium size company. Some countries use a multiple test and require two or more positive answers to consider the firm an SME, as in Belgium, where the test involves a 2-out-of-3 analysis that waives audit committee requirements depending on size of workforce, size of turnover, and size of balance sheet.

The *size of workforce* is commonly associated with requirements for employee representation in the board, as in the case of the Czech Republic; Denmark; Germany; the Netherlands, and Sweden. In some jurisdictions this dimension is also associated with gender diversity requirements, particularly with quotas, but other dimensions are also used for this, including *size of capital*, *size of balance sheet*, *size of revenues* and *size of market capitalization*.

The *size of market capitalization* is frequently associated with the requirements for the independence of the board and for the formation and composition of the audit committee, as it is the case in Argentina; Australia; Chile; Israel; Lithuania; the Netherlands; Turkey, and the UK, among others. This dimension is often used in conjunction with whether the firm is or not part of an index (something often determined considering market capitalization, but not only). That is the case in Australia, Israel and Malaysia. In the United States, considering the dimension of *size or the market capitalization* (and also the *size of the revenues*), some small companies are granted certain accommodations with respect to standards for compensation committees and, on some exchanges, with respect to audit committee composition requirements.

The regulations that determine a minimum (and sometimes also a maximum) size for the board are in many jurisdictions related to the *size of the equity*, the *size of the assets* or the *size of the balance sheet*. That is the case in Germany, for example, where the maximum number of board members is 9 for companies with up to €1.5 million of equity; of 15 for companies with more than € 1.5 million but less than €10 million, and of 21 for companies with more than €10 million of equity (section 95 sentence 4 AktG).

In Japan, the *size of equity* is used in conjunction with the *size of debt* to impose requirements for committees to be composed with a majority of outside directors.

The use of ownership/control structure as criterion for flexibility and proportionality

The *ownership/control structure* criterion is used less often for board composition, board committees and board member qualifications than the previous criteria. Twelve jurisdictions report using it and most commonly in the dimension that looks for the presence of a *controlling shareholder* (Figure 4.6).

Controlled companies are in some cases allowed more flexibility to comply with board composition requirements, particularly with a ratio of independent directors either for the board or also for the audit committee. That is for example the case in France, where the presence of a controlling shareholder waives the recommendation in the code of corporate governance for half of the board to be composed on independent directors, but also in Germany, Hungary, and Mexico.

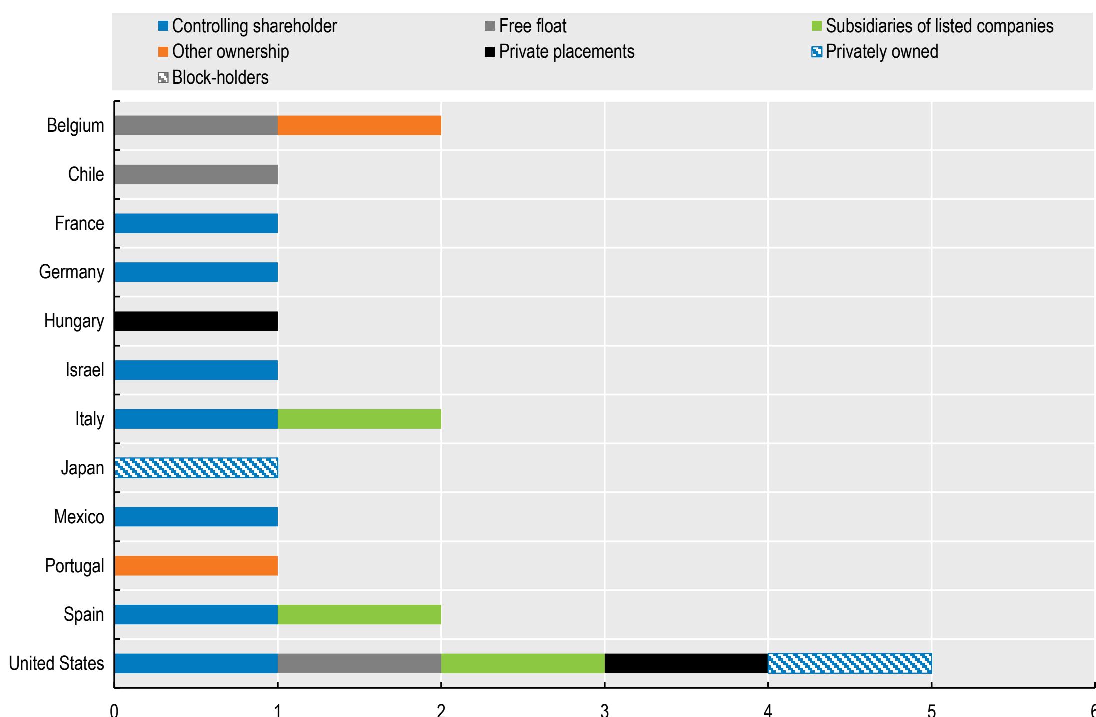


Figure 4.6. Use of the ownership/control structure criterion for board composition

Source: OECD Survey.

In the United States, controlled companies (defined as those where more than 50% of the voting power is held by an individual, group, or another company) are exempt from the requirement to have a majority of independent directors on their boards; from standards for nominations and compensation committees; and, in some cases, from certain exchange standards for audit committees.[10]

In Italy, on the other hand, controlled listed companies have more stringent requirements for board composition including boards with a majority of independent directors and committees composed with only independent directors.[11]

The use of legal form as criterion for flexibility and proportionality

The *legal form* of firms is also a relevant consideration to introduce flexibility and proportionality in the corporate governance framework of several jurisdictions in relation to board composition, board committees and board member qualifications. In Ireland, the legal form determines the minimum size of the board; Israel adopts special rules for partnerships; and in Mexico SAPIBs[12] have lower requirements for independence of board members and of audit committees, and no limitations for the maximum number of board members, which is set at 25 for SABs.

In the United States, exclusions are granted from some or all corporate governance requirements to: asset-backed issuers; unit investment trusts; foreign governments; any issuer organized as a trust or other unincorporated association that has no board of

directors and limits its activities to passively owning or holding securities, rights, collateral, or other assets on behalf of its securities holders.

The use of maturity of the firm as criterion for flexibility and proportionality

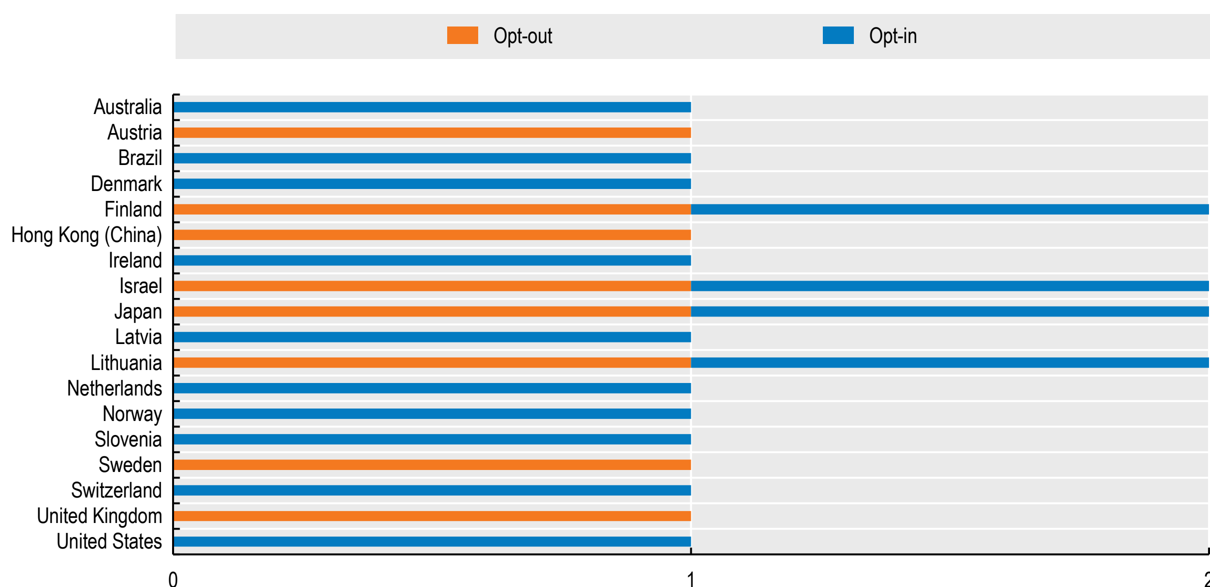
Four jurisdictions use the criterion of *maturity of the firm* to introduce flexibility and proportionality in this area of regulation:

- In Brazil, Novo Mercado listing rules establish the separation of roles of CEO and Chair, but this is allowed for the first three years of listing for new firms.
- In Israel, certain exceptions for board composition requirements are available for five years after IPO (for firms remaining under a given market cap).
- In Italy some governance requirements enter into force three years after the IPO.
- In the United States, certain issuers are allowed phase-in or transition periods to come into complete compliance with various corporate governance listing standards. These include issuers listing in conjunction with an initial public offering or a carve-out or spin-off transaction; issuers emerging from bankruptcy; and issuers listing on an exchange after having traded over-the-counter.

The use of opt-in and opt-out mechanisms

Opt-in and opt-out mechanisms are used for the regulation of board composition, board committees and board member qualifications by 18 jurisdictions (Figure 4.7.). A large variety of optional mechanisms are in place, particularly in terms of the number of committees.

Figure 4.7. Use of opt-in and/or opt-out mechanisms for board composition

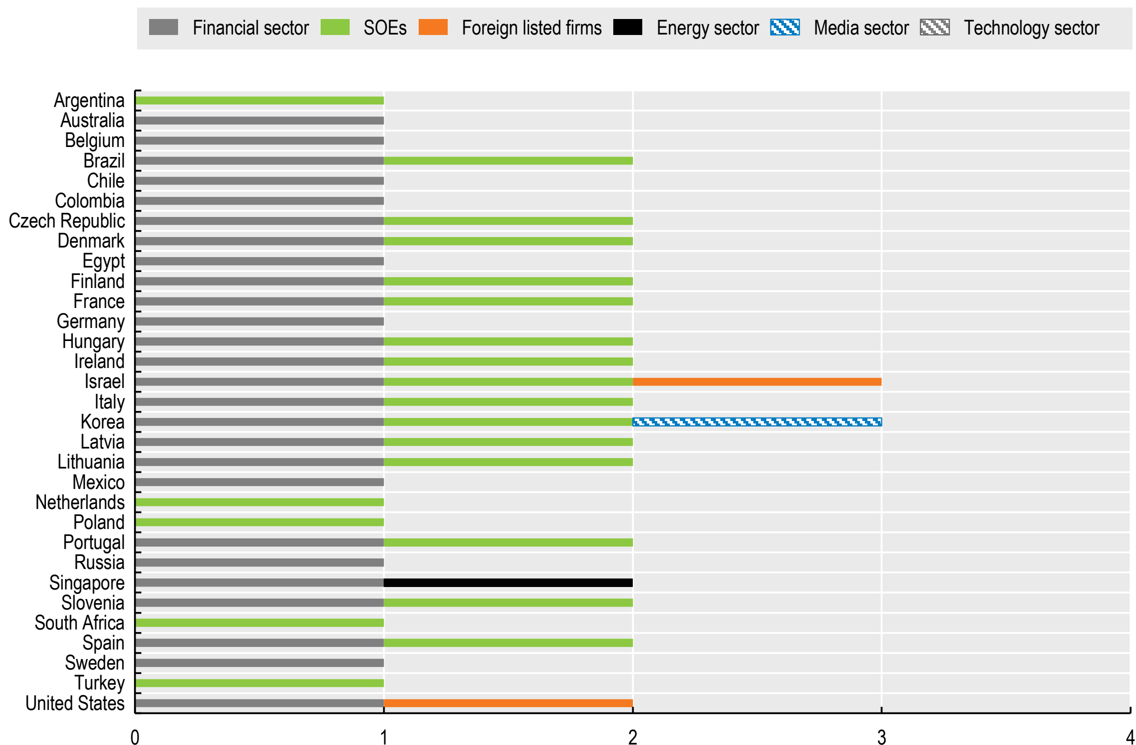


Source: OECD Survey.

The use of sectoral criteria for flexibility and proportionality

An analysis of the results per sector of activity reveals that flexibility and proportionality criteria for board composition, board committees and board member qualifications are used by most jurisdictions (31), with a varying degree of scope (Figure 4.8.). Most jurisdictions that present flexible sectoral regulations report having special regimes for the financial sector and for their State-owned companies.

Figure 4.8. Use of flexibility and proportionality in different sectors for board composition



Source: OECD Survey.

Case study: United Kingdom

This section sets out the UK's approach to the creation and governance of companies, the role and appointment of directors, their duties and responsibilities and the composition of the board as a whole, including board diversity.[13] It concludes with a look ahead to future developments including changes to the UK Corporate Governance Code, industry-led action and planned legislation.

Overview of Company Law

The UK approach to corporate governance is based on a mixture of legal statute, codes of practice and precedent set by the courts. The statutory framework is deliberately open (for example, there is no definition in law of a non-executive director). This has the great advantage of flexibility: best practice can evolve through case law and industry-led action without the need to wait for legislative change. Any necessary enforcement action can be taken by regulatory bodies in a proportionate way without the expense of court

proceedings. An arguable shortcoming is that there is no single source setting out the duties of directors and of the board as a whole.

Company Law in the UK is codified in the Companies Act 2006 (CA 2006). This iteration of the Act was the culmination of a nine-year project which amounted to the biggest review of UK company law for over 40 years. The project comprised a three-year in-depth investigation by a Government-appointed expert group—the Company Law Review Steering Group (CLR)—alongside detailed research on specific issues by the Law Commissions of England and Wales and Scotland, and extensive public consultations on a wide range of technical matters by the Government itself. The new Act which emerged from this exercise consolidates the great bulk of the pre-existing companies' legislation and makes it more relevant to the business conditions of the 21st century.

One area of discussion was whether any new legislation should be more specific about what the responsibilities of company directors should be. The outcome was that not only have the legal responsibilities of directors been for the first time 'codified' – in other words set out in statute, rather than left to be addressed by common law principles – but they have been in some respects expanded with the aim of ensuring that, in running their companies, directors take into account a range of wider factors, economic, social and environmental, that are considered part of responsible corporate behaviour in the 21st century. The Act also recognised the trend of the courts in recent years of expecting higher standards of skill and care from company directors. The changes made in these two areas now form the basis for how directors are expected to operate and account for their actions to their companies and the outside world.

Why reform took place

The Company Law Review's 1999 *Strategic Framework* paper promoted the approach of *'think small Company first'*, in an attempt to reform the law in a manner which had regard to problems faced by small companies, who make up the majority of business models in the UK. The paper noted that *'Company law...makes little attempt to respond to the peculiar needs of small firms, either in accessibility and simplicity of operation or in substantive provision. The start-up and development of such businesses is a particularly important process for which the law should provide an optimal climate'*.[14]

One of the main objectives was to simplify the procedures for small companies and remove high costs associated with compliance with prior regulation, which was considered archaic and burdensome. This approach ensures that anybody is able to start and run a company and benefit from limited liability, and where a company is small enough, be exempted from some more complex requirements (such as company secretaries, audit regimes or annual meetings).

It was felt that the UK should update its Company law principles and align them with changes in business practice, especially in relation to director duties. These duties (along with other company law principles) had been developed by case law pre-dating the 19th century, and the Government was concerned that both the members of the company (shareholders) and directors themselves needed to better understand the duties of directors. In this area, both the Company Law Review and the Law Commission were in agreement that the law needed to include codified duties which were clear, accessible, certain and comprehensible.[15] The 2006 Act created an integrated system of legislative regulation that combines industry self-regulation with external regulatory monitoring and control.

Company registration

When a company is registered with the registrar, Companies House,[16] the process is referred to as 'incorporation'. This term is referenced in the governing legislation[17] and derives from the Latin verb *'corporare'*, meaning to 'furnish with a body'.[18] In legal terms, the process of registration brings into existence a distinct entity with its own legal personality, the ability to enforce and exercise legal rights, own property and be subject to enforceable legal liabilities. Ultimately, the company is recognised as an entirely separate body from its shareholders and the directors who control it, with the ability to sit as a corporate director on a board in its own capacity.[19]

The CA 2006 facilitates a number of forms of registered companies, including limited liability (by shares or a guarantee), unlimited liability, public[20] and private companies.[21] The legislation is exceedingly flexible in the sense that it provides companies with the freedom to organise their boards in the manner they deem appropriate to their business model, rather than provide a substantive list of 'rules' regarding the qualification and composition of director boards.

The law differentiates between private and public companies by requiring private companies to appoint a minimum of one director, and public companies a minimum of two directors.[22] Further, the legislation stipulates that both private and public companies must have at least one director who is a natural person[23] to ensure that an individual can be held accountable for the actions of that company, as well as requiring the director to be of the minimum age of 16 years old.[24] The first directors of the company are named in the application for registration of the company, with any subsequent changes in directors requiring notification to the registrar. The last qualification requirement necessitates the director appointed to have no previous disqualifications under the Company Directors Disqualification Act 1986.

The concept of executive and non-executive directors does not derive from statute. It is introduced by supplementary codes of practice, a range of which exist to cover different circumstances. The *UK Corporate Governance Code* is the main source of guidance for public companies on how they should appoint, compose, conduct and separate the functions of the board and their committees. The Code is overseen by the Financial Reporting Council (FRC).[25]

Appointment and removal of a company director

The procedure for the appointment of new directors is usually set out in the company's articles of association.

A 'de jure' director is an individual who is validly appointed to the board. This entails an application for registration of the company with information provided on the proposed directors (and company secretary if the company is a public company). The individuals must give their consent to act as directors.[26] Once the certificate of incorporation is issued by the registrar, those persons named as directors are deemed to have officially been appointed to office, by virtue of section 16 (6) CA 2006. Thereafter, subsequent appointment procedures will be determined by the company's articles of association, usually requiring ordinary resolution (more than 50% of vote) or a decision made by the board to elect a new director.

Under the UK Corporate Governance Code all directors of FTSE 350 companies should be subject to annual election. Non-executive directors should be subject to annual re-election if they have served on the board for longer than 9 years.

The company's shareholders can remove a director by the act of an ordinary resolution at a general meeting,[27] notwithstanding any agreements between the individual and the company (since removal may leave the company liable for damages).[28] Further, it is common for the articles of association to permit directors to remove an individual director before the expiration of his period in office. The delivery of notice to the individual is a necessity in both instances.

Both appointment and removal of directors must be notified to the registrar by the company within 14 days.[29] Such information will then be available for public inspection.

Definition of a director

The term 'director' is not defined in the Act. The nearest that the Act comes to a definition of the term is found in section 250 CA 2006, which says that the term 'director' includes *any person occupying the position of director by whatever name called.* This is a long-standing feature of UK company law and has remained intact following the law reform process. It means that, in determining whether any person is or has been a director of a company, account must be taken not only of whether a person has been duly appointed and registered as a director in accordance with the prescribed procedures (legally recognised as a 'de jure' director), but also of whether that person is or has been exercising the functions of a director, such as making the sort of decisions that directors routinely make.

The CA 2006 includes provisions to identify individuals who are not formally appointed as directors but play an influential part in the managing of the company. The decision to avoid formal appointment can be taken for numerous reasons, including the desire to escape liabilities of a director, or the desire to act as a director despite prior disqualification. Section 251 (1) defines an individual as a 'shadow director' if they are *a person in accordance with whose directions or instructions the (majority) directors of a company are accustomed to act*. The Act excludes from this definition a person functioning to provide directors with advice in a professional capacity or a parent company holding subsidiaries. The courts have developed legal tests to determine when an individual is acting as a shadow director. If a person is found to be a shadow director, they will owe fiduciary, common and statutory duties to the company.

A third category of *'de facto'* director is not referred to in legislation and has been developed in common law. A *de facto* director is someone who has not been formally appointed and notified to Companies House as a director, but nevertheless considers, acts and represents themselves as a director of the company to third parties. Typical actions would be signing documents on behalf of the company, being present in board meetings and exercising powers usually reserved for the board. It is possible for one individual to be acting as both *de facto* and shadow director.

In summary, the broad definition of the term 'director' ensures that persons who are commonly referred to in such terms will be directors for company law purposes and will be treated as directors by the law. Further, the deliberately wide definition also allows the law on directors' duties to be applied to persons who, for one reason or another, do not formally register themselves as directors.

Directors, shareholders and directors' fees

The nature of directorship is central to company law, with directors having fiduciary duties to the company.[30] Directors may have various other capacities. In private

companies, the directors are usually also the shareholders owning most if not all the shares in the company. They may be paid through dividends, fees or a mixture of the two. In such instances there is less need for mechanisms to ensure accountability of directors to shareholders, since they are one and the same. In public companies, the directors will normally own some shares but their main sources of remuneration will typically derive from their fees and other reward packages. Agreeing the remuneration of executive directors is a significant responsibility, which for quoted companies is typically entrusted to a remuneration committee composed of non-executive board members.

The remuneration paid to directors has recently become controversial, partly because of the value of the packages earned and partly because of a perceived lack of connection between the directors' pay packet and the performance of the company. In response, shareholders in quoted companies now have the opportunity to vote on proposed remuneration. Planned legislation will require large quoted companies to publish the ratio between directors' remuneration and average UK employee earnings in the company. Several companies already publish this information on a voluntary basis.

The evolution of board powers

Until the end of the 19th century, it was generally assumed that the general meeting of shareholders was the supreme organ of the company, with directors acting as agents of the company subject to the control of the shareholders in general meetings.[31] However, in a Court of Appeal decision in *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame [1906] 2 Ch 34*, judges established that the division of powers between the board and shareholders depends on the construction of the articles of association, and where the managerial powers were vested in the board, the general meeting could not usurp or interfere with their lawful exercise. The articles were held to constitute a contract by which the members had agreed that "the directors and the directors alone shall manage".[32] This approach was confirmed by the House of Lords in *Quin & Axtens v Salmon* [1909] AC 442 and has since received general acceptance.

Legislation has sought to codify these principles. Section 33 of CA 2006 provides that the articles of association formulate a statutory contract between the members (shareholders) of the company and the company itself. Unless the directors are acting contrary to the law or the provisions of the articles of association, the powers of everyday management of the company are vested in them.

In summary, for private companies the division of powers as between board and shareholders is a matter for private ordering by the members of the company rather than something specified in law. The directors' authority is derived from shareholders through a process of delegation via the articles of association and not from a separate piece of legislation from the State. For public companies, this principle is modified through the UK Corporate Governance Code and secondary legislation, reflecting the legitimate public interest in the management of these companies.

Board structure

The United Kingdom has a unitary board model with a single tier of management, comprised of executive and non-executive directors (if the company has appointed them) serving collectively and equally liable under the eyes of the law. This differs from many countries in continental Europe where a two-tier structure is implemented, differentiating between directors with an operational role and supervisory directors responsible for the oversight of the managerial board.[33]

The duties of directors

The CA 2006 sets out in sections 170-77 the duties owed by directors to the company. The duty to exercise reasonable care, skill and diligence is one of these and illustrates the importance of a high standard of business conduct and consideration of the long-term consequences of decisions. This duty also provides an example of the proportionality present in the law as it provides the courts with flexibility to determine the threshold against which the directors should be performing.

The question for the court is to conclude whether directors have carried out their duty according to the 'general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions in relation to the company'.[34] The level of skill, care and diligence required for the running of a small private family-run business with two shareholders and one employee is clearly going to be fundamentally different from that of a public entity with 1000+ shareholders, 250+ employees and a significantly high turnover. The law accommodates for the different types and sizes of companies present in the UK and holds the directors accountable in a proportionate manner.

This section of CA 2006 provides further flexibility and proportionality by requiring the judiciary to consider, when deciding whether or not a breach of duty has occurred,[35] both the knowledge and skills that would objectively be expected of anyone acting as a director and also the subjective knowledge held by the individual director in question. This objective requirement acts as a protective measure to ensure that directors are not able to rely on the defence that they are ill-informed or unexperienced.

"Enlightened shareholder value": Section 172 of CA 2006

The central duty for directors is found in section 172 of the CA 2006, which states that a director must "act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

a) the likely consequences of any decision in the long term,

b) the interests of the company's employees,

c) the need to foster the company's business relationships with suppliers, customers and others,

d) the impact of the company's operations on the community and the environment,

e) the desirability of the company maintaining a reputation for high standards of business conduct, and

f) the need to act fairly as between members of the company".

The Company Law Review Steering Group was presented with the task of evaluating the most suitable approach for duties owed by company directors.

The Company Law Review came to the conclusion that the *enlightened shareholder value* approach, combining a focus on long-term shareholder value, whilst capturing the inclusivity of the pluralist approach was best. Section 172 requires directors to pursue shareholder wealth with a long-term focus that seeks sustainable growth and profits based on responsible attention to the full range of relevant stakeholder interests, including those of creditors.

The UK Corporate Governance Code

The main guidance on principles relating to the board of directors and board committees can be found in the UK Corporate Governance Code 2016. The underlying principle of the Code is to 'facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company'[36]. It states that the fundamental principles of good corporate governance are accountability, transparency, probity and focus on sustainable success of the company in the long term. The Code applies to all public companies with a Premium listing of equity shares (rather than debt instruments) on the London Stock Exchange. The Code applies irrespective of company size or country of incorporation.[37]

The flexibility and proportionality of the Code

The UK Corporate Governance Code is widely recognised as an international benchmark for good governance practice. It is considered proportionate and flexible because of the *comply or explain* principle, meaning that companies should comply with the rules or explain why they do not. The explanation should also indicate whether the deviation from the Code's guidelines was limited and when the company intends to return to conforming with the provisions. The Code provides a coherent and focused method of company disclosure, with the aim of initiating sanction through investor behaviour.

Statements of compliance or non-compliance can be found in the Corporate Governance statement, which is contained in the Annual Report. As the Annual Report is a public document and available to shareholders and other stakeholders, this approach enables interested parties to challenge companies on their compliance with the Code. Companies and their major investors engage on a regular basis on key matters, such as remuneration policy and director appointments.

The role of the board

The Code requires the board of directors to take equal, collective responsibility for the long-term success of the company, taking account of a range of stakeholders as set out in Sections 172 of CA 2006. It provides high-level guidance which advocates the organisation of protective mechanisms to provide prudent and effective controls by the company in order to assess and manage risk, without hindering or discouraging entrepreneurship.

Information on how the board operates and who is responsible for which decisions should be published annually in the company report. Information on delegation of powers should be clear and accessible to the company investors, so the right people are held to account and shareholder activism is stimulated. Additionally, the annual report should include information on the chairman, deputy chairman (if one exists), chief executive, senior independent director, and committee composition (members and chairman). This is the ideal breakdown of the board composition for listed companies in the UK.

Division of responsibilities

One of the main provisions of the Code is that no individual should have unfettered powers of decision. The Code prohibits the same individual acting in the capacity of a chairman and chief executive (unless consent of major shareholders is obtained). It also requires the responsibilities of these respective roles to be clearly set out and made public.

The Code also provides criteria against which the Chairman can be tested to ensure there are no conflicts of interests.

The Chairman has responsibility to facilitate constructive relationships between executive and non-executive directors. This is to be achieved by providing an open culture for debate and contributions, ensuring enough time is dedicated to all agenda items and special attention granted to strategic issues. The Chairman should also be the intermediary between the board and shareholders, providing them with accurate information on key board decisions.

Non-executive directors

The Code sets out the role of Non-Executive Director (NEDs). They provide scrutiny of the executive branch of the board of directors, constructively challenging and aiding with strategy of the company as a whole. They are not responsible for the day-to-day functioning of the company's management, but nonetheless are a part of the unitary board and are equally liable with the executive directors. The Code prescribes that apart from smaller companies, at least half of the board should consist of independent NEDs. Small companies are expected to appoint a minimum of two NEDs.

The NEDs are advised to assign amongst themselves a senior independent director who can provide a sounding board for the chairman and a point of contact for shareholders when the normal channels (through the chairman or executive directors) are inappropriate or unavailable.

Board committees

The Code sets out the role of the board sub-committees and enables the board to delegate important tasks and ensure independence. This has two main advantages: important topics such as the relationship with the company's auditors can receive adequate attention without the need to engage the whole board and second, the board committee can take an independent view on matters that may affect the executive directors (such as remuneration) without presenting a conflict of interests.

Companies will typically have remuneration, nomination and audit committees comprised mostly of NEDs and chaired by the executive chairman. The attendance of these committees should be restricted to members only, unless an invitation is provided to other board members.

Qualification of directors

The Code stipulates that responsibility for ensuring that directors possess the suitable level of skills, experience, knowledge and familiarity with the company is left to the board itself. However, the Chairman is entrusted to encourage the board to refresh their skills and knowledge and provide the resources for them to do so. The Chairman is also advised to provide tailored, formal inductions to new directors and review and agree development plans with existing members of the board. It is good practice for boards to conduct 'board effectiveness reviews' with an independent consultant, which allows the directors to voice any concerns about how business is conducted or the relationship between other board members.

Diversity of company boards

The boards of public companies have not generally been very representative of the composition of the company's workforce or its customers. The Government and professional bodies are united in wishing to capitalise fully on the skills and talents of all those involved in business. There is also evidence that diverse boards are more independent and take better decisions. Diverse boards with a plurality of views and experience, would be in a better position to compete globally. For these reasons of fairness, competitiveness and resilience, the UK has sought to ensure that the boards of listed companies in particular should better reflect their workforces, customers and the wider society.

The Davies Review

In 2010, the Government appointed Lord Davies of Abersoch, to chair a review to examine the underrepresentation of women on boards. In 2011 Lord Davies published a 'Women on Boards' report which aimed to push the issue of gender equality forward and promote the cause amongst UK listed companies. [38]

While encouraging companies to go beyond compliance, successive Governments have chosen not to introduce overly prescriptive regulations in this area. Following the Davies review, a gender disclosure requirement was introduced in the narrative reporting regulations that came into force in 2013. These regulations require all quoted companies to disclose, in their annual report, the number employees of each gender, on their board, in senior management positions and in the company as a whole. The rationale was to allow the board and shareholders to have a clear picture of how gender diversity was represented across the workforce. The increased level of transparency would also allow wider public accountability, encouraging companies to take diversity on boards more seriously.

In addition to the legislative measure, the UK has adopted a voluntary, business-led approach to improve the number of women on the board of the top 350 listed companies. Lord Davies published his final report in October 2015; it showed that FTSE 100[39] companies exceeded the 25% target that he set in 2011. At that time, only 12.5% of those posts were occupied by female directors, so the proportion had doubled in just six years to over 27%. There were 152 all-male boards across the FTSE 350, now there are 8. In his final report Lord Davies extended the voluntary target to 33% for the FTSE 350 by 2020, he also recommended the appointment of a new Chair to focus on women in the executive layer of FTSE 350 companies.

The Hampton – Alexander Review

In February 2016, the Government appointed Sir Philip Hampton, Chair of GlaxoSmithKline and the late Dame Helen Alexander to chair an independent review that would continue the work of Lord Davies in pushing for increased female representation on FTSE boards, whilst also extending its focus to women in senior executive positions. The Review published its first report in November 2016 and a progress report in November 2017 recommending that: (i) 33% of FTSE 350 Board members should be women by the end of 2020, and (ii) 33% of FTSE 350 leadership teams (Executive Committees and their Direct Reports) should be women by the end of 2020.[40]

Future board scheme

The Department for Business, Energy and Industrial Strategy (BEIS) and UK Government Investments is actively supporting the Future Boards Scheme, which is a business-led initiative to help talented, senior women get board-level development opportunities and gain the experience they need to successfully apply for board positions. A good match will benefit both the board and the participant, so boards will be asked what skills/experience they are looking for and matched with carefully-selected candidates. Individuals will not be matched with boards where there is a conflict of interest or a chance of them gaining a competitive advantage.

The model has been designed so that in the medium term it could be expanded beyond women candidates, to improve broader diversity on boards.

The Parker Review—Beyond One by '21

Sir John Parker led an independent review into the ethnic diversity of UK boards between 2014 and 2016. He published a report and draft recommendations for consultation in November 2016, and a final report and recommendations in October 2017.[41]

The Review concluded that boardrooms did not reflect the ethnic diversity of the UK. 8% of FTSE 100 board directors are people of colour compared to 14% of the population. Only 2% of board directors are UK citizens of colour. 51 companies do not have any directors of colour.

The Review has recommended that each FTSE 100 board should have at least one director of colour by 2021, and each FTSE 250 board should have at least one director of colour by 2024.

While Government did not commission the review, it welcomed the recommendations and will be helping to monitor progress.

Diversity reporting

The EU non-financial reporting directive[42] introduced a requirement for the large public interest entities to disclose the diversity policies applied to their boards. The UK Corporate Governance Code and other guidance already supports best practice by instructing that on new appointment of directors, companies should have regard to the benefits brought from diversity on the board, including gender.

As part of its response following the recent Corporate Governance Reform consultation, the Government asked the FRC to consider how best to encourage greater transparency for all quoted companies regarding company diversity policies, targets, and progress towards those targets. The FRC consultation[43] on these and other matters closed at the end of February 2018.

Planned corporate governance reforms

As highlighted in the previous sections, the current UK regulatory framework setting out the roles and duties of company directors (section 172) and also providing for current shareholder voting rights as well as reporting requirements of companies, such as the requirement to produce a triannual pay policy and an annual remuneration report, is largely embedded in the Companies Act 2006. The legislative requirements apply proportionately to different subpopulations of companies. For example, while the directors' duty set out in section 172 applies to all company directors, smaller companies

are exempt from the requirement to produce an annual Strategic Report,[44] and only 'quoted companies'[45] are required to comply with the existing shareholder voting regime[46] (The number of 'quoted' companies has fallen through the years, and there are currently "only" around 900 such companies, which have to comply with the current reporting requirements around executive pay and apply the shareholder voting arrangements for executive pay matters).

As already explained, in the UK model of corporate governance, this regulatory framework is then complemented by voluntary measures, by the Financial Conduct Authority's (FCA) Disclosure and Transparency Rules (DTR) and Listing Rules[47], and by the UK Corporate Governance Code.[48]

One of Britain's biggest assets in the global economy is its reputation for being a dependable place in which to do business. The UK's legal system, framework of company law and standards of corporate governance are admired internationally and are important factors in making the UK an attractive place in which to invest.

During the last few years there has been a number of proposals, sometimes developed by business itself, to update the corporate governance framework. In some cases, these have been made in response to concerns raised by actions of few businesses risk undermining the reputation of British business generally.

The 2017 Green Paper on corporate governance reform[49] focused on three specific aspects of corporate governance where the Government thought there could be particular scope to build on, and enhance, the current framework: i) Executive pay and shareholder voting; ii) Strengthening the employee, customer and wider stakeholder voice, and iii) Corporate governance in large privately-held businesses.

Executive pay

Overall, executive compensation levels in the largest companies have increased significantly since 1998, particularly in the period to 2011. The large increase in pay levels from c. £1m in 1998 to £4.3m in 2015 is not reflected by increases to pay levels in the wider economy. The result of this is that the gap between executive remuneration and the pay for the wider workforce in a company has widened very significantly in many companies.

Disquiet about executive pay has become more acute in recent years in the context of the economic downturn and relatively weak overall pay growth during the recovery. Issues around general income and wealth inequality have come to the forefront of public discussion, and executive pay is seen as emblematic of an unfair division of reward in society. There is strong concern that executive pay is often excessive, and that success is not shared fairly.[50] There is also evidence that current pay structures can provide problematic incentives,[51] and that pay can be asymmetric (i.e. strong performance is rewarded, but poor performance is not punished).[52]

Despite signs that reforms introduced in recent years have resulted in behavioural change of some companies, and that the growth of executive pay has been more modest in recent years, there is still significant concern about the level of pay and about its structure. There has also been concern from shareholders that, while most companies demonstrate good practice, there remain too many examples of companies that do not act in accordance with the intended spirit of the rules, for example by not reacting to significant dissent, or even the loss of advisory shareholder votes on remuneration, or by providing little evidence that they have taken employee and wider stakeholder considerations into account.

While it remains vital to allow companies the flexibility on pay they need to recruit and retain talent, there is thus still scope for possible improvement.

Strengthening the stakeholder voice

Shareholders are the owners of the company, and a shareholder focus thus appears natural. The UK equity market is one of the largest in the world, attracts a lot of investment and has a very international shareholder base. According to ONS analysis, shares in UK quoted companies were worth a total of £2.04 trillion at the end of 2016, with 53.9% of this value of shares being held by the rest of the world rather than UK shareholders.[53] Good investor protection is a vital driving force in attracting investment, and being able to have a strong say about how your money is utilised is a dominant component of this.

Section 172 in the Companies Act is a careful balance, maintaining shareholder primacy whilst also putting a duty on directors to "in doing so" (i.e. while acting in the interests of the owners of the company) have regard to a variety of other stakeholder and wider considerations. These wider considerations range from impacts on the local community, to environmental impacts, to listening to employee voices and considering relationships with suppliers and customers.

Investors and asset managers are increasingly emphasising the importance of wider societal factors for long term sustainable growth and calling for more transparency around how companies manage the considerations above in order to demonstrate that they are creating long term value.[54]

Furthermore, given that many companies will benefit from public investment and use public services, that they rely on their employees and that they have the capacity to cause large externalities on the environment and on supplier businesses, it appears right that section 172 places this duty on directors.

There are recent developments such as B Corps, which meet high social sustainability and environmental standards, and the Big Innovation Centre with its Purposeful Company agenda.[55] They make the point that long-term value creation depends on companies having a clear strategic vision around their purpose – *"their role in the world from which profits result"*. Having a clear understanding of all the relevant stakeholder voices appears of vital importance for this.

While we acknowledge such developments coming out of the business community, it is clear from recent corporate failings, and from the responses we received during the consultation period, that more could be done in this area to drive further change. The consultation responses raised concerns that many businesses and directors treat the wider considerations in section 172 as too much of a tick-box exercise, without really giving sufficient thought to them.

Corporate governance in large privately-held and public unlisted companies

While the agency problem and the issues arising from it are less acute in the case of private companies because ownership and control of the business are usually closely intertwined, all the wider problems identified above arise independent of the legal form of the business. This is especially true where companies should have due regard for wider stakeholder views.

Employees are as important a stakeholder in private companies as they are in public companies. The impact bad employment practices can have on the business itself in the long-term, but also on wider society, applies irrespective of the legal form of a company. The same holds for the effects caused by companies not taking into account their environmental impacts, effect on the community, or poor treatment of suppliers; they exist whether a company is public or private. Bad practices among private companies contribute to the erosion of trust in business, and where bad business practice leads to the collapse of companies and potentially large pension schemes, this can have devastating effects on local areas and create wider economic costs.

We acknowledge that private companies are different, and that many successful private companies are driven by the entrepreneurial spirit of their owners. Our approach is thus not to treat public and private companies identically. There are, however, areas in which the legal form of a company is largely irrelevant. In areas where this is the case, we think it is fair and beneficial to ask private companies to think about their governance standards with the aim to spread good practice and increase standards among those companies that are currently not thinking about good governance enough.

Rationale for intervention

The proposed reforms are unlikely to affect substantially the large majority of UK companies that already follow good governance practice. Instead, the proposals build on the existing strengths of the system, with targeted further interventions. They aim to incentivise more companies to think long-term and take stakeholder voices into consideration, and to ensure that systems are in place to address instances of bad governance and corporate excesses. Such bad practices in a small number of companies can and have had, large negative impacts on perceptions of business overall. They reduce trust in business as a force for good. Ensuring that good practices are more wide-spread and that bad practices are addressed should thus, by improving the public perception of business, be beneficial especially to those companies that already do the right thing.[56]

The rationales for intervention can broadly be classified in three areas. Firstly, the proposed policy package aims to address *equality and fairness* concerns; it aims to address the notion that current systems do only benefit a small minority and to halt the observed erosion in trust in business. This rationale is primarily not about economic efficiency but aims to address distributive concerns. It is overarching and is thus a rationale for intervention across all three main areas for reform.

The second rationale evolves around *asymmetric information and a principal-agent problem*. As explained above, corporate governance systems and especially executive pay has evolved in order to address the principal-agent problem in public companies. However, it seems clear that some problems still remain, and that implemented solutions might at times cause unintended consequences. Short-termism might be a particular problem as, according to a recent study by PwC, median CEO tenure has fallen significantly to 4.8 years.[57] Therefore, CEOs often do not face potentially negative consequences associated with short-termism. The interests of stakeholders, whose relationship with the company is often much more long-term than that of short-term shareholders or CEOs, can often be better aligned with those of long-term shareholders. Giving more emphasis to the stakeholder voice could thus provide valuable insights to companies themselves.

Finally, not only are there externalities of good and bad governance as described above (i.e. bad governance causing an erosion in trust in business which ultimately can affect all

businesses), but companies, independent of legal form, can cause *more direct externalities.* Bad employment practices can be to the detriment of employees, not having due regard to environmental impacts can cause unnecessary environmental damage, and companies not maintaining good relations with suppliers and not factoring in impacts on the local community can have devastating localised effects. Incentivising all companies to have proper regard to such issues should thus mean that companies might internalise more of these externalities into their decision-making, leading to better outcomes for society as a whole.

The reforms are targeted and specific. They are designed with the aim of introducing negligible or limited burden on the majority of businesses that are already following good practice. Instead, the proposals are largely targeting those businesses that currently fail to follow good standards and are causing negative impacts on business as a whole. Where the Government introduces new requirements to all businesses, it aims to be proportionate by exempting smaller businesses, and cause minimal administrative burden by building on existing requirements and processes.

As explained in detail in the following section, the reform package includes four areas of legislative change, which are going to be introduced via a single statutory instrument. The legislative changes are combined with a number of non-legislative initiatives, for example industry-led and shareholder initiatives and inviting the FRC to consider changes to the Corporate Governance Code. These elements are mutually reinforcing and will help deliver the desired outcomes.

Reforms in detail

Executive pay

(Secondary Legislation). Require quoted companies[58] with over 250 UK employees subject to current *executive* pay reporting requirements to:

- report annually, in their remuneration reports, the ratio of the CEO's total annual remuneration to the average of the company's UK employees. The ratio will be based on the CEO's Single Figure of Total Remuneration and compare that to the figure for the UK employee median full-time equivalent remuneration, and also to each quartile of UK employee remuneration. Employee remuneration must include wages and salary, employer pension contributions and variable pay, and it can include other pay and benefits the company may wish to include provided that this is stated clearly; and
- provide a short narrative explanation each year showing how the ratio relates to the company's wider strategy and workforce pay and policies, including a comment on the change to the ratio compared to the previous year and on long-term trends.

(Secondary legislation). Require companies to provide more clarity and explanation on the impact share price changes have (had) on executive compensation. Quoted companies will have to:

- set out, in the annual remuneration report, the amount of the executive compensation package (SFTR figures) for executive directors that is a result of share price changes, and whether the remuneration committee has used discretion when awarding the pay package, especially as a result of share price changes.

- show, in the forward-looking pay policy, the impact share price changes could have on compensation of executive directors, specifically on variable remuneration under Long-Term Incentive Plans (LTIPs). The illustrative share price increase will be 50%.

(Non-legislative). Invite the FRC to revise the UK Corporate Governance Code to:

- be more specific about the steps that premium listed companies should take when they encounter significant shareholder opposition to executive pay policies and awards (and other matters);
- give remuneration committees a broader responsibility for overseeing pay and incentives across their company and require them to engage with the wider workforce to explain how executive remuneration aligns with wider company pay policy (using pay ratios to help explain the approach where appropriate); and
- extend the recommended minimum vesting and post-vesting holding period for executive share awards from three to five years to encourage companies to focus on longer-term outcomes in setting pay.

(Non-legislative). Invite the Investment Association to implement a proposal it made in its response to the green paper to maintain a public register of listed companies encountering shareholder opposition to pay awards of 20% or more, along with a record of what these companies say they are doing to address shareholder concerns. The Investment Association launched this register in December 2017.

Stakeholder voice in the boardroom

(Secondary legislation). Introduce new reporting requirements on all large companies to explain how their directors comply with the requirements of section 172 of the Companies Act to have regard to employee interests and other factors.

- 'Large' companies that are already required to produce a strategic report will be required to add a statement in the Strategic Report describing how directors have had regard to the wider stakeholder matters and interests set out in section 172(1)(a)-(f) of the Companies Act.[59] In order to achieve more visibility for reporting on this aspect of the duty of directors, companies not already required to make their annual accounts and reports available on a website will be required to make this new statement available on a suitable company website.
- Build on the existing content of the Directors' Report to require companies to provide a summary of how the directors have engaged with employees, how the directors have had regard to employee interests, and the effect of that regard on the principal decisions taken by the company during the financial year. This requirement thus extends the existing 'Employee Involvement statement' and will apply to all companies covered by the current reporting requirement, in other words all companies with more than 250 UK employees.
- Require 'large' companies[60] to report, as part of the Directors' Report, on their engagement with suppliers, customers and others in a business relationship with the company. This will comprise a statement summarising how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the effect of that regard on the principal decisions taken by the company during the financial year.

Companies can set out all the new information required in their Strategic Report with a cross-reference in the directors' report.

(Non-legislative). Invite the FRC to augment this by consulting on the development of a new Code principle establishing the importance of strengthening the voice of employees and other non-shareholder interests at board level as an important component of running a successful, sustainable business. As a part of developing this new principle, the

Table 4.1. Summary of reform elements and their estimated impacts

Executive Pay		
Proposed measure	Type	Impacts
Pay ratio reporting	Secondary legislation	Benefits (non-monetised) Incentivises company boards and senior management to think more about pay dispersion within their companies and how pay is shared across the wider workforce. Provides a tool that enables shareholders and stakeholders to observe basic trends on pay distributions within companies over time, and to question boards more effectively about levels of pay and reward within the company. Costs (monetised), best estimates Additional regulatory burden of (in total): £4.05m in year one; and £2.56m annually thereafter.
Illustrate impact of share price changes on executive remuneration	Secondary legislation	Benefits (non-monetised) Greater transparency to shareholders and others on how future share price changes may affect executive remuneration. Encourage a more informed approach to the scrutiny and approval of share-based remuneration that discourages mechanistic outcomes. Costs (monetised), best estimates Annualised additional regulatory burden to business, estimated to be £1.18m in total.
Invite FRC to revise the UK Corporate Governance Code with respect to the three elements set out under 3) on page 16.	Non-legislative / code-based	Changes to the Code apply on a 'comply or explain' basis. While Code provisions are thus not legislative requirements, they are likely to have some cost impact on businesses. The Code is owned by the FRC. Should the FRC decide to adopt the Government's proposal, it will assess the regulatory impacts of changes. However, we expect any possible Code-changes to have a minimal impact on business overall. This is because: a) the impact on individual business would be limited - many companies already follow good practice in this area and could implement changes to their practice at minimal cost; b) the Code applies 'only' to premium-listed companies. As of January 2018, the FCA Official List identifies c. 1 200 premium equity-listings, with 750 being by UK companies. A large proportion (over half) of these 1 200 listings are also by closed-ended investment funds and open-ended investment companies.
Invite the Investment Association to implement a register of listed companies encountering shareholder opposition of 20% or more, along with a record of what these companies say they are doing to address shareholder concerns.	Non-legislative / industry-led	The register will help to hold those companies that encountered significant shareholder opposition to account, but also gives such companies a visible platform to explain their decisions, and to demonstrate what they are doing to address concerns raised by shareholders. The register does not introduce any direct regulatory burden on business. It is now live and is available under: www.theinvestmentassociation.org/publicregister.html
Strengthening the stakeholder voice		
	Type	Impacts
Section 172 reporting	Secondary legislation	Benefits (non-monetised) Driving up overall standards to levels already attained by many companies. Incentivise stronger stakeholder engagement, sustainability and long-termism. Help reduce the risk of future governance failures, improve transparency

		and restore trust in business. Costs (monetised), best estimates Additional regulatory burden, estimated to be (in total): £11.41m in year one; and £5.46m per annum thereafter.
Invite FRC to develop new Code principles on importance of stakeholder voices at board level.	Non-legislative / code-based	See explanation provided for *"Invite FRC to revise the UK Corporate Governance Code with respect to the three elements set out under 3) on page 16"* above.
Asking ICSA and the Investment Association to complete guidance on engagement with stakeholders. Invite the GC100 group to complete and publish new advice and guidance on the practical interpretation of the directors' duties in section 172.	Non-legislative / industry-led	This work will complement legislative changes by providing helpful guidance to companies. By providing guidance on the interpretation of s172 duties it should make it easier for companies to comply with the newly introduced reporting requirement in a meaningful way.
Corporate governance in large privately-held and public unlisted companies		
Proposed measure	Type	Impacts
Require companies of a significant size to disclose their corporate governance arrangements in their Directors' Report and on their website	Secondary legislation	Benefits (non-monetised) Driving up overall governance standards to levels already attained by many companies. Help reduce the risk of future governance failures, improve transparency and restore trust in business. Build lender and supplier confidence that a company is well run. Costs (monetised), best estimates Additional regulatory burden, estimated to be (in total): £1.23m in year one; and £0.59m per annum thereafter.
Invite the FRC to work with a Coalition Group consisting of the Institute of Directors, the CBI, the TUC, the Institute for Family Business, the British Venture Capital Association and others to develop voluntary corporate governance principles for large private companies.	Non-legislative / industry-led	This work will complement legislative changes by providing a helpful framework for companies. The development of governance principles for private companies that has wide support from stakeholders should: a) help raise standards by identifying what is best-practice and what is expected; and b) provide a widely used – but voluntary - reference point which large private companies can use in reporting on their corporate governance arrangements. The work of the Coalition Group, for which the FRC provides the secretariat, is now underway under the leadership of James Wates (of Wates Construction).
Other		
Proposed measure	**Type**	**Impacts**
Invite the FRC, FCA and Insolvency Service to update existing MoUs and letters of understanding between them (or conclude new ones).	Non-legislative	This work will ensure that existing enforcement powers are used effectively and reduce duplication, overlap and regulatory inefficiency. It will help build confidence in the robustness of the existing enforcement regime.

Source: UK BEIS.

Government has invited the FRC to consider and consult on a specific Code provision requiring premium listed companies to adopt, on a "comply or explain" basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce.

(Non-legislative). Encourage industry-led solutions by asking ICSA (the Institute of Chartered Secretaries and Administrators: The Governance Institute) and the Investment Association to complete and publish joint guidance on practical ways in which companies can engage with their employees and other stakeholders. The Government has also invited the GC100 group of the largest listed companies (FTSE100 General Counsels) to complete and publish new advice and guidance on the practical interpretation of the directors' duties in section 172 of the Companies Act 2006.

Corporate governance in large private companies

(Secondary legislation). Require companies of a significant size to disclose their corporate governance arrangements in their Directors' Report and on their website, including whether they follow any formal code, or recognised set of corporate governance principles. Following discussions with stakeholders, the Government has decided that the threshold for "significant size" will be set such that companies will be covered by this requirement if they: a) have more than 2 000 employees globally; or b) have a global turnover figures over £200m and a balance sheet over £2 billion. This is unless they are subject to an existing corporate governance reporting requirement (such as listed companies, charitable companies and others).

(Non legislative). Inviting the Financial Reporting Council to work with the Institute of Directors, the CBI, the TUC, the Institute for Family Business, the British Venture Capital Association and others to develop corporate governance principles for large private companies. These will be voluntary principles, and companies will be under no compulsion to adopt them. The objective is to develop principles that command widespread support and endorsement from business and that, in due course, they become the framework which most large privately-owned companies will choose to reference.

Enforcement

(Non-legislative). Government has asked the FRC, the FCA and the Insolvency Service to conclude new or, in some cases, revised letters of understanding with each other to ensure the most effective use of their existing powers to sanction directors and ensure the integrity of corporate governance reporting. The Government will consider, in light of this work, whether further action is required.

Conclusions

The survey results show that flexibility and proportionality are used by all jurisdictions included in the review for the implementation of board composition, board committees and board member qualifications. This was to some extent expected, as the OECD Corporate Governance Factbook had already documented a great diversity of board arrangements across jurisdictions, with corporate governance systems often using soft law to offer guidance as how to foster well-functioning boards within a flexible and proportionate framework.

The case study from the UK illustrates the process of setting the framework for board composition, board committees and board member qualifications that has taken place in one of the most advanced equity markets in the world. It highlights the combined approach of setting key requirements in the law and using the UK Corporate Governance Code[61], which is a legislative requirement for companies with Premium listing of equity shares, and its flexible approach to foster best board practices. 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 or the Quoted Companies Alliance (QCA) Corporate Governance Code.[62]

The ambitious reform agenda and the rationales for change also show the UK authorities' openness to revisiting and, where necessary revising, policies and adopting reforms as it may be necessary to ensure frameworks are able to adapt to changes in markets. Among the reforms envisaged ahead, it is interesting to note the ambition to use proportionality to introduce corporate governance disclosure requirements beyond listed companies, in order to strengthen large private companies' governance arrangements.

Notes

[1] Three countries have hybrid systems that allow for three options and provide for an additional statutory body mainly for audit purposes. Italy and Portugal have established models similar to one-tier or two-tier systems in addition to the traditional model with a board of statutory auditors. Japan amended the Company Act in 2014 to introduce a new type of board structure – a company with an audit and supervisory committee - besides models providing for a board with statutory auditor and a company with three committees.

[2] In the UK it is two, it is seven for large companies in Chile, and 12 for the companies with two-tier boards in Norway.

[3] In the United States, for example, while Delaware law and exchange rules permit a company to have a classified board which typically has three classes of directors serving staggered three-year board terms, many companies have adopted annual re-election, and the classified board system has become less prevalent. In France, it is recommended that the terms of office of the board members should be staggered. In Hong Kong, China, one-third of the directors are required to retire from office by rotation at each annual shareholder meeting.

[4] In the cases of Chile, France, Israel and the US, companies with more concentrated ownership are subject to less stringent requirements or recommendations. In Italy, a stricter requirement for a majority of independent directors is imposed in cases involving integrated company groups with pyramid structures that may contribute to more concentrated control. Portugal requires an "adequate" number of independent directors that takes into account shareholder structure and free float. In Israel, according to a list of recommended (not binding) corporate governance rules set forth in the First Addendum to the Companies Law, board independence requirements is correlated to the ownership structure of the company (companies with dispersed shareholding are required to have a majority of the independent directors, while companies with controlling shareholders are required to have at least one-third of the independent directors).

[5] Full or majority independent membership is required or recommended for all three committees in most of the jurisdictions, while provisions on chair independence in audit committees are more common compared to the nomination committee or remuneration committee. The Swedish code recommends that the largest shareholders (or their representatives) make up the majority of a nomination committee.

[6] Some jurisdictions (e.g. Australia) allow some flexibility for listed companies to adopt and disclose more efficient and effective alternative governance practices instead of having a separate board-level committee.

[7] In Italy, at least one board member must be elected from the slate of candidates presented by shareholders owning a minimum threshold of the company's share capital. In Israel, it is recommended for initial appointment and required for re-election, that all outside directors be appointed by the majority of the minority shareholders.

[8] For example, Singapore's code states that the board should comprise directors who as a group provide core competencies such as accounting or finance, business or management experience, industry knowledge, strategic planning experience and customer-based experience or knowledge. Some other jurisdictions set out a requirement or recommendation only for certain board members, such as independent directors, members of audit committees, or Chair of the board.

[9] The listing rules issued by Borsa Italiana for firms that belong to the STAR market segment, which includes medium-sized companies which comply with enhanced disclosure and governance requirements, require them to: (i) appoint a remuneration committee and a control and risk committee; (ii) have a minimum quorum of independent directors present within board meetings (at least 2 for boards with up to 8 members, 3 for boards with between 9 and 14 members, and 4 for boards with more than 14 members).

[10] They are not exempt, however, from standards for audit committees mandated under the Exchange Act as set forth in Rule 10A-3.).

[11] The Italian framework provides for some governance requirements as a condition to allow the listing of companies subject to management and coordination ("direzione e coordinamento") by another company. The law and the implementing regulation adopted by the Italian Securities Regulator (Consob) provide some reinforced board and committees composition requirements to be fulfilled in order for the company to be listed. Such requirements are additionally strengthened if the parent company is also listed (and consequently the subsidiary is not only part of an integrated group but also a pyramid).

[12] Listed firms in the equity market of Mexico can have the legal status of Sociedades Anónimas Bursátiles (SAB), or Sociedades Anónimas Promotoras de Inversión Bursátil (SAPIB), and these types of firms have different requirements for listing, board composition, and information disclosure.

[13] Officials at the UK's Department for Business, Energy & Industrial Strategy were asked by the OECD Corporate Governance Committee to produce this officials-level working document for internal discussions by the OECD Committee. As such, it is factual and does not develop or recommend new policy options.

[14] Company law Review Steering Group, Department of Trade and Industry, Modern Company Law for a Competitive Economy, The Strategic Framework (1999).

[15] Company Law Modernisation and Corporate Governance in the UK – Some Recent Issues and Debates, by Professor Roman Tomasic, pp.46.

[16] An executive agency of the Department of Business, Energy and Industrial Strategy, by which the registrar of companies performs various functions including the incorporation and dissolution of registered companies, the examination and storage of information legally required by companies by virtue of the Companies Act 2006, and where required, the publication of all of this information.

[17] Section 15(1) of the Companies Act 2006 - On the registration of a company, the registrar of companies shall give a certificate that the company is incorporated.

[18] Susan McLaughlin (2009), Unlocking Company Law.

[19] The existence of corporate directors is subject to reform by the Small Business, Enterprise and Employment Act 2015, in a bid to increase transparency of company ownership in the UK. Corporate directors will soon be prohibited, bar some limited exceptional circumstances.

[20] A company whose shares may be purchased by the general public and traded freely on a stock exchange.

[21] A company whose shares may not be offered to the public for sale and which operates under legal requirements which are less strict than those for a public company.

[22] Section 154 (1) & (2) Companies Act 2006.

[23] Section 158 (1) Companies Act 2006.

[24] Section 157 (1) Companies Act 2006.

[25] The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality. It's funded by membership fees.

[26] Section 12 (3) Companies Act 2006.

[27] Section 168 (1) of the Companies Act 2006.

[28] Section 168 (1) of the Companies Act 2006.

[29] Section 167 of the Companies Act 2006.

[30] The fiduciary duties as a director encompass a relationship of trust and loyalty between the director, the company, its members, and stakeholders. The expectation is that directors will act in good faith, and in the best interests of the company. These common law duties overlap and inter-connect with the statutory duties as laid down in the Companies Act 2006.

[31] Gower, *Principles of Company Law* (6th ed.), citing Isle of Wight Rly Co v Tahourdin (1884) LR 25 Ch D 320.

[32] *Per* Cozens-Hardy LJ, p 44.

[33] See: www.accaglobal.com/content/dam/acca/global/PDF-students/2012s/sa_oct12f1fab_governance.pdf, pp.5.

[34] Section 174 (2)(a) of Companies Act 2006.

[35] Understanding Company Law, Alastair Hudson 2012.

[36] See: www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf.

[37] A Premium Listing is only available to equity shares issued by trading companies and closed and open-ended investment entities. Issuers with a Premium Listing are required to meet the UK's super-equivalent rules which are higher than the EU minimum requirements. A Premium Listing means the company is expected to meet the UK's highest standards of regulation and corporate governance – and as a consequence may enjoy a lower cost of capital through greater transparency and through building investor confidence; see: www.londonstockexchange.com/companies-and-advisors/main-market/companies/primary-and-secondary-listing/listing-categories.htm.

[38] See: www.gov.uk/government/publications/women-on-boards-5-year-summary-davies-review.

[39] The FTSE 350 Index is a capitalisation-weighted index consisting of the 101st to the 350th largest companies listed on the London Stock Exchange. Promotions and demotions to and from the index occur quarterly in March, June, September, and December. The Index is calculated in real-time and published every minute. Related indices are the FTSE 100 Index (which lists the largest 100 companies), the FTSE 350 Index (which combines the FTSE 100 and 250), the FTSE SmallCap Index and the FTSE All-Share Index (an aggregation of the FTSE 100 Index, the FTSE 250 Index and the FTSE SmallCap Index).

[40] See: www.gov.uk/government/publications/ftse-women-leaders-hampton-alexander-review.

[41] See: www.gov.uk/government/publications/ethnic-diversity-of-uk-boards-the-parker-review.

[42] Directive 2014/95/EU: https://ec.europa.eu/.../company-reporting/non-financial-reporting_en.

[43] See:www.frc.org.uk/consultation-list/2017/consulting-on-a-revised-uk-corporate-governance-co.

[44] See: www.legislation.gov.uk/uksi/2013/1970/pdfs/uksi_20131970_en.pdf.

[45] As defined in section 365 of the Act, these are UK registered companies that are quoted on the main London Stock Exchange or on a stock exchange in the European Economic Area, the New York Stock Exchange or NASDAQ.

[46] See: www.legislation.gov.uk/uksi/2013/1981/pdfs/uksi_20131981_en.pdf.

[47] See: www.handbook.fca.org.uk/handbook/LR.pdf.

[48] See: www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx.

[49] See: www.gov.uk/government/consultations/corporate-governance-reform.

[50] Kiatpongsan and Norton (2014) show, using international survey responses, including for the UK, that people underestimate the pay ratios between CEOs and average workers, and that their ideal ratios are much lower than actual observed ratios.

[51] Edmans et al (2016) show that vesting equity induces CEOs to reduce investment in long-term projects and increase short-term earnings. Continuous and frequent vesting of share plans can thus result in CEOs aiming to deliver to short-term targets. Edmans et al (2014) provides evidence highlighting that CEOs strategically time corporate news around months in which their equity vests.

[52] Bell and Van Reenen (2016) find supporting evidence for this in UK companies with weak corporate governance.

[53] ONS: Ownership of quoted shares 2016. Available at: www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2016.

[54] See: www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter and http://cecp.co/wp-content/uploads/2018/02/SII-Investor-Letter_final.pdf?redirect=no.

[55] See: www.biginnovationcentre.com/purposeful-company.

[56] Acharya and Volpin (2010) explain how weak corporate governance can lead to excessive compensation even in firms with good governance because of competition on pay. Due to such externalities, the overall level of governance in the economy can be inefficiently low.

[57] PwC: CEO Success Study. For summary findings, see: www.strategyand.pwc.com/uk/home/press_contacts/displays/ceo-success-study-2016-uk.

[58] That is, UK-registered companies with a listing on the UK Official List, NASDAQ, the New York Stock Exchange or a regulated exchange in the EEA.

[59] Section 414A of the Companies Act 2006 requires all companies that are not small to prepare a strategic report. This new requirement will though only apply to large companies as defined in the Companies Act – i.e. companies meeting at least two out of the following three criteria: i) turnover of more than £36m; ii) balance sheet total of more than £18m; and iii) more than 250 employees.

[60] Applying the Companies Act definition of 'large': companies meeting at least two out of the following three criteria: i) turnover of more than £36m; ii) balance sheet total of more than £18m; and iii) more than 250 employees.

[61] The UK Code has just been updated and the new version will apply from 1 January 2019: www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code

[62] www.theqca.com/news/briefs/143736/new-qca-corporate-governance-code-released.thtml

[62] www.frc.org.uk/directors/corporate-governance-and-stewardship/governance-of-large-private-companies

References

European Commission (2013), "Directive 2013/50/EU Of The European Parliament And Of The Council of 22 October 2013", http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0050&from=EN.

ICSA: The Governance Institute (2017), The future of governance: Untangling corporate governance, http://www.icsa.org.uk/assets/files/pdfs/Press/icsa-the-future-of-governance-report-1.pdf?utm_source=Mondaq&utm_medium=syndication&utm_campaign=inter-article-link.

Isaksson, M. and S. Çelik (2013), "Who Cares? Corporate Governance in Today's Equity Markets", OECD Corporate Governance Working Papers, No. 8, OECD Publishing, Paris, http://dx.doi.org/10.1787/5k47zw5kdnmp-en.

OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, https://doi.org/10.1787/9789264236882-en.

OECD (2017), "OECD Corporate Governance Factbook 2017", http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.

Chapter 5. Say on pay and the detail of disclosure of remuneration

This chapter presents the results of the review in the area of say on pay and the detail of disclosure of remuneration. It takes stock of the criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating to the area across the 39 jurisdictions that responded to the survey used for the review. It also includes a case study of the Swedish corporate governance framework in the area submitted by Rolf Skog and Erik Lidman.

Introduction

Say on pay and the detail of disclosure of remuneration

The Committee's first thematic review, conducted in 2009, focused on board practices related to setting incentives and governing risks. It covered 29 jurisdictions, including in-depth reviews of Brazil, Japan, Portugal, Sweden and the United Kingdom. The review and its findings (OECD, 2011), explain that since the financial crisis boards are under scrutiny with respect to their ability to effectively oversee executive remuneration, as recommended by the G20/OECD Principles.[1] It points out that the challenge lies not only in setting an adequate *level* of executive and director remuneration, but also in designing incentive schemes that are *aligned* with the longer term interests of the company as a whole.

The report also noted that legislators and regulators have limited capacity to influence remuneration outcomes with legal and regulatory tools, which was the reason why very few jurisdictions had legislated specific measures affecting the setting of remuneration at the time. Rather, it noted that policy makers have focused on facilitating the well-functioning of firms' own governance arrangements, so that they can deliver appropriate remuneration and incentive outcomes (Box 5.1.). In this respect, the report highlights the role of say on pay mechanisms in providing shareholders a means to express their views on director and executive remuneration, as well as of disclosure of remuneration outcomes and better explanations of how incentive-based remuneration aligns with company performance.

Although some of the fundamental issues remain, much has changed in relation to the rules and practices for say on pay and, to a lesser degree, regarding disclosure of remuneration, since the period covered in the 2011 OECD report. The Principles themselves have also been subject to an extensive review and now address the topic in more detail.

Box 5.1. Excerpts from OECD (2011) Board practices: Incentives and governing risk

As a general rule, legislators and regulators capacity to influence remuneration outcomes via hard means is quite limited, and very few jurisdictions have legislated specific measures to control the level of executive and director remuneration. Policy makers have rightly focused more on measures that seek to improve the capacity of firm governance structures to produce appropriate remuneration and incentive outcomes. These can roughly be characterised as i) measures to improve internal firm governance and especially via mandating certain levels of independence by the board; ii) improved disclosure to shareholders on remuneration outcomes, and better explanation of how incentive based remuneration aligns with company performance; and iii) providing mechanisms to allow shareholders a means of expressing their views on director and executive remuneration.

Many jurisdictions have favoured soft law measures that can go further in providing guidance on the structure of remuneration systems. Codes are often a more appropriate mechanism for normative controls on remuneration and guidance on remuneration structure; they are generally more flexible to individual firm characteristics and can adapt to changing market circumstances. (…)

Policy options have focused on improving shareholder engagement and remuneration disclosure. Active shareholder engagement can provide a strong monitoring function on the role of boards in the remuneration process. The legal frameworks across countries vary greatly in the extent to which shareholders have a voice in setting/influencing director and executive remuneration, from placing the matter entirely in the hands of the general meeting, to giving shareholders no formal role. The Principles recommend simply that shareholders should be able to make their views known.

The experience of OECD countries suggests that the effectiveness of "say on pay" provisions is fundamentally linked to having active and informed shareholders with a sufficient capacity to influence the board. Policy makers need to identify innovative mechanisms for providing institutional shareholders with better incentives and cost effective means, for exercising their shareholder rights. Policy measures adopted to date have included introducing codes of behaviour for institutional shareholders to exercise their voting rights diligently and reducing the costs of shareholder participation by more effective proxy access.

The quality and timeliness of disclosures around incentive and remuneration arrangements is also critical to informed shareholder engagement, and providing a level of assurance to minority shareholders that remuneration is structured to align executive and director incentives with the interests of the company as a whole. Accordingly, a key policy focus for many jurisdictions has been (and should continue to be) to improve the disclosure requirements to support pre-existing "say on pay" arrangements. These measures are focused on both a greater level of disaggregated disclosure and a more comprehensive description of the drivers of remuneration outcomes and their relationship to firm performance. In other jurisdictions, code makers have introduced amendments designed to encourage more description of how incentive arrangements align manager/director interests with those of the company and shareholders.

Issues and trends

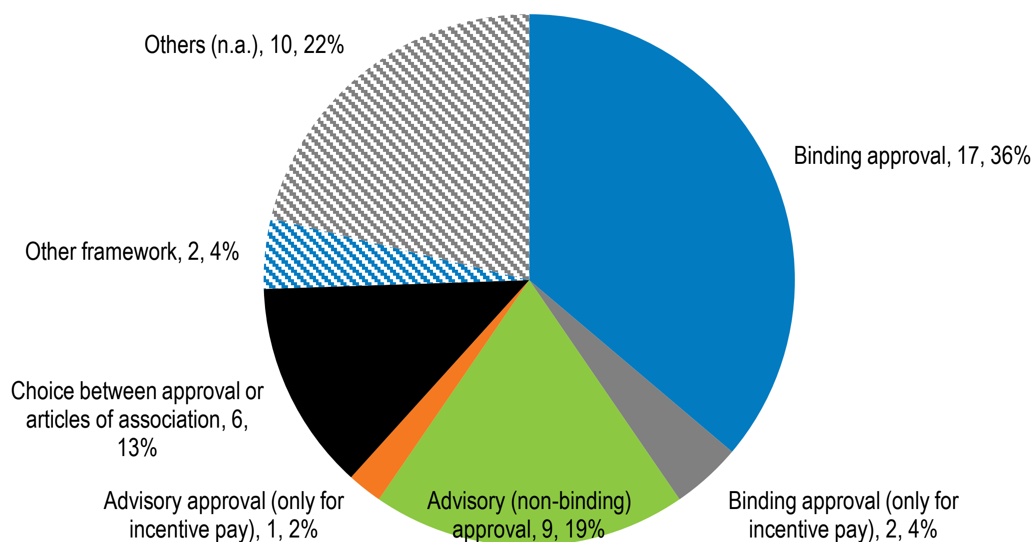
The discussion about compensation practices did not start with the financial crisis, but attracted significantly more attention after it. In the face of the collapse and near-collapse of large and sophisticated firms, many believed that their corporate managers had been remunerated in ways that led to reckless performance and that compensation practices had to be reined in to reintroduce sound incentives and accountability.

Beyond any subjective views on the appropriate form and level of executive remuneration, the reality is that since the financial crisis a large number of jurisdictions have made policy interventions to address the issue of executive (and board) compensation involving the two instruments that are subject to this review, namely disclosure and say on pay (Thomas and Van der Elst, 2014[10]). These types of interventions largely aim to give information and a voice to the firms' stakeholders that could exercise pressure to establish executive pay at an efficient level, and to better align incentives.

Even if the main focus might have been CEO pay, remuneration disclosure and say on pay mechanisms have extended in most jurisdictions to cover all senior managers and also to the board. Even jurisdictions that did not experience a problem (or the perception) of misaligned or uncontrolled compensation have also adopted, at least partially, these

mechanisms for monitoring and adjusting executive pay. They are now seen by the investor community as important accountability and stewardship tools for governance frameworks (see section 3 for a description of the Swedish experience).

Figure 5.1. Say on the remuneration policy across jurisdictions



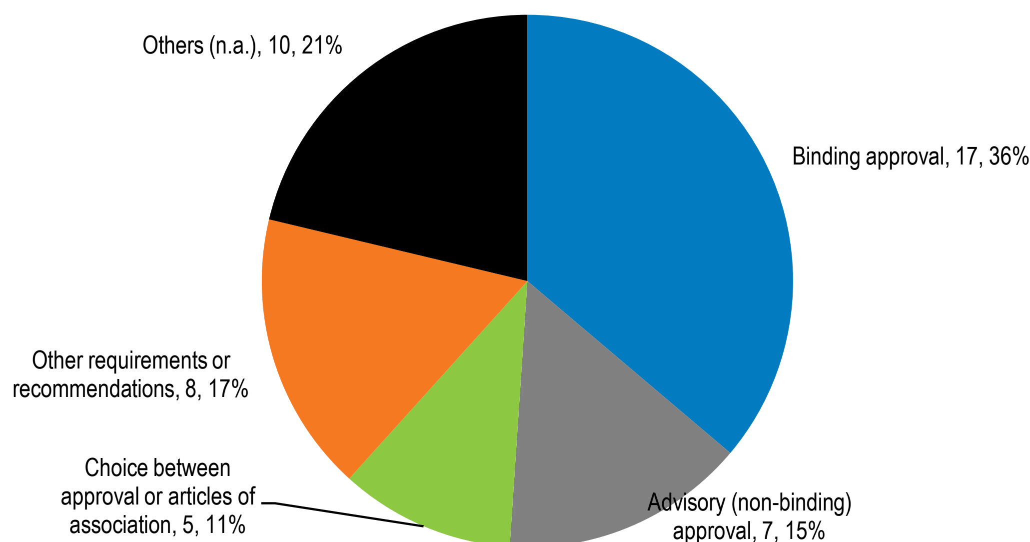
Note: This Figure shows the number of jurisdictions in each category and their percentage share out of the 46 jurisdictions included in the sample.
Source: OECD, 2017 Corporate Governance Factbook.

The OECD Corporate Governance Factbook tracks these developments. Nearly ninety per cent of jurisdictions covered in the 2017 edition had by year end 2016 introduced one or more mechanisms of normative control of remuneration, most often through a Code or other soft law instruments that rely on a flexible "comply or explain" approach.[2] Only India and Saudi Arabia reported maximum limits on remuneration, while a majority of jurisdictions had adopted general criteria or specific measures to address the links between remuneration and the longer-term interest of the firm (with schemes adopting most commonly a 2 or 3-year vesting period for stock options) and caps on severance payments (between half and 2-years' remuneration).

A majority of jurisdictions included in the OECD Corporate Governance Factbook set forth a requirement or recommendation for a binding (36%) or advisory (15%) shareholder vote on remuneration policy (Figure 5.1.).

The OECD Corporate Governance Factbook describes a wide variety of features of the "say on pay" mechanisms used by jurisdictions. These include cases where the vote covers only the remuneration policy in general versus others when it affects the total amount or level of remuneration (Figure 5.2.). Likewise, some mechanisms encompass the compensation of the senior managers only, while others also affect the remuneration of board members.

Figure 5.2. Say on level/amount of remuneration across jurisdictions



Note: This Figure shows the number of jurisdictions in each category and their percentage share out of the 41 jurisdictions included in the sample.
Source: OECD, 2017 Corporate Governance Factbook.

This variability and its impact on cross-border holdings by investors was invoked by the EU when in 2014 it first proposed the recently adopted amendments to the EU Shareholder's Rights Directive (2007/36/EU). The European Council described that the remuneration information disclosed by EU companies was "not comprehensive, clear nor comparable" and that shareholders often "do not have sufficient tools to express their opinion on directors' remuneration" (European Commision, 2014, p. 5[11]). For this, it proposed to adopt an obligation to disclose the remuneration policy and individual remunerations, combined with a shareholder vote on the company's remuneration policy, as it was finally adopted in April 2017 (Box 5.2.).

The effects of the existing say on pay and disclosure mechanisms vary across jurisdictions, but a recent study shows interesting results. Analysing financial data for 17 000 publicly traded companies in 38 jurisdictions with and without say on pay mechanisms in place, one study has found that CEO pay growth is slower and its sensitivity to firm performance higher (about 5% more) when a say on pay mechanisms is present, regardless if it is binding or only advisory (Correa and Lel, 2016). The study also finds, on the one hand, that the effects over CEO pay are larger in firms with poor performance, and, on the other, that most votes against pay packages come from sophisticated investors, rather than from retail stockholders.

It is not the objective of this report to evaluate the results of the say on pay and compensation disclosure mechanisms, and the jury is still out as to whether the results already documented are indeed increasing the alignment of compensation with the long term interest of the company. It is nonetheless worth noting that the measurements and analysis so far do not capture the degrees of flexibility and proportionality in the mechanisms evaluated. The results of this thematic review could enrich that research and our debate on compensations policies, as the issue of executive pay and its alignment remains at the heart of the corporate governance reform in many jurisdictions.

Box 5.2. Excerpts from the 2014 amendment proposal for the EU Shareholder's Rights Directive

According to the principle of subsidiarity the EU should act only where it can provide better results than intervention at Member State level and action should be limited to what is necessary and proportionate in order to attain the objectives of the policy pursued. As regards this aspect it is important to note that there is strong evidence that the EU equity market has to a very large extent become a European/international market. (…)

On the objectives to ensure sufficient transparency and shareholder oversight on directors' remuneration and related party transactions, the existing Member State rules in these areas are very different and as a result, they provide an uneven level of transparency and protection for investors. In both cases, the result of the divergence of rules is that investors are, in particular in case of cross-border investments, subject to difficulties and costs when they want to monitor companies and engage with them, and have no effective tools to protect their investments. (…)

Nevertheless, Member States should have a degree of flexibility as far as the transparency and information required in this proposal are concerned, in particular in order to allow the norms to adequately fit into the distinct corporate governance frameworks. To allow for such flexibility only some basic principles regarding shareholder identification, transmission of information by intermediaries and facilitation of the exercise of rights should be ensured. (…)

To this end, an amendment to the Shareholders Right Directive is the most appropriate legal instrument as it allows a certain flexibility for Member States, while at the same time providing the needed level of harmonization. Amending the Directive also ensures that the content and form of the proposed EU action does not go beyond what is necessary and proportionate in order to achieve the regulatory objective.

Strengthening the link between pay and performance of directors.

The proposal aims at creating more transparency on remuneration policy and the actual remuneration awarded to directors and creating a better link between pay and performance of directors by improving shareholder oversight of directors' remuneration. The proposal does not regulate the level of remuneration and leaves decisions on this to companies and their shareholders.

Articles 9a and 9b will require listed companies to publish detailed and user-friendly information on the remuneration policy and on the individual remuneration of directors, and Article 9b empowers the Commission to provide for a standardized presentation of some of this information in an implementing act. As is clarified in Article 9a paragraph 3 and 9b paragraph 1 all benefits of directors in whatever form will be included in the remuneration policy and report. The Articles give shareholders the right to approve the remuneration policy and to vote on the remuneration report, which describes how the remuneration policy has been applied in the last year. Therefore, such report facilitates the exercise of shareholder rights and ensures accountability of directors.

Box 5.3. A critique of the French Say on Pay system

By Professor Alain Pietrancosta as discussed in Say On Pay: The New French Legal Regime in light of the Shareholders' Rights Directive II **(Pietrancosta, 2017[15])**.

France has thus decided to take the lead on this particular issue (apparently without a clear consciousness of doing so), by way of a pre-emptive over-implementation of the European Shareholder' Rights Directive, so as to transform a mere 'say on pay' into a real 'decide on pay'.

Indeed, this combination of an ex ante binding vote, on the UK model, followed by an ex post binding vote, on the Swiss model, is rather unique and has consequently raised concerns from corporate practice. The French say on pay is accused of being excessively rigid and a new manifestation of needless red tape. Surely, the compulsory character of the ex post vote has been strongly criticised for weakening the remuneration packages offered by French listed companies, and as such creating a competitive handicap for them in the international market for top executives, and dispossessing the boards of their core legal power of setting the top executives' compensation.

After all, the strong stance taken by the French lawmaker expresses a political choice that is hard to challenge on the grounds of legitimacy; although the disputed evidence of the economic efficiency of the say on pay tool weakens the case for such a stringent legal regime.

What is more difficult to understand is the failure to comply with other say on pay requirements contained in the European Shareholder' Rights Directive, as if the excessive focus on the legal nature of the ex-ante / ex-post votes had overshadowed aspects of the say on pay regime other than procedural. Such is the case for:

- the personal scope of application of the say on pay, the French one being more restrictive than the European one, which covers all members of the administrative, management or supervisory bodies of the company;

- the mandatory nature and the content of the remuneration policy, which is much more demanding, ambitious and results-oriented in the European directive;

- the ex post remuneration report, whose content is much more informative and meaningful in the Shareholder' Rights Directive.

As a result of these discrepancies, the brand new French say on pay mechanism must be significantly revised by June 10, 2019, an obligation to reform that is likely to be ill-received by some vested interests. Optimists may however see it as an opportunity to think about reversing some of the options retained in the Sapin II Law and to soften it with flexibility and proportionality elements, which can only be based on a more coherent and general vision.

The UK, which was among the first jurisdictions to adopt a say on pay mechanism, is one of them. In August 2017 Prime Minister May described how "in some companies executive pay has become disconnected from the performance of the company itself" (Department for Business, Energy & Industrial Strategy, 2017). Her government is asking the custodian of the UK Corporate Governance Code to make adjustments to its

recommendations to encourage firms to simplify pay packages by increasing cash payments and limiting equity-based incentives to stock options with long vesting periods and selling restrictions.

France has recently approved a law (*Loi Sapin 2*) that introduces a new say on pay mechanism that amends the consultative mechanism France adopted four years ago and that is in line with the requirement of the amended EU Shareholders' Rights Directive. Under the new mechanism, an annual, ex-ante and binding vote, is due on the remuneration policy of the firm, while the remuneration report is subject to an annual, binding and ex-post vote. The remuneration report has to describe the remuneration (fixed, variable, and exceptional components) included in the total compensation (including benefits of any kind) paid or allocated in the prior year to each of the key executives[3] (Box 5.3.). The first shareholders' votes under the new French system, applicable during a transition phase until 2018, have put CEO pay in a near rejection scenario in at least three large companies – one of those companies' CEOs had already had his remuneration rejected, albeit only consultatively, last year (Ana Lutzky, 2017).

The view of the G20/OECD Principles

The G20/OECD Principles address say on pay and the detail of disclosure of remuneration within Chapter II. It deals with the rights and equitable treatment of shareholders and key ownership functions and was subject to important revisions during the 2015 review. In section C.4. of that chapter it is stated that:

> *Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known, including through votes at shareholder meetings, on the remuneration of board members and/or key executives, as applicable. The equity component of compensation schemes for board members and employees should be subject to shareholder approval (OECD, 2015).*

The annotations further clarifies that the call for disclosure of remuneration of board members and key executives is justified by the need for shareholders to fully understand the remuneration policy and compensation costs to the firm, and how they link to company performance. The text makes a direct link between this investors' assessment and their general power to re-elect or nominate new members to the board if they are not satisfied with the results.

The annotations also address how the features of a say-on-pay mechanism may influence the ability of a firm's governance framework to reflect and react to the strength and tone of shareholder sentiment. Such features may include a binding or only advisory vote; a vote that takes place ex ante or ex post; a vote that affects the remuneration of key executives, the members of the board, or both; a vote that encompasses only the overall rules of the compensation policy or also set actual limits for remuneration, and a vote that may have effect over aggregates levels of executive compensation or also regarding the remuneration of specific individuals.

The main recommendations of Chapter II on the area of practice covered by the review are complemented by section D of Chapter VI., The Responsibilities of the Board, and section A.4. of Chapter V, Disclosure and Transparency.

Section D.4 of Chapter VI establishes that the board should fulfil certain key functions, including aligning key executive and board remuneration with the longer term interests of the company and its shareholders. For this, the annotations explain that it is regarded as

good practice for boards to develop and disclose a remuneration policy statement covering board members and key executives. For large companies, best practices is described as having remuneration policy and contracts for board members and key executives handled by a special committee of the board, ideally composed of a majority of independent, non-executive directors.

In turn, section A.4. of Chapter V, Disclosure and Transparency, establishes that disclosure by firms should include, but not be limited to, material information on the remuneration of members of the board and key executives. The annotations on that section again make the link between remuneration and long term company performance, explaining that firms are generally expected to disclose this information so that investors "can assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to company performance". The annotations further describe that disclosure of remuneration on an individual basis (as opposed to overall figures encompassing all executives and/or board members as a group) "is increasingly regarded as good practice and is now mandated in many countries".

Flexibility and proportionality with respect to say on pay

As mentioned in the G20/OECD Principles' annotations cited above, there is a general trend in the direction of including say on pay mechanisms and rules regarding the disclosure of remuneration in the mandatory parts of national government frameworks. But as any intervention of this nature, these policies have a cost, mostly for the firms, but also for regulators and others. Some firms may already have detailed remuneration reports available and may be ready to discuss them with investors on a voluntary basis. Others may not. For them, these interventions have an effect and a cost. A case can certainly be made that the benefits for the firms outweigh the costs, as these practices will improve their governance framework. But the questions from a flexibility and proportionality perspective is what will be the effects of the intervention in the real world, for the heterogeneity of firms from different sectors and going through diverse stages of maturity at changing cycles within the economy.

A flexible and proportional approach allows for targeted interventions, which limit the risk of undesired side-effects. In the area of say and pay and the detail of disclosure on remuneration, it is not difficult to imagine, for example, that more detailed disclosure could increase a firm's exposure to third party hiring offers, if the level of remuneration it pays is below average. As mentioned, this can have the effect of pushing the remuneration average up. Likewise, the more power is transferred to shareholders in the setting of the remuneration, the weaker the board will be to recruit new managers. This could lead to the firm not having the best possible executive team.

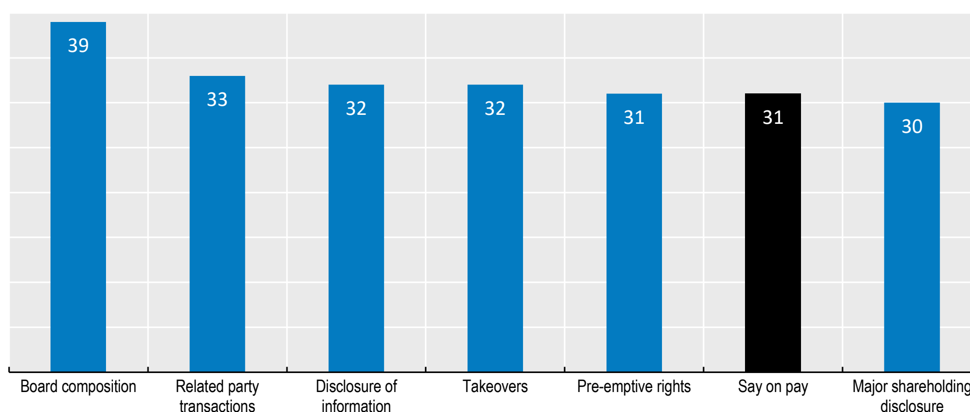
In this perspective, the inquiry from a flexibility and proportionality approach is to asses when, for which firms and under which circumstances, a policy intervention may be appropriate. For example, does it make sense to adopt a say on pay binding vote in a company with a controlling shareholder that commands a majority of the votes? Maybe not, at least not in all circumstances. However, it may be useful for minority investors to receive detailed information on the compensation practices of the firm to assess the risk of abusive private benefits of control. Is it necessary to demand the same level of disclosure of remuneration to a medium sized company that wants to conduct an IPO as that which is demanded of a blue chip firm? Again, maybe not, because such imposition may add-up to other costs of going public and deter growth companies from accessing the equity market financing they may need to expand.

These are some of the issues behind the use of a flexible and proportional approach that this review is trying to capture. How jurisdictions use flexibility and proportionality criteria and mechanisms to ensure that their governance framework is fit for purpose. This chapter focuses only on regulations related to *say on pay and the detail of disclosure of remuneration.* It reflects how national policymakers aim to strike a balance between imposing costs on firms and the need to facilitate investor protection with voting rights and disclosure of compensation policies and practices, in a way that is conducive to investor confidence, monitoring, and sound governance. The next section presents the main results from the survey responses as to how this is implemented.

Survey results

Out of the 39 jurisdictions included in the survey, 31 reported at least one criteria or optional mechanism to allow flexibility and proportionality in the area of say on pay and the detail of disclosure on remuneration (Figure 5.3.)

Figure 5.3. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation

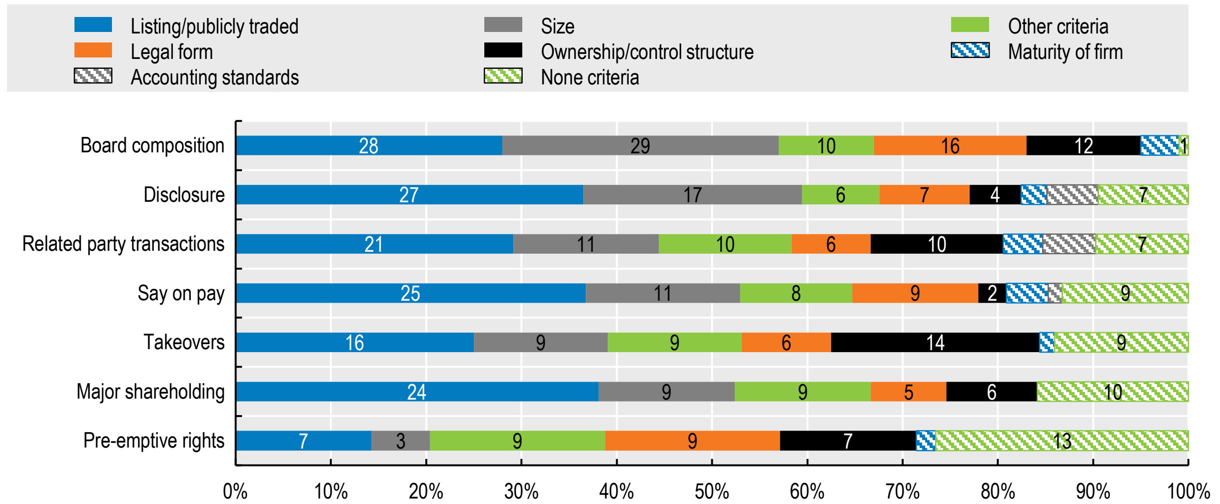


Source: OECD Survey.

Looking at the frequency of use of the different criteria across the regulatory areas, Figure 5.4. shows that there were 9 jurisdictions that did not report using any criteria for flexibility and proportionality with respect to say on pay and the detail of disclosure on remuneration.

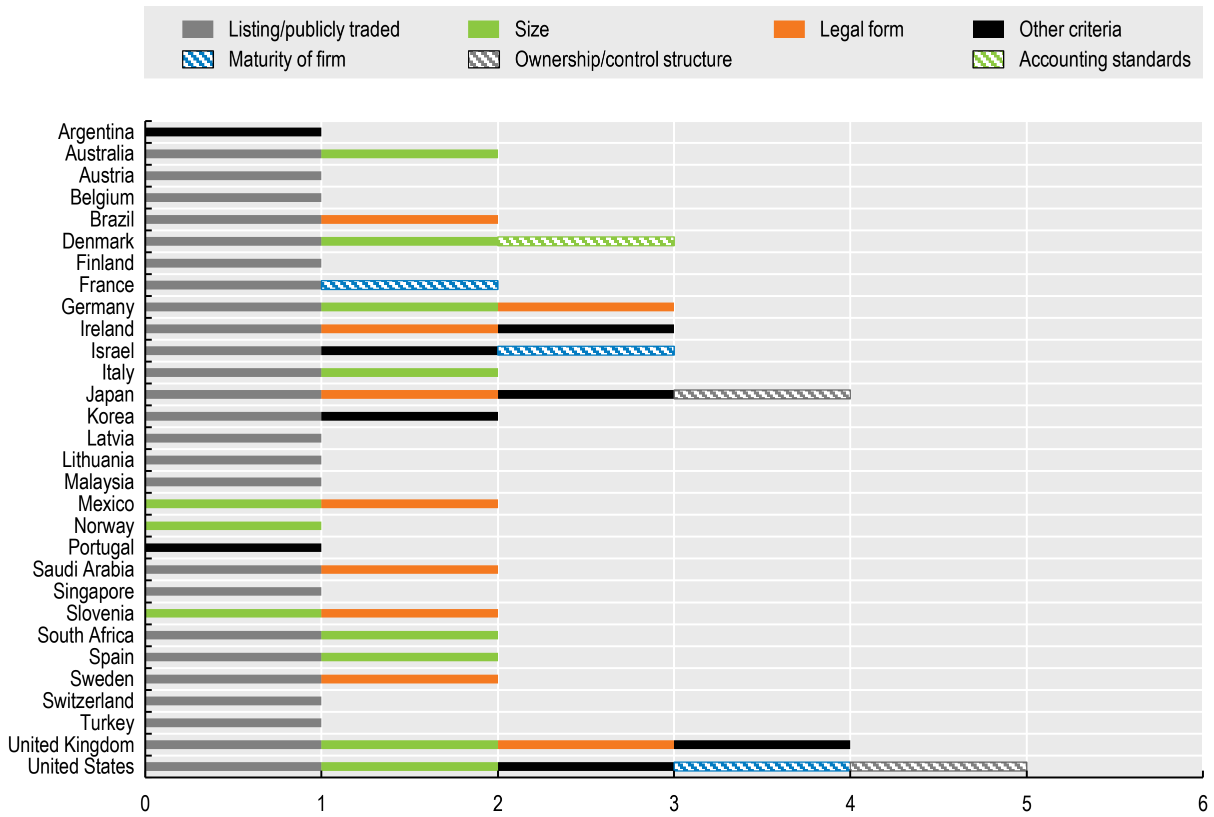
As described in the main chapter of this thematic review, among all the criteria that jurisdictions employ the most to promote flexibility and proportionality in their corporate governance frameworks, the criterion of *listing/publicly trading* and the criterion of *size* are by far the most used when considering all areas of practice. Aligned with the general results, the *listing/publicly traded* criterion is the most used in the area of say on pay and the detail of disclosure on remuneration, followed by *size* and *legal form* (Figure 5.4.). Figure 5.5 shows the frequency and distribution among different types of criteria that jurisdictions have reported.

Figure 5.4. Overall use of criteria across all areas of regulation



Source: OECD Survey.

Figure 5.5. Use of criteria for say on pay across jurisdictions



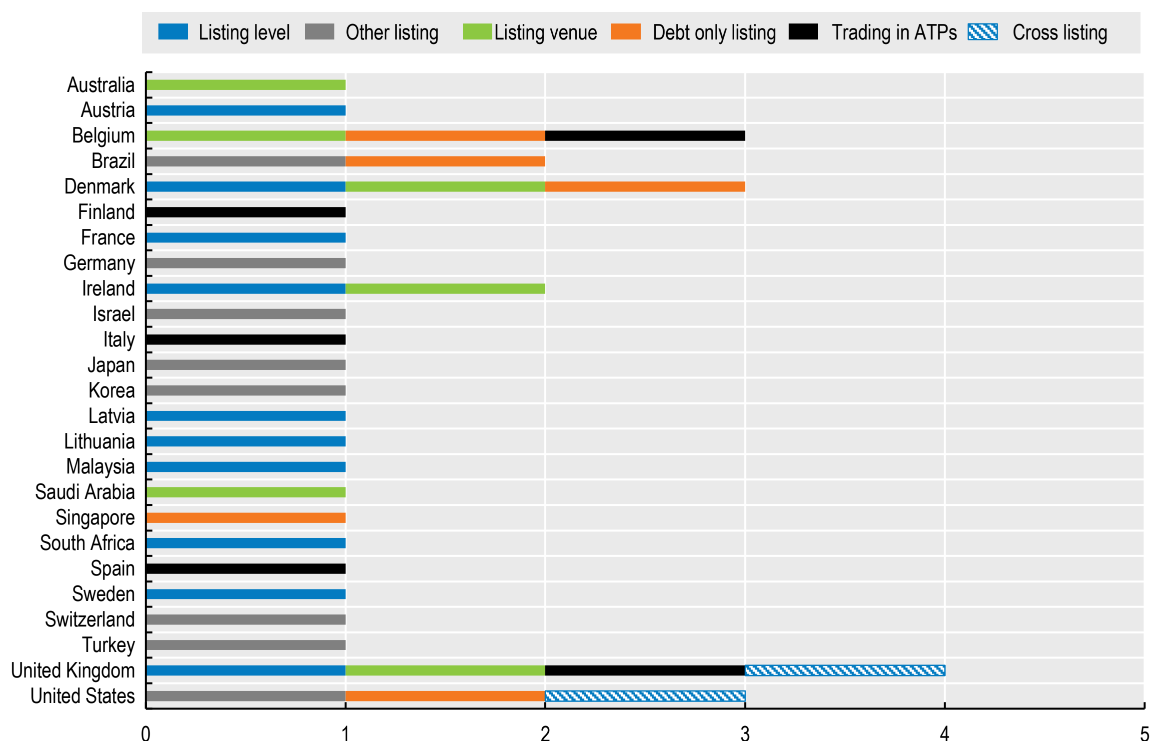
Source: OECD Survey.

The use of listing/publicly traded as criterion for flexibility and proportionality

Listing/publicly traded is used in the area of say and pay and the detail of disclosure on remuneration by 25 jurisdictions (about two thirds of participating jurisdictions) and is present in the corporate governance framework in several dimensions, with the *listing level* being the most common policy consideration (Figure 5.6.).

Most jurisdictions report that they use *listing/publicly traded* as a criterion in the sense that non-listed companies are not subject to the same disclosure or to the say on pay mechanism. Some discriminate between *listing levels*, establishing more stringent disclosure requirements for top levels. This is the case in Malaysia's Main and ACE markets, but not in its LEAP market. In Saudi Arabia's Main market the rules in this area of practice are mandatory while in the *Nomu* – or parallel – market they are voluntary. In Brazil, compensation disclosure requirements also apply differently for different categories of issuers, based on their *listing level*.

Figure 5.6. Use of the listing/publicly traded criterion for say on pay



Source: OECD Survey.

In other cases, obligations normally reserved to listed companies are extended to companies whose shares are traded, even if not listed. In Belgium, France and other EU member countries, a distinction is made not only in relation to if the company is listed or not, but also if its shares are *traded in a regulated market*. In Singapore, in turn, disclosure obligations are not applicable to firms that have a *debt only listing*.

Furthermore, in Australia, for companies listed in the ASX, their inclusion in the S&P ASX 300 index (determined by market capitalization) triggers the need to establish a

remuneration committee that modifies the remuneration disclosure and setting regime applicable to listed companies in general.

The use of size as criterion for flexibility and proportionality

The 11 jurisdictions that reported using *size* as a criterion for flexibility and proportionality regarding say on pay and the detail of disclosure on remuneration report using different dimensions of it. *Size of revenues*, *size of assets* and *size of workforce* are the more frequently used (Figure 5.7.).

Figure 5.7. Use of the size criterion for say on pay

Source: OECD Survey.

In the case of Italy, for example, the law mandates Consob, the securities regulator, to establish the detail of disclosure of remuneration policy and practices that firms must present in their remuneration report. The law allows Consob to differentiate the detail of disclosure according to the *size* of the firm (article 123ter, para. 8, of the Consolidated Law on Finance). Consob has used this power to regulate that smaller companies can provide a simplified report using aggregated instead of individual data, among others.

In Slovenia, companies are required to submit a report to the shareholders' general meeting on the remuneration received by the management and the board in the past financial year, including information about the company's subsidiaries. These reporting requirements are reduced for SMEs which are only required to disclose simplified information in the notes to their financial statements (article 294(5) of the Companies Act).

In Korea, the *size* of the remuneration may determine the detail of disclosure. Listed companies disclose executive pay and stock options in their business report but only when the remuneration of an executive exceed a stated amount (500 million won) the disclosure has to be individual instead of aggregated (article159-2(3) Financial

Investment Service and Capital Markets Act). A similar rule applies in Japan under the Financial Instruments and Exchange Act when the total compensation of an executive exceeds 100 million yen (about USD 900 000 by June 2018).

The use of the legal form as criterion for flexibility and proportionality

The *legal form* criterion is used in Mexico, for example, where two distinct legal forms admitted to listing have differentiated requirements. *Sociedades Anónimas Bursátiles* (SABs) and *Sociedades Anónimas Promotoras de Inversión Bursátil* (SAPIBs), are two different legal forms that can be adopted by companies that want to list their shares, with the latter form being a vehicle to facilitate IPOs of SMEs. Because of this, SAPIBs are subject to a lighter-touch detail of disclosure, although the approval of compensation practices by shareholders is the same for both types of firms.

The use of other criteria for flexibility and proportionality

Maturity of the firm, ownership/control structure and *accounting standards* are rarely used in the regulation of say on pay and detail of disclosure on remuneration. Israel, for example, considers the *maturity of the firm*, defined as the years passed since the IPO, to determine when the company has to get shareholders' approval to its remuneration policy. For newly listed companies it is within five years after the IPO (if the prospectus included information about the remuneration policy) while for the rest the requirement applies every three years. The remuneration disclosure requirements under the Danish Financial Statements Act consider the *accounting standards* used as a criterion to determine the disclosure obligations of firms. Small companies that use IFRS only have to disclose remuneration information in their financial statements and not pursuant to the rules of the Act.

Other criteria were also mentioned by respondents, beyond those listed in the survey. These included the number of shareholders and the amount of stated capital (Japan); the qualification of the company as public interest entity (Portugal); the existence of a takeover bid (Ireland), and the passing of a shareholders' resolution (UK).

In the United States, which is the jurisdiction that reported the highest use of flexibility and proportionality criteria in this area, the general say on pay rules are in place since 2011. They establish that public companies subject to the Exchange Act rules governing proxy solicitations must provide shareholders with an advisory vote on the compensation of selected executives not less frequently than once every three years. In a separate advisory vote, which must be held at least once every six years, shareholders can vote on how often a say on pay vote should occur (every one, two, or three years). Both decisions by shareholders are advisory votes, so neither the say on pay nor the vote on frequency is binding on the company. This general say on pay regime in the United States is adjusted in terms of flexibility and proportionality in several circumstances, including:

- *Emerging growth companies:* Under the JOBS Act these companies are not required to conduct shareholder advisory votes as long as the company remains an emerging growth company, which generally is defined in relation to total annual gross revenues below USD 1.07 billion during the most recently completed fiscal year.[4]
- *Foreign private issuers:* Securities registered by some foreign private issuers are not subject to the say on pay or the say on frequency votes.
- *Private placements:* If a company has registered securities under Section 12 of the Exchange Act, it must comply with the shareholder advisory votes described

above unless it satisfies one of the exceptions described above. Companies that are not subject to Section 12 and private companies are not required to do so.

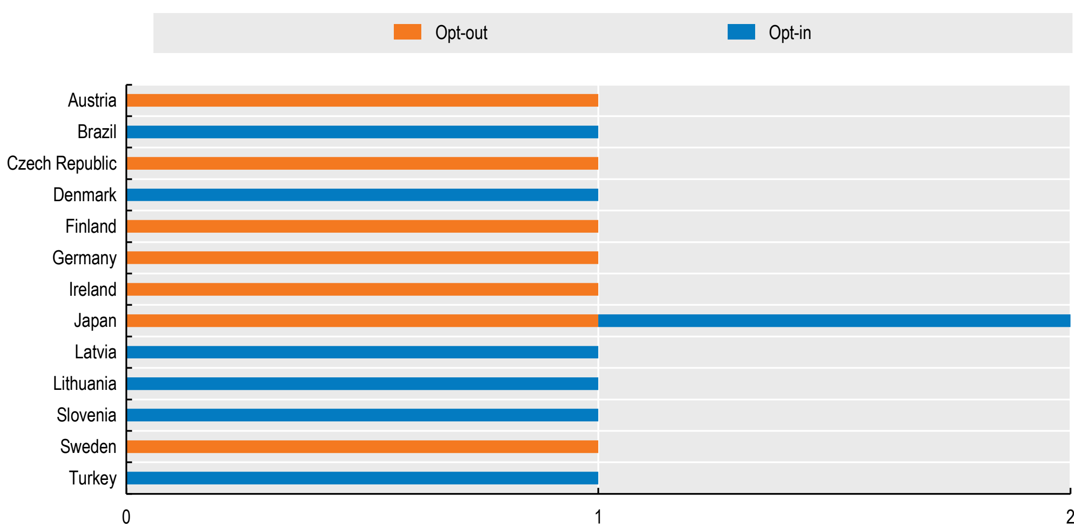
- *Multiple class shares with no voting rights:* Issuers with multiple classes of shares where the listed (or publicly held) shares do not have voting rights are not subject to the shareholder advisory votes described above.
- *Debt only listing:* Companies that have only listed debt securities are not subject to the shareholder advisory votes described above.

Similar exceptions apply to the compensation disclosure regime in the United States, except that multiple class share companies with no voting rights and companies with debt only listings are required to provide full compensation disclosure unless they may rely on another exception.

The use of opt-in and opt-out mechanisms for flexibility and proportionality

Opt-in and opt-out mechanisms are used for say on pay and the detail of disclosure on remuneration only by 13 jurisdictions (Figure 5.8.). Germany, for example, uses an opt-out mechanism that allows firms to omit certain remuneration disclosures in their financial statements if shareholders representing 3/4 of the share capital agree to it.

Figure 5.8. Use of opt-in and/or opt-out mechanisms for say on pay



Source: OECD Survey.

The use of sectoral criteria for flexibility and proportionality

An analysis of the results per sector of activity reveals that flexibility and proportionality criteria for say on pay and the detail of disclosure on remuneration are used in a majority of jurisdictions (24), with a varying degree of scope (Figure 5.9.). Most jurisdictions that present flexible sectoral regulations report having special regimes for the financial sector and for their State-owned companies.

Figure 5.9. Use of flexibility and proportionality in different sectors for say on pay

Source: OECD Survey.

Case study: Sweden

Overview

This case study describes the regulation on say on pay and disclosure on remuneration policies in Sweden's corporate law and the flexibility and proportionally mechanisms therein. It is structured in three parts. In part one, the Swedish law and practice on say on pay is presented, with special attention paid to the extent to which the law allows for flexibility and proportionality. Part two offers the background related to the motives and circumstances behind the introduction of the say on pay regulation in Sweden and its development until present day. The case study is summarized in part three, with a discussion of the political economy and results of the reform, and its effects on remuneration of board members and management.

Description of law and practice

The sources of regulation and practice

The Swedish statutory regulation of shareholder influence on remuneration policies is primarily found in the Swedish Companies Act (2005:551),[5] with some additional regulation notably to be found in the Annual Accounts Act (1995:1554).[6] The statutory regulation is supplemented by the Swedish Corporate Governance Code ("the Code") issued by the Swedish Corporate Governance Board[7] and the rulings by the Swedish Securities Council ("the Securities Council"), a self-regulatory body tasked with interpreting the Code.[8] In the following sections, the contents of the statutory regulation,

the Code, and finally the Securities Council's rulings are presented. The flexibility and proportionality mechanisms present in the different sources of law are given an extra focus and are discussed continually in the text.

The content of the statutory regulation

The say on pay regulation in the Swedish Companies Act governs the *decision-making procedures* regarding remuneration of directors and executives. Rather than putting up a substantive regulation, creating and defining quantifiable limitations on remuneration decisions, the purpose of these rules is to give shareholders control over, and transparency, with regards to the remuneration levels of the company's board of directors and executive managers. Thus, the Companies Act prescribes that it is the general meeting that decides on remuneration and incentive schemes[9] for the board of directors (Chapter 8, section 23a of the Companies Act). The decision is passed with simple majority (more than half of the votes cast) and is usually based on a proposal from the nomination committee.[10]

Regarding the remuneration of the board of directors, there are no flexibility and proportionality mechanisms – a general meeting decision is always required, without any regards to if it is a private company[11] or a public and listed company.[12] For the remuneration of the management in companies with shares listed on a regulated market,[13] the general meeting must pass a resolution on remuneration guidelines prepared annually by the board of director (Chapter 7, section 61 and Chapter 8, section 51 of the Companies Act).

If the amount of remuneration is not fixed, the guidelines must specify the nature of the remuneration, the conditions under which it is payable, and an estimated total cost for the company's obligations, given different conceivable outcomes (Chapter 8 section 52 of the Companies Act). The guidelines may also provide that the board of directors may deviate from the guidelines if there are particular reasons for doing so in an individual case (Chapter 8 section 53 of the Companies Act), which in a sense is a flexibility mechanism. The same can be said regarding the policy choice for a 'guideline' format instead of more detailed decisions, which gives the board the possibility to adjust its decisions. As stated above, the rules regarding remuneration guidelines are also a proportionality mechanism as they apply only to companies listed on regulated markets.

The guidelines are required to be passed by the general meeting in companies listed on regulated markets and shall relate to all forms of remunerations and incentive schemes, such as salary, provisions, pensions, bonuses, profit shares, benefits, synthetic options and employee stock options.[14] This requirement also pertains to subsidiaries to public companies, whether these are public or private.

Finally, there is a duty for companies listed on regulated markets to inform about the latest remuneration guidelines in the management report in the annual accounts (Chapter 6 section 1a in the Annual Accounts Act). [15]

The content of the Code

In addition to the statutory regulation described above, the Swedish Corporate Governance Code contains some requirements that further add to and complement the law. The Code has one major proportionality mechanism in that it only applies to companies listed on regulated markets, and one general flexibility mechanism in that it

applies to these listed companies under a "comply or explain" regime, in effect allowing companies to "opt-out" of the application of the Code.[16]

The requirements on remuneration are found in section 9 of the Code. According to this section, companies listed on regulated markets are to have a formal and openly stated process for deciding on remuneration of members of the board and the management. The board also has to have a remuneration committee, responsible for preparing the remuneration guidelines required by the Companies Act, as described above, as well as for monitoring and evaluating variable remuneration schemes and following up on the effectiveness of the remuneration guidelines, and remuneration structures and levels in the company.

The chair of the board may be the chair of the remuneration committee while the other members are to be independent of the company as well as the management, so that the committee is composed in a way that ensures the independence and integrity of its work.[17]

The Code's requirement for a formal and openly stated remuneration process and the requirement for a remuneration committee resemble the regulation in the Companies Act in that they mainly are procedural rules for the decision-making on remuneration. In a similar manner, the Code also prescribes that all equity based and share-price related incentive schemes for the management are to be adopted by the general meeting, and that incentive schemes designed for board members are only to be devised by the shareholders themselves (not by the board, management or other employees of the company).

However, the Code also contains a few rules of a more substantive nature. These include that variable remuneration is to be linked to predetermined and measurable performance criteria aimed at promoting the company's long-term value creation and that variable remuneration paid in cash is to be subject to predetermined limits regarding the total outcome; that equity based and share-price related incentive schemes are to be designed with the aim of achieving increased alignment between the interests of the participating individuals and the company's shareholders; and that fixed salary during a period of notice and severance pay are together not to exceed an amount equivalent to the individual's fixed salary for two years.

Rulings of the Securities Council

Finally, the applicable statutes and the Swedish Corporate Governance Code are supplemented by rulings of the Swedish Securities Council. The tasks of the Council includes to interpret the Code and review attempts to circumvent the provisions of Chapter 16 of the Companies Act and determine in which cases the principles set out in chapter 16 should be applied (as a matter of best practice) even if not directly applicable.[18]

Over the years, the Securities Council has given many rulings regarding what is generally acceptable with regards to remuneration policies and especially equity based incentive schemes with regards to Chapter 16 in the Companies Act. By 2002 the rulings had become so numerous that the Securities Council decided to replace the previous individual rulings with a new so-called principal ruling, Council ruling 2002:01.

The 2002:01 ruling, together with the roughly 40 rulings regarding incentive schemes given by the Council since then, is a principal source of law regarding incentive schemes for executives and board members, and say on pay. While the Companies Act provides the general procedural rules regarding decisions on remuneration, and the Code

complements the Act with some additional procedural rules as well as some substantive recommendations, the Securities Council's rulings add quite a few more detailed substantive and procedural provisions not further described here. However, in relation to flexibility and proportionality, a few examples are appropriate to illustrate the Securities Council's rulings' supplementary relationship to Chapter 16 of the Companies Act and the provisions of the Code regarding equity-based incentive schemes.

The Securities Council's rulings widen the above-mentioned rules to include, in addition to equity-based schemes, related types of schemes such as those based on synthetic options. They also broaden the group of related parties that are affected by Chapter 16 to include not only directors, executives and other employees of the company, but also those about to take such positions. They put extensive restrictions on the board of directors to participate in equity-based schemes, and address several of the various ways of circumventing Chapter 16 as infringements of best stock market practice. The Securities Council also gives more specific directions regarding which information that is to be given to shareholders before an upcoming general meeting where resolutions regarding incentive schemes are to be passed.

As opposed to the Code, the Securities Council's rulings are applicable to all companies listed on alternative trading platforms as well as regulated markets, but not to unlisted companies, which can be considered a proportionality criterion. And while the Securities Council rulings provide the most substantive regulation, compared to the Code and the Companies Act, a flexible and functional regulatory method is applied in the rulings. Ruling 2002:01 provides a good example of this, where the Securities Council, addressing the size of the remuneration, states that "it is important that the size of the remuneration is reasonable", but that in the end what is best practice and a reasonable remuneration size has to be something for "the shareholders to decide with regards to the company size, international expanse, and competition."

The motives, circumstances and political economy

The Swedish corporate governance model and say on pay

The Swedish corporate governance structure is based on some distinctive features, one of them being that the shareholders hold nearly omnipotent power over the board of directors and the management, and that (although uncommon) the owners may intervene in virtually any matter through general meeting resolutions. Furthermore, since most of the listed companies in Sweden directly or indirectly have one or several block holders that actively engage in the administration and management of the company, there is little room for the directors or the management to act in their own self-interest instead of in the shareholders' interest. In other words, the principal-agent problem is not a central issue in Swedish corporate governance and therefore not an issue for the Swedish legislator. Because of this, say on pay discussions have never really been a natural part of the Swedish debate on corporate governance in the way that it has been in the Anglo-American corporate governance model.

The "Leo-case" and its legal implications

The springboard for the regulation described in part one was the so-called "Leo-case". The Leo-case consisted of a series of stock trading deals with insiders in 1983 in the pharmaceutical company Leo AB, a subsidiary to Wilh. Sonessons AB, which at the time was listed on the Stockholm Stock Exchange. A select inside circle of some thirty

business executives (consisting of board members in Leo, Wilh. Sonessons AB, and senior executives in Volvo AB) were offered preferential share purchases in Leo at a price of SEK 50.60 in a directed share issue taking place one year before Leo's IPO. The price in the subsequent IPO was SEK 75.00. The number of shares offered to this inside circle was considerable.

When the circumstances were revealed a year later it immediately blew up into one of the largest scandals in Swedish business history. The scheme was not only deemed as a case of abuse of the minority shareholders, but because of its proportions and the public exposure of the companies and officials involved, it was also perceived as exceedingly damaging for the public's trust in the Swedish enterprises and industry. By order of the Prime Minister, a public investigation was launched to determine what measures should be taken to prevent further incidents of the sort.

The investigation group was named "the Leo Commission", and the initial directive for the commission was to propose a legal ban on directed share issues to board members and management of listed companies. However, the Stockholm Stock Exchange, together with the Swedish Industry and Commerce Stock Exchange Committee, pre-empted any legislative efforts to ban directed share issues by adopting self-regulatory measures. They released principles of best practices for the Swedish stock market that addressed directed share issues, and more importantly, formed the Securities Council with the purpose to govern and cultivate these best practices and discipline companies which would not follow them. The Leo Commission and the legislator chose to simply complement the self-regulation with the so-called Leo Act, which was subsequently incorporated into the Companies Act 2006 with some minor changes, becoming Chapter 16 of the Act, discussed above. In addition, in 1993 the Swedish Industry and Commerce Stock Exchange Committee released a recommendation regarding the disclosure of remunerations of directors and executives in listed companies, with requirements inspired by the Cadbury report. Briefly summarized, the recommendation stated that the individual remunerations of the chairman of the board and the managing director were to be disclosed in the annual accounts, together with a general, non-individual description of the agreements on severance pay and pensions for other management and executive employees.[19]

After the Leo case, not much was done in the area of management remuneration and say on pay by the legislator. The activity of the Securities Council has effectively addressed new issues regarding remuneration schemes, and the best practices promoted have been generally followed by the market actors in the interest of and preference for a well-functioning self-regulation over a more rigid legislative approach. Thus, there has been no need for further legislative initiatives.[20]

The introduction of the Swedish Corporate Governance Code

It was not until the introduction of the Swedish Corporate Governance Code in 2005 that the next major step in the area was taken. This took place in the context of the introduction of national corporate governance codes and regulations around the world. As a result, concerns were raised in the public discussion that the Swedish corporate governance system might become questioned and challenged by international investors, thereby limiting the flow of international capital to Sweden, if Sweden would not get on the bandwagon and adopt a national code of its own.

To address these concerns, a new government commission was established in 2002 and given the task to propose measures that would strengthen the trust for the Swedish

corporate governance system and Swedish enterprise and industry at large. The commission was named "the Trust Commission". In its work, the Trust Commission considered the choice between legislation and self-regulation as different approaches to strengthening the trust in the Swedish corporate governance system and Swedish industry. While acknowledging the advantages of legislative measures, such as democratic basis and legal certainty, the Trust Commission concluded that the flexibility and efficiency of the already well-functioning self-regulatory approach was a better choice for adapting the Swedish regulation to the international practice of governance codes.

Thus, partially consisting of members from the Trust Commission, the so-called Code Group was formed in 2003 to draft a national corporate governance code with inspiration from international practice, in particular the British code. The Code, which came into force in 2005, contained an opt-out option as it is applied under a 'comply or explain' regime.

However, unlike today's Code, which is applicable to all companies listed on regulated markets, the Code of 2005 only applied to companies with a market value over 3 billon SEK (roughly EUR 300 million). At the time of the Code's introduction, this meant that the Code was applicable to roughly 100 of the largest companies listed on the Stockholm Stock Exchange. This limitation was not intended to be permanent but rather seen as a proportionality mechanism through which the largest companies, deemed to be best equipped to comply with the Code and to set practice in its application, would lead the way. In 2008 the scope of the Code was broadened to include all companies listed on regulated markets.[21]

Another difference between the original Code of 2005 and today's Code is that since the first version in many ways was a synthesis of a variety of international sources, it was fairly detailed in comparison with today's Code. This also applied to the rules on management remuneration, as it basically contained the rules now found in Chapter 8 of the Companies Act.[22]

The Code was not that fondly received by market participants in 2005. In some parts, the Code was deemed too rigid and detailed for a Swedish context, while in others too soft to achieve the explicit goal of giving more credibility to the Swedish corporate governance regulation. As a result of the view that some parts of the Code were too rigid, it was considerably condensed in 2008 to the briefer form we know today. A discussion also followed between the market participants, the legislator and the Swedish Corporate Governance Board (that by this time had been entrusted with the administration of the Code) regarding the rules on remuneration guidelines, which were found to be too soft. This dialogue led to the adoption of the rules in the Companies Act, already described.

Following this change in 2008, the Code was left with no regulation regarding say on pay at all until the rules in the present Code's Section 9 (regarding remuneration of the board and management) were introduced in 2010. These rules were added to the Code to accommodate the European Commission's recommendation 2009/3177/EC (regarding the regime for the remuneration of directors of listed companies).[23]

The political economy and effects of the regulation in Sweden

As seen in the description of the Swedish say on pay regulation, the apparent flexibility and proportionality mechanisms in this regulation are the restriction of the application of

most of the rules to listed companies, the exclusion of private companies from provisions in the Companies Act on remuneration, and the 'comply or explain' regime of the Code.

It would, however, be a too confined perspective, and therefore misleading, to emphasize these as the most important flexibility and proportionality mechanisms in the Swedish corporate governance framework. Rather, what creates the key flexibility and proportionality element is the system in and of itself, particularly because of the close interplay between the market participants, the self-regulatory bodies (which are composed of representatives from the different market actors), and the legislator. Above, we have given several examples of the system's flexibility and the interplay between the actors at work.[24]

The Securities Council's development of the rules regarding share-based incentive schemes should also be mentioned as an example of the system's flexibility. With regards to how the Council's interpretation of the Code, the Companies Act and best practice together with its short processing time (in general announcing a ruling within a week when a query has been presented before the Council) and the almost unwavering adherence to the Council's rulings, the Council plays a key role in keeping the Swedish corporate governance framework fit for purpose.

These finer aspects of the Swedish framework are far harder to capture and explain than the more apparent legal mechanisms even though they, combined, are among the most important factors in the framework. It is even more difficult to explain why and how they are so efficient, although the answer at least partially lies in the fact that the Swedish stock market and business sector by all measures, and even considering globalisation, still is a small and relatively limited community with tight connections.

With this in mind, it is not very surprising that the EU say on pay regulation has not been received with much enthusiasm in Sweden. The conventional wisdom seems to be that the introduction of some of the provisions and regulations described here has been encumbering to the inherent system flexibility. For instance, the requirement for the general meeting to resolve on management remuneration guidelines introduced to the Code in 2005 and the Companies Act in 2008 rather seems to have made the remuneration system less flexible, since a standard practice quickly evolved around these guidelines amongst companies that now present documents of very similar content.

As far as the remuneration levels are concerned, little and inconclusive empirical research has been carried out in Sweden, but the experience again seems to indicate that the rules have had none or just marginal effects.[25] This might not be that surprising considering that, as discussed, remuneration levels have never really been a big problem in Sweden (in comparison to for instance in the UK and the US) and that the rules were adopted mainly as efforts towards aligning the Swedish corporate governance framework with international standards.

Partially, this might be credited to the shareholder-centric corporate governance system, where the shareholders decide on the board and management remunerations, and where the board, by law, is entirely separated from the management. Another factor is probably the long tradition of egalitarian values, with homogenous societal norms that keep the remunerations at what is considered to be acceptable levels. This effect might be particularly strong due to the closeness of the business community, where deviations from what is considered to be the standard practice are quickly noticed and identified both by the community itself and the public media.

Of course, large parts of the regulation and legal mechanisms that have been described above have had a highly positive impact on the Swedish corporate governance framework. For instance, the Leo Act covered the important area of share-based incentive schemes that obviously required the legislator's attention. The creation of the Securities Council was also a success that became an indispensable asset to the Swedish stock markets. However, neither the Leo Act nor the Securities Council are say on pay mechanisms in a conventional sense. The Leo Act is rather a form of protection of minority shareholders, addressing the more specific problem for the Swedish system of balance of power between majority and minority shareholders predominant in Swedish corporate governance (Lekvall et al., 2014, pp. 18-19[17]). The Securities Council is in a similar manner a construction that fits well into the flexible self-regulatory body, building on its strengths.

To sum up, the main point is not to suggest an export of the Swedish approach to the rest of the world, but rather the opposite. When it comes to corporate governance there is no "one size fits all". This is at the centre of this exercise on flexibility and proportionality. The strive for international uniformity, even when driven by the desire to advance the international corporate governance agenda and to endorse cross-border engagement and capital flow, might be best served by a flexible and proportional adaptation to local features of each jurisdiction. We should aim to strike a balance, respecting the advantages of different corporate governance models and what makes them successful in their own context.

Conclusions

The survey results show that flexibility and proportionality are used by a large number of jurisdictions for the implementation of say on pay and the disclosure of remuneration. Similar to other areas of regulations, *listing* status is the most used criterion for flexibility, followed by *size* – mainly of revenues and workforce – and *legal form*.

The issues addressed by this area of practice, mainly a concern about levels of executive compensation and their misalignment with the long-term interest of the company, remain highly disputed even in jurisdictions that were early adopters of say on pay mechanisms and have detailed compensation disclosure regimes.

As demonstrated by the Swedish case study example, many jurisdictions that did not have an out-of-control executive pay problem (or perception of a problem in their public opinion) have introduced both the disclosure and say on pay mechanisms. This is not only a result of the power of the EU that thrusts convergence of legislation among member countries, but also the perception of jurisdictions that their governance framework may be perceived as incomplete, and therefore more risky by international and institutional investors, in the absence of such mechanisms.

A flexible and proportional approach, rooted in the particular features of the national corporate governance, offers jurisdictions an opportunity to present a corporate governance regime that is not only updated to the latest policy tools, but also fit for the challenges it actually faces locally, as well as tailored to the needs of a diverse pool of firms across the market.

Notes

[1] The Committee addressed these issues in its 2010 report on the lessons from the financial crisis.

[2] "For example, in Austria, the law requires that the remuneration of board members must be commensurate with their responsibilities and scope of work as well as the economic situation of the company. In Hong Kong, China, the Code recommends that a significant portion of executive directors' remuneration be linked to corporate and individual performance. The Norwegian Code, on the other hand, recommends that the company should not grant share options to board members, and that their remuneration not be linked to the company's performance. In Turkey, listed companies are required to have a remuneration policy to be approved at the general shareholders meeting and disclosed on the company website, and dividends, share options and performance-based plans are not allowed for independent board members".

[3] If the ex-post vote results are negative, fixed compensation elements are not called into question but variable or exceptional items allocated to the executive cannot be paid until the total remuneration is approved by the general meeting at a later vote.

[4] Firms may lose their status after five years, if they become a large accelerated filer or issue more than $1 billion of non-convertible debt in the previous three years, among other conditions.

[5] Mainly in Chapter 7 section 61; Chapter 8 section 23a and 51-53; and in Chapter 16.

[6] Mainly in Chapter 6 section 1 a.

7 The Code is a fundamental part of the self-regulation of the Swedish stock market, and it is considered to be a codification of best practice in Swedish corporate governance. All companies whose shares or depositary receipts are listed on a regulated market in Sweden (at present, the Nasdaq Stockholm main market and NGM Equity) are required under the listing rules to apply the Code (as a key component in complying with best practice) in their corporate governance practices.

[8] The Securities Council's rulings are in effect binding on the listed companies on the same grounds as the Code, since they are considered to be expressions and interpretations of best stock market practice. However, whereas the Code's applicability is limited to companies listed on regulated markets, the Securities Council's rulings are also applicable to companies whose shares or depositary receipts are listed on multilateral trading facilities (at present, First North, Nordic MTF and Aktietorget).

[9] For equity based incentive schemes, see the section below regarding Chapter 16 of the Companies Act.

[10] The Swedish nomination committees usually consist of representatives from the three to five largest shareholders of the company and the presiding chairman. The Code requires that the nomination committee is independent from the presiding board and the management of the company (see section III.2 of the Code).

[11] That is, the Swedish company form generally chosen for closed companies, where the company shares may not be offered to the public.

[12] The alternative that the board decides on its own remuneration would be considered self-dealing under Swedish company law.

[13] The management includes senior executives such as the chief financial officer, the chief HR officer, and business managers.

[14] However, directed equity schemes are exempted. They are instead governed by Chapter 16 of the Companies Act which requires that directed issuance of shares, warrants or convertibles to the directors, executives or employees in a public company , i.e. equity based incentive schemes, must be approved through a resolution by the general meeting (Chapter 16 section 2 of the Companies

Act). A general meeting resolution in accordance with Chapter 16 is valid only if it is supported by shareholders holding at least nine-tenths of the votes cast and the shares represented at the general meeting (Chapter 16 section 8 of the Companies Act). The element of flexibility and proportionality in Chapter 16 consists in that the scope of the chapter is limited to the public company form. Since the public company form is a requirement for listing on multilateral trading facilities as well as on regulated markets, the chapter de facto pertains to all listed companies, and the proportionality lies in the fact that private companies are not required to follow the rules regarding equity based incentive schemes.

[15] If an issuance has been carried out and required the approval of the general meeting in accordance with Chapter 16, information about the result of said action must also be presented in the management report (Chapter 16 section 10 in the Companies Act).

[16] In practice, one third of the companies listed on regulated markets deviate from the Code in one or several regards (according to the 2017 statistics). The number of companies deviating from the Code has been decreasing over the years.

[17] The determination of independence is a general assessment of all factors that may give cause for questioning the individual's independence and integrity with regards to the company or its management, and in section 4.4 of the Code, a guide to the independence assessment is provided.

[18] The Council does not interpret legislation, since this is a matter for the courts. Thus, actions that are directly covered by Chapter 16 in the Companies Act are not subject to the interpretation of the Council.

[19] These rules were tested in the spring of 2002, when it came to the public's attention that the chairman of ABB had received an EUR 100 million pension agreement (by all standards a high level, and especially so in a company that at the time had very strained finances). Since the 1993 recommendation only applied to Swedish companies, the remuneration levels of the Stockholm-listed but Swiss company ABB came as a surprise. The Swedish Industry and Commerce Stock Exchange Committee reacted quickly and six months later a revised recommendation was released, which among other changes now covered foreign companies listed in Swedish stock markets.

[20] Put in the flexibility and proportionality perspective of this review, the stock market in Sweden was left unattended to by the legislator during the period since it was recognized that the self-regulation through the Securities Council and the Swedish Industry and Commerce Stock Exchange Committee provided efficiency and flexibility that might only have been damaged if meddled with through legislation.

[21] The question was later raised if the scope of the Code's application should be extended even further to cover companies listed on the exchanges organized as multilateral trading facilities as well. The exchanges themselves, however, strongly opposed this idea, claiming that the Code's requirements would be disproportionately strenuous to such companies. However, since then a middle segment has been created on the multilateral trading facility Nasdaq First North Premier. Premier's listing requirements are a compromise between those of the regular multilateral trading facility list First North and the regulated main market listing, including a recommendation for the listed companies to apply the Code. This provides a mechanism of flexibility through which companies not yet qualified or ready to list their shares on a regulated market have a clearly appointed way to "opt-in" to the application of the Code.

[22] The guideline rules were also more detailed originally, requiring that the guidelines were to include the ratio between fixed and variable remuneration and the connection between performance and remuneration; the main terms for bonus and incentive schemes, main conditions for non-monetary benefits, retirement, and severance pay; as well as the circle of executives included. The guidelines were also to inform of any significant deviations from previous years' guidelines.

[23] The 2009 recommendation was however deemed far too detailed and ambitious to be implemented to the letter since it was founded on a different view on corporate governance regulation, and thus the more flexible version that has been described above was enacted. Together with the Code's 'comply or explain' regime, this was held as a compromise between an adaption of the 2009 recommendation and the Swedish model of corporate governance, and the draft of the expansion was described as "A balance between Sweden on the one hand being a good EU-citizen and on the other the Swedish companies and their owner's need for a [corporate governance] solution that works here [in a Swedish context]." Note: free translation of a passage in a letter from the Swedish Corporate Governance Board published in the national Swedish newspaper Dagens Industri on October 27, 2009 regarding the adaption of the Code with regards to the 2009 recommendation.

[24] These include: i) the instalment of the Securities Council as a self-regulatory response to the Leo; ii) the quick introduction and revision of the recommendations regarding disclosure of remunerations to directors and executives as responses to public opinion; iii) the revision of the Code to adapt it to the Swedish system, as well as the legislator's incorporation of the rules on remuneration guidelines in the Companies Act on request by private actors to strengthen the appearance of the Swedish corporate governance framework; iv) how it was a result of dialogue between the Swedish Corporate Governance Board and the exchanges themselves not to apply the Code to the companies listed on multilateral trading facilities; and v) how the market actors dodged legislative action by incorporating the 2009/3177/EC recommendation into the Code.

[25] At least not a positive effect – the general experience rather seems to be that the introduction of the requirements to disclose the remunerations of directors and executives has led to an increase in remuneration levels. Thomas & Van der Elst, 2014, seems to support this experience.

References

Ana Lutzky (2017), "Say on pay : que faut-il retenir de la saison 2017 des AG du CAC 40 ?", http://www.ircantec.retraites.fr/sites/default/files/public/aef_12_07_17_0.pdf.

Bebchuk, L. and J. Fried (2004), "Pay without Performance, The Unfulfilled Promise of Executive Compensation, Part II: Power and Pay The Unfulfilled Promise of Executive Compensation", www.law.harvard.edu/faculty/bebchuk/pdfs/Performance-Part2.pdf.

Correa, R. and U. Lel (2016), "Say on pay laws, executive compensation, pay slice, and firm valuation around the world", Journal of Financial Economics, Vol. 122, pp. 500-520, http://dx.doi.org/10.1016/j.jfineco.2016.09.003.

Gabaix, X., A. Landier and J. Sauvagnat (2013), "CEO Pay and Firm Size: an Update after the Crisis ", http://pages.stern.nyu.edu/~xgabaix/papers/CEO_EJ.pdf.

Gao, H. et al. (2015), "Effects of Managerial Labor Market on Executive Compensation: Evidence from Job-hopping", Journal of Accounting and Economics, http://ssrn.com/abstract=2262604

IRRC & ISS (2016), Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk, http://www.irrcinstitute.org.

Lekvall, P. et al. (2014), The Nordic Corporate Governance Model, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2534331.

OECD (2010), Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles, http://www.oecd.org/corporate/ca/corporategovernanceprinciples/44679170.pdf.

OECD (2011), Board Practices: Incentives and Governing Risks, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264113534-en.

OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, https://doi.org/10.1787/9789264236882-en.

OECD (2017), "OECD Corporate Governance Factbook 2017", http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.

Pietrancosta, A. (2017), Say on Pay: The New French Legal Regime in Light of the Shareholders' Rights Directive II, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3065673.

Thomas, R. and C. Van der Elst (2014), "Say on Pay Around the World", SSRN Electronic Journal, http://dx.doi.org/10.2139/ssrn.2401761.

UK Department for Business, Energy & Industrial Strategy (2017), Corporate Governance Reform: The Government response to the green paper consultation, http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640470/corporate-governance-reform-government-response.pdf.

Chapter 6. Related party transactions

This section presents the results of the review in the area of related party transactions. It takes stock of the criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating to the area across the 39 jurisdictions that responded the survey used for the review. It also includes a case study of the Italian corporate governance framework in the area submitted by Marcello Bianchi (Assonime).

Introduction

Related party transactions

One aspect of corporate governance that has attracted increasing attention in recent years is the potential abuse of related party transactions (RPTs). In addition to several high-profile corporate scandals since the early 2000s, concerns have also been driven by a trend towards more concentrated ownership at company level. This trend is caused by a decline in the number of publicly listed companies in several advanced markets where listed companies traditionally have been characterized by dispersed ownership and a strong increase in listings in emerging markets which are typically characterized by concentrated ownership.

There is broad agreement that there is nothing wrong per se with entering into transactions with related parties and that these transactions can be economically beneficial especially in a company group structure. Therefore, prohibiting such transactions is not considered as a solution except in some specifics cases, such as company loans to its directors. However, the potential for abuse by insiders such as controlling shareholders is real. Indeed, such self-dealing has been a key aspect of the development of corporate governance frameworks in many jurisdictions over the last decade (OECD, 2012).

Against this background, the Committee agreed to include related party transactions among the seven areas of regulation for this thematic review on the use of flexibility and proportionality in corporate governance frameworks. This chapter presents the results of the review by taking stock of the criteria that may motivate and allow flexibility and proportionality in the application of rules and regulations across the 39 jurisdictions that responded the OECD survey prepared for the reviews. Information about the research methodology and an overview of the results are presented in the first chapter of the report.

The widely accepted definition of related party transactions, which is provided by the International Accounting Standards Board (IASB) in IAS 24, is a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged. Since the definition of related parties includes key management personnel, their remuneration is also recognised as a RPT by IAS 24. However, executive remuneration is not covered in this chapter because the Committees' thematic peer review on flexibility and proportionality also includes a specific chapter on say on pay and the detail of disclosure on remuneration.

Corporate control structures and related parties

In financial reporting standards and corporate governance regulations, the concept of related parties in general includes three main elements: (1) a person or a company that controls or has significant influence over the company; (2) companies that are under the control of the company or that are under common control with the company, in particular in group structures; and, (3) key management personnel.

Transactions between the company and its key management personnel that fall into the definition of a RPT are in general related to the remuneration of key executives and board members. This is also one of the most important, if not the most important, policy issues identified by the traditional agency approach to corporate governance, which primarily

focuses on the problems arising from the separation of ownership and control in dispersed ownership structures.

The remuneration issue put aside, the central problem that is addressed by the regulatory framework for related party transactions, including the definition of related parties, remains to be associated with the presence of controlling shareholders or blockholders. Here the agency problem is not between the managers and dispersed owners, but between the controlling shareholders and the minority shareholders.

The ownership structure at company level can be described in two main dimensions. The first is the distribution of ownership among different categories of owners, such as retail investors, pension funds, insurance companies and large individual owners. The second dimension is the degree of concentration of ownership and the portion of the company that is owned by its largest owners.

As shown in Table 6.1, there are significant differences among countries with respect to the categories of owners. For example, institutional owners is the largest category in both the United States and the United Kingdom, holding around 70% of the total capital. In some emerging markets and Asian economies, such as Brazil, Indonesia, Singapore, Russia and Turkey, corporations hold between one-third and half of the total capital. This can be seen as an indicator of strong presence of company groups in these countries. It other Asian economies, namely Japan, Korea and Hong Kong, China, and three large European markets, France, Germany and Italy, corporations also hold on average between 20 to 30% of the total shares. While institutional investors are not as dominant as in the US and UK markets, they also play an important role in these countries.

It is important to note that institutional investors typically are required to disclose their equity holdings if their assets under management are over certain thresholds. Therefore, the amounts in the table for institutional investors should be considered as the minimum numbers. A significant portion of "other free-floating shares" may also be held by institutions in many economies. This is also true for the category of individuals, which basically represents the controlling owners or other strategic investors. Minor retail investments are included in the free-floating numbers.

With respect to the concentration of ownership in individual companies, there is a recent discussion on the re-concentration of ownership in the hands of institutional investors mainly in the United States and some other countries usually classified as having dispersed ownership structures. For example, among the largest 20 US companies, the 5 largest institutional investors in 2016 held on average 21% of the capital and the largest 20 institutional investors held 33% of the company's capital (Bebchuk *et al.*, 2017).

While concentration of ownership of capital is a principal indicator of control at company level, there are several arrangements available in corporate governance frameworks that allow actual control without holding a majority of the company's capital. This includes, multiple-class share structures, shareholder agreements, special voting rules, cross-shareholdings and pyramid structures. For example, many large tech companies that went public in the United States over the last decade have a controlling ownership through multiple-class share structures (Isaksson and Celik, 2013).

The presence of a controlling shareholder is generally assumed to reduce agency problems by closer monitoring of management. However, controlling ownership structures established through separating voting rights from cash flow rights – such as multiple class shares – do not have the same effect. These structures may contribute to a misalignment of incentives between controlling and non-controlling shareholders.

(OECD, 2007). The consequence will be an increased potential for abusive related party transactions by the controlling shareholders.

Table 6.1. Ownership structure in selected countries, as a percentage of total, as of end 2016

	Corporate	Government	Individuals	Institutional investors	Others	Other free floating shares
Brazil	29.3	11.8	12.6	25.0	0.3	21.0
China	13.1	41.8	8.4	8.2	0.1	28.4
France	21.9	7.8	9.2	29.4	1.1	30.6
Germany	22.0	5.2	8.4	28.9	2.9	32.6
Hong Kong (China)	21.3	25.2	14.0	13.1	0.2	26.2
Indonesia	44.5	15.5	7.4	7.5	0.0	25.1
Italy	19.9	7.8	21.4	23.0	1.0	26.9
Japan	20.1	5.9	2.5	26.6	0.9	44.0
Korea	26.1	13.2	11.8	15.4	1.6	31.9
Malaysia	30.1	33.0	7.9	11.3	0.3	17.4
Mexico	16.3	0.7	25.9	19.0	0.3	37.8
Poland	20.6	9.4	20.2	32.1	0	17.7
Russia	33.3	24.0	17.5	9.0	0	16.2
Singapore	29.8	10.1	14.0	13.2	0.3	32.6
Turkey	47.8	9.4	10.4	11.3	0.3	20.8
United Kingdom	4.5	6.0	3.4	66.4	0.5	19.2
United States	2.3	1.3	2.1	72.9	0.2	21.2

Note: Data cover top 100 listed companies in each market in terms of market capitalisation. Ownership amounts that are not identified in the dataset and company annual reports are classified as "other free floating shares". Data represents simple averages.
Source: OECD calculations based on data from FactSet, Thomson Reuters and company annual reports.

Another important observation from Table 6.1 is that in China; Hong Kong, China; Malaysia and Russia, state ownership also plays an important role with an average ratio ranging from 24 to 42%. In some jurisdictions, there are specific rules addressing state-owned enterprises with respect to RPTs. One key difference emerges from IAS 24, which provides broad exemptions for SOEs from disclosure requirements that are posed to other companies.

The approach of the G20/OECD Principles

Recognising the developments in the corporate ownership worldwide and the fact that controlling owners may take advantage of minority shareholders through abusive self-dealing, the 2015 revision of the G20/OECD Principles further elaborated the recommendations on related party transactions. They now provide guidance with respect to RPTs in three dimensions: disclosure, approval and board responsibility.

With respect to disclosure, the introduction of International Financial Reporting Standards (IFRS) by many countries and convergence of IFRS with other financial reporting standards have to a large extent lead to a harmonized ex-post reporting of RPTs. In addition to disclosure of recurrent transactions in periodic company reports, material transactions are required to be disclosed on an ongoing basis. The G20/OECD Principles also calls for disclosure of major share ownership rights, including beneficial owners, and voting rights that will be necessary for identifying related parties. Such disclosure may

include information about the group structure and intra-group relations as well as the ownership of controlling shares and cross-shareholding relationships.

Once the related party transactions have been identified, the emphasis moves on to setting procedures for approving them in a manner that protects the interest of the company and its shareholders. Company boards are in general seen as occupying a crucial role in the approval of RPTs often with a specific role for independent board members. The G20/OECD Principles also recognises approval by disinterested shareholders as an emerging practice.

With respect to the responsibilities of the board, the G20/OECD Principles establishes monitoring of related party transactions and managing conflicts of interest as an important board function. The duty of loyalty here emerges as of key importance to protect minority shareholders, since it underpins effective monitoring of RPTs by the board. This is particularly important for group structures, where the G20/OECD Principles sees the duty of loyalty for a board member as related to the company and all its shareholders and not to any individual or group of shareholders, regardless of how different shareholders voted at the annual shareholders meeting.

Regulatory frameworks for related party transactions around the world

The corporate governance framework of a country typically comprises elements of legislation, regulation, self-regulation and voluntary standards. As an important policy issue in all markets, related party transactions are addressed by a combination of different elements of the corporate governance framework. The focus is mainly on the disclosure requirements and the procedures for approval by board and/or shareholders. Based on the information provided in the OECD Corporate Governance Factbook, Table 6.2 summarises the main features of the regulatory frameworks for RPTs with respect to disclosure and approval procedures in the 39 jurisdictions surveyed in this report.

All jurisdictions have adopted IAS 24 or US GAAP for the disclosure of related party transactions in periodic financial reports, with the exception of Argentina, Australia and Japan. In addition to financial reports, many countries also require listed companies to disclose additional information on RPTs in a periodic corporate governance report. For example, in Brazil, the Czech Republic, Germany, Hungary, Portugal and Slovenia there are certain requirements for companies in a group structure to disclose intra-group transactions, including the negative impact of any influence by the parent company (OECD, 2017). More than half of the countries also require ongoing (immediate) disclosure of material RPTs, as part of the shareholder approval procedures.

A key global trend in corporate governance since the early 2000s has been the empowerment of shareholders in the corporate decision making and monitoring processes. This is also true for the approval of RPTs, in which shareholders are playing an increasingly greater role. However, in general the requirement for shareholder approval has been developed as an additional mechanism to mitigate the risk of potential abusive RPTs. In four countries (Portugal, Russia, Sweden and the United Kingdom), there is a requirement for shareholder voting for approval of RPTs without a requirement for board approval. In all other jurisdictions with a shareholder approval mechanism, a board approval mechanism for non-routine RPTs is also in place.

Table 6.2. Regulatory frameworks for related party transactions

Jurisdiction	Disclosure: Periodic disclosure	Disclosure: Ongoing disclosure (Immediate for specific RPTs)	Approval procedure – Board approval: Non-routine RPTs	Approval procedure – Board approval: Review by INEDs/audit committee	Approval procedure – Board approval: Opinion from outside specialist	Approval procedure: Shareholder approval (non-equity)
Argentina	Local standard	Required	Required	Optional	Optional	Required
Australia	Local standard		Required			Required
Austria	IAS 24		Required			
Belgium	IAS 24	Required	Required	Required	Required	
Brazil	IAS 24	Required			Recommended	
Chile	IAS 24		Required	Required	Recommended	Required
Colombia	IAS 24	Required	Required	Recommended		Required
Czech Rep.	IAS 24					
Denmark	IAS 24					
Egypt						
Finland	IAS 24					
France	IAS 24		Required		Required	
Germany	IAS 24					
Hong Kong (China)	IAS 24 or local standard	Required	Required	Required		Required
Hungary	IAS 24		Required			Required
Ireland	IAS 24		Required		Required	Required
Israel	IAS 24	Required for SHs approval	Required	Required		Required
Italy	IAS 24	Required	Required	Required	Required if requested by INEDs	Required
Japan	Local standard	Required	Required	Recommended		
Korea	IAS 24	Required	Required			
Latvia	IAS 24 and local standard		Required			
Lithuania						
Malaysia						
Mexico	IAS 24	Required	Required	Required	Required	Required
Netherlands	IAS 24					
Norway	IAS 24		Required			Required
Poland	IAS 24					
Portugal	IAS 24					Required
Russia	IAS 24 or local standard	Required		Recommended	Recommended	Required
Saudi Arabia	IAS 24	Required	Required		Required	Required
Singapore	IAS 24, US GAAP or local standard	Required	Required	Required	Required	Required
Slovenia	IAS 24			Required		
South Africa	IAS 24	Required	Required	Required	Optional	Required
Spain	IAS 24		Required	Required		Required
Sweden	IAS 24	Required				Required
Switzerland	IAS 24 or US GAAP, Swiss GAAP FER or local standard	Required			Recommended	
Turkey	IAS 24	Required	Required	Required	Required	Required
United Kingdom	IAS 24	Required				Required
United States	US GAAP, Item 404 of Regulation S-K, ASC 850 and Rule 4-08(k) of Regulation S-X		Required	Recommended	Recommended	Required

Source: OECD Corporate Governance Factbook 2017

The board approval mechanism has also been evolving in many jurisdictions towards a stronger involvement of independent directors. In eleven countries shown in Table 6.2, independent board members are required to review related party transactions as part of the audit committees' functions or in some cases as members of the board. While for example the audit committee must review and approve a RPT in Singapore, in Turkey a board decision is required with approval of majority of independent directors. In the United States, however, the board of directors *may* put in place certain procedural mechanisms including a review by a special committee of independent directors and receipt of an opinion from outside specialist.

In many cases where there is a requirement for board or shareholder approval, there are also quantitative materiality thresholds in place. However, none of the criteria has been adopted as common practice worldwide. Market capitalisation, annual turnover, share capital, total assets are among used criteria with thresholds ranging from 5 to 50% of the total amount.

On the other hand, in some jurisdictions shareholder approval is required for individual RPTs if it is disapproved by any director (Chile) or by the committee of independent directors (Italy) or by the majority of the independent directors (Turkey) or if a board member has conflicts of interest (Colombia). France has a somewhat hybrid system where shareholder vote is required, but transactions that are not approved can also be carried out. This is complemented by a provision in the French Commercial Code that the interested party can be held liable for any detrimental consequence that the unapproved transaction may have had on the company (OECD, 2017).

An important aspect of the shareholder approval procedures is whether shareholders with material interest are allowed to participate in decisions of the shareholders' meetings. Half of the countries in Table 6.2 with a mandatory shareholder approval procedure for material related party transactions also require that shareholders with material interest in the transaction should abstain from voting at the shareholder meeting.

The consequence is that the transaction should be approved by the majority of the minority, where minority means all disinterested shareholders. A different example is the Chilean system where a qualified majority (2/3) requirement was introduced.

The case for flexibility and proportionality

The main purpose of flexibility and proportionality in corporate governance frameworks is to meet the needs of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources.

With respect to regulating the governance of related party transactions, one main factor that needs to be taken into account is the ownership and control structure at company level, which is also identified as one of the company characteristics that may call for flexibility and proportionality. Although for the purpose of analysis, distinctions are usually made between countries with concentrated and dispersed ownership structures at company level, the real picture is somewhat more complex.

As discussed above, there are many companies with a controlled ownership structure in countries that are generally classified as having a dispersed ownership structure. At the same time, there are many companies in concentrated ownership structure countries, mainly in continental Europe, that have a significant free-float ratio, which would indicate a wide dispersion of ownership.

However, identifying the actual ownership and control at company level requires information beyond just capital ownership, including voting rights, pyramid holding structures and cross-shareholdings. Indeed, this plurality in company ownership characteristics calls for flexibility and proportionality.

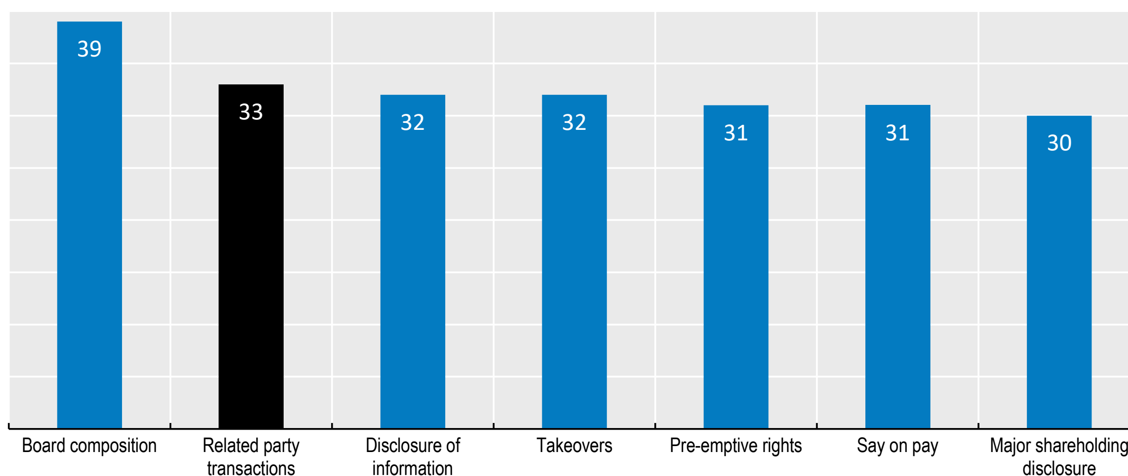
As described above, most countries have similar financial reporting requirements for RPTs by listed companies as a result of widespread acceptance of IFRS and convergence of IFRS with major national standards. However, in part due to the ex post nature of financial reporting, some jurisdictions have seen this as insufficient for corporate governance disclosure and have introduced complementary requirements with respect to, for example, on-going disclosure of material related party transactions. Since most companies in the world are required to follow principles-based accounting standards, to the extent possible, it would also be cost-effective to align the principles for RPT disclosure requirements with the accounting standards.

With respect to the review and approval procedures of material RPTs, the influence of controlling owners on the board may limit the effectiveness of the board's role in the process. This is why appointment of independent directors has emerged as an important mechanism to support minority rights. However, and for the same purpose, more recently empowering shareholder meetings has also been used in many countries. In this context, low free-float levels in some markets has a potential to create unintended consequences such as giving disproportionate powers to minority shareholders, which may also endanger companies' competitive position. These are all examples of the complexity of issues surrounding RPTs, and cases for flexibility and proportionality.

Survey results

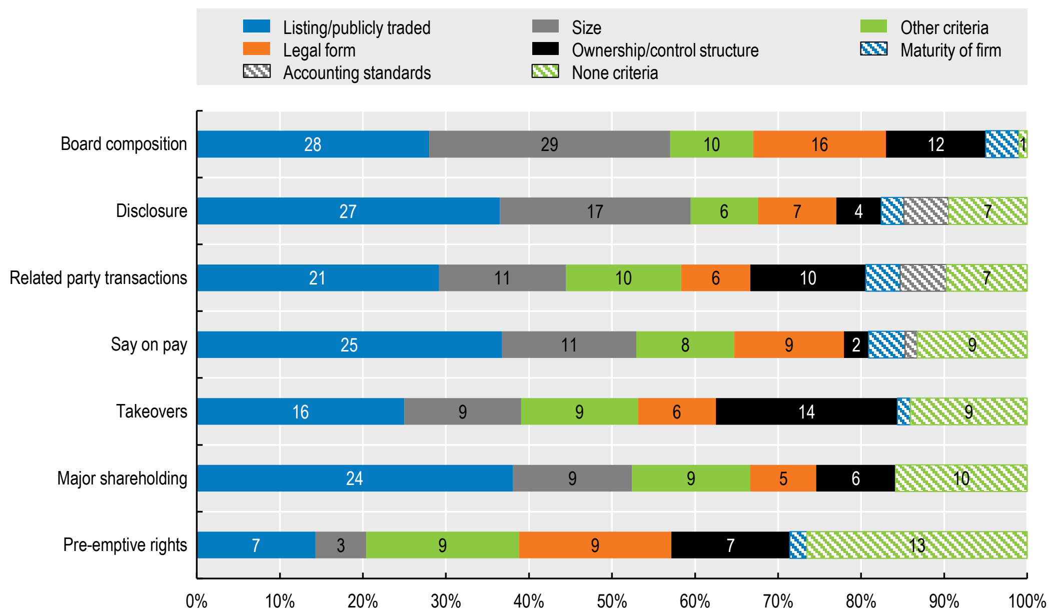
Out of the 39 jurisdictions included in the survey, 33 jurisdictions reported at least one criteria or optional mechanism that allow for flexibility and proportionality in the area of related party transactions (Figure 6.1.).

Figure 6.1. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation



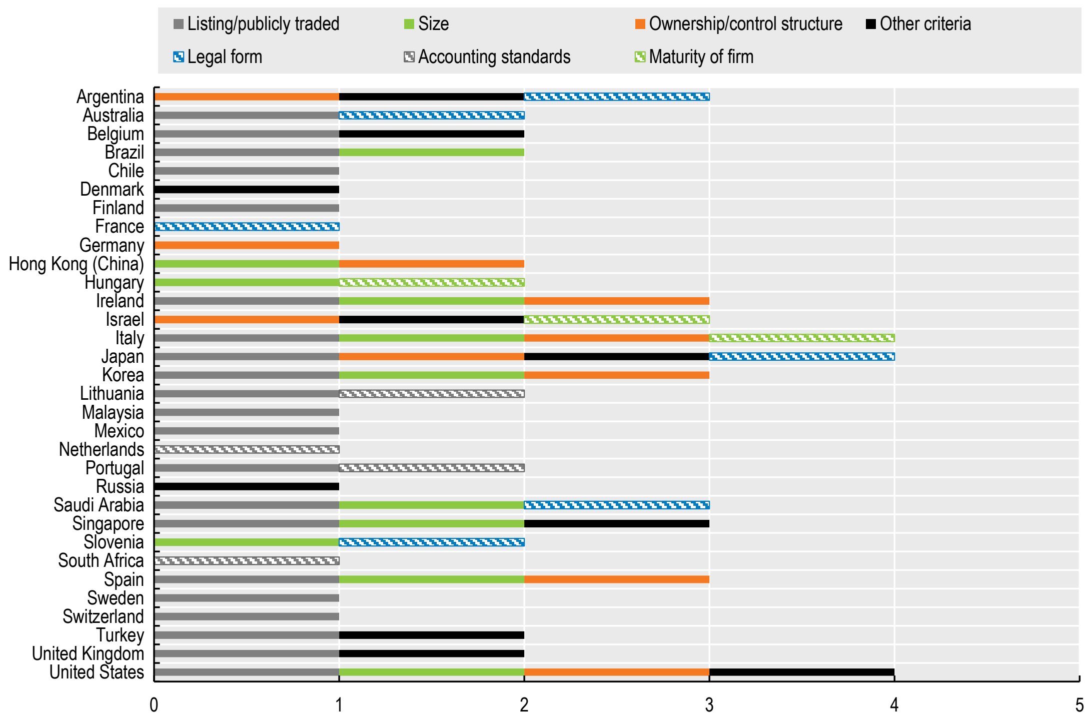
Source: OECD Survey.

Figure 6.2. Overall use of criteria across all areas of regulation



Source: OECD Survey.

Figure 6.3. Use of criteria for related party transactions across jurisdictions



Source: OECD Survey.

Looking at the frequency of use of criteria across the different regulatory areas, Figures 6.2. and 6.3. show that there were only 7 jurisdictions that did not report any criteria for flexibility and proportionality with respect to related party transactions.

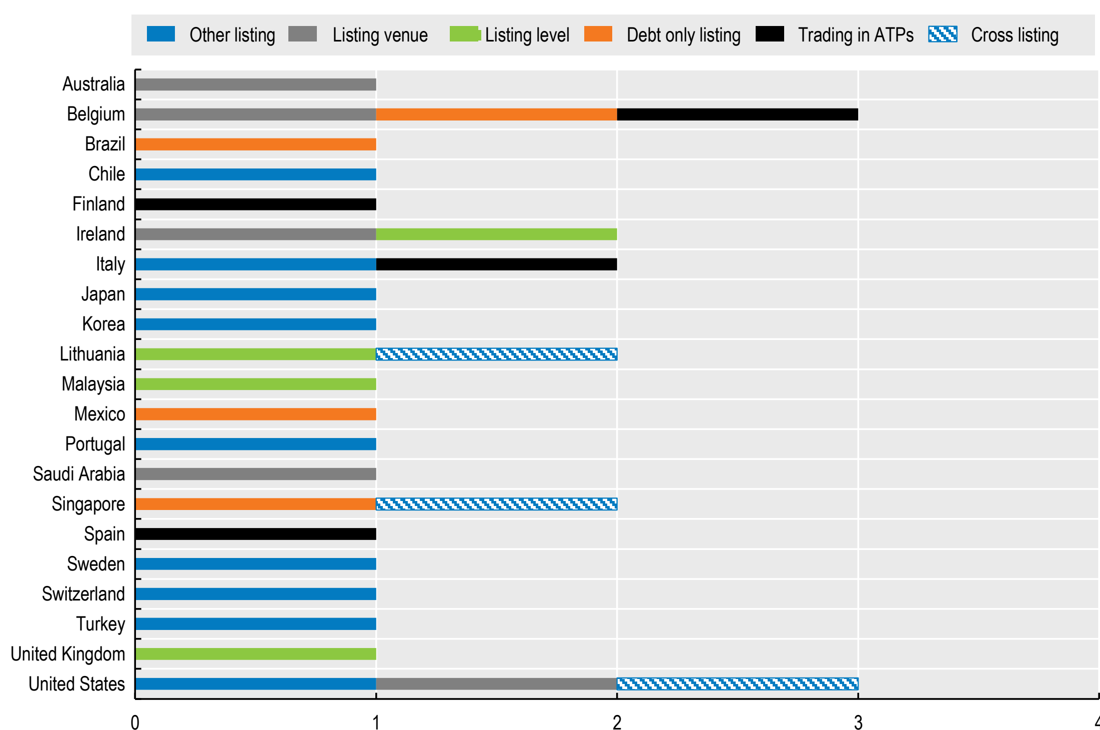
As described in the main chapter of this thematic review, among all the criteria that jurisdictions employ to promote flexibility and proportionality in their corporate governance frameworks, the criterion of *listing/publicly traded* and the criterion of *size* are by far the most used when considering all areas of practice.

In line with the overall results of the survey, the most common criterion from flexibility and proportionality in the area of RPTs is listing status, which is used in 21 countries, followed by size in 11 countries and *ownership/control structure* in nine countries.

The use of listing/publicly traded as criterion for flexibility and proportionality

Despite being the most common criterion, the way that listing status is used for flexibility and proportionality with respect to related party transactions varies widely across countries. Figure 6.4. shows that some jurisdictions offer flexibility with respect to the *listing level or venue*, including *alternative trading platforms*. There are also a few cases where *cross-listing* is a criterion (Lithuania, Singapore and United States) and when companies that only have debt instruments listed are subject to different regulatory frameworks (Belgium, Brazil, Mexico and Singapore).

Figure 6.4. Use of listing/publicly trading criterion for related party transactions

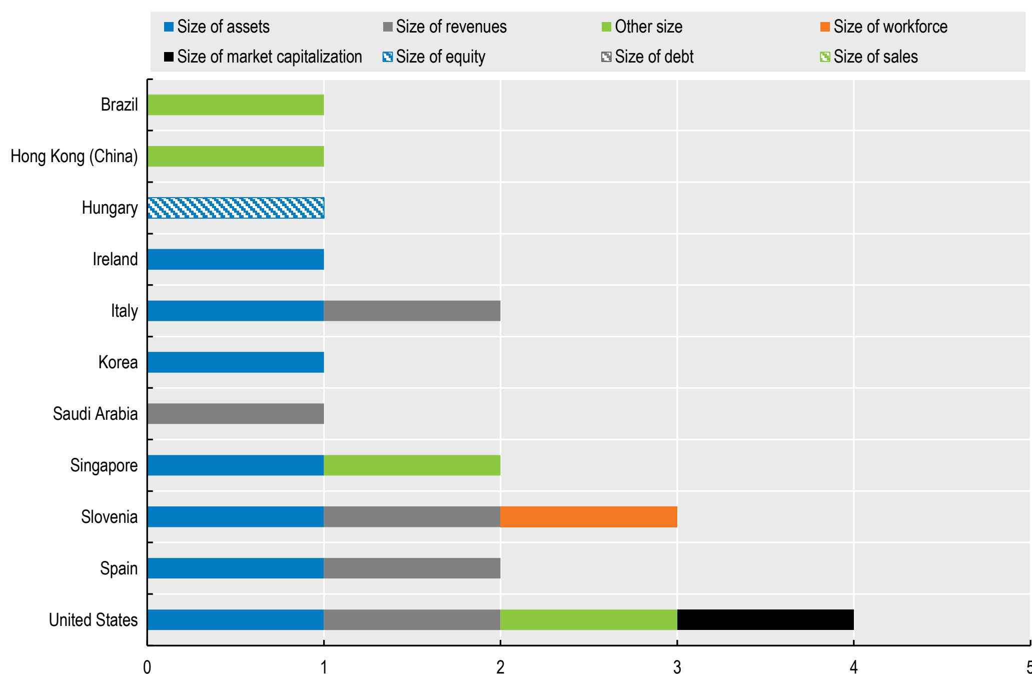


Source: OECD Survey.

The use of size as criterion for flexibility and proportionality

As seen in Figure 6.5., *size* also appears as an important criterion used in the RPT regulatory framework by 11 jurisdictions.

Figure 6.5. Use of size criterion for related party transactions



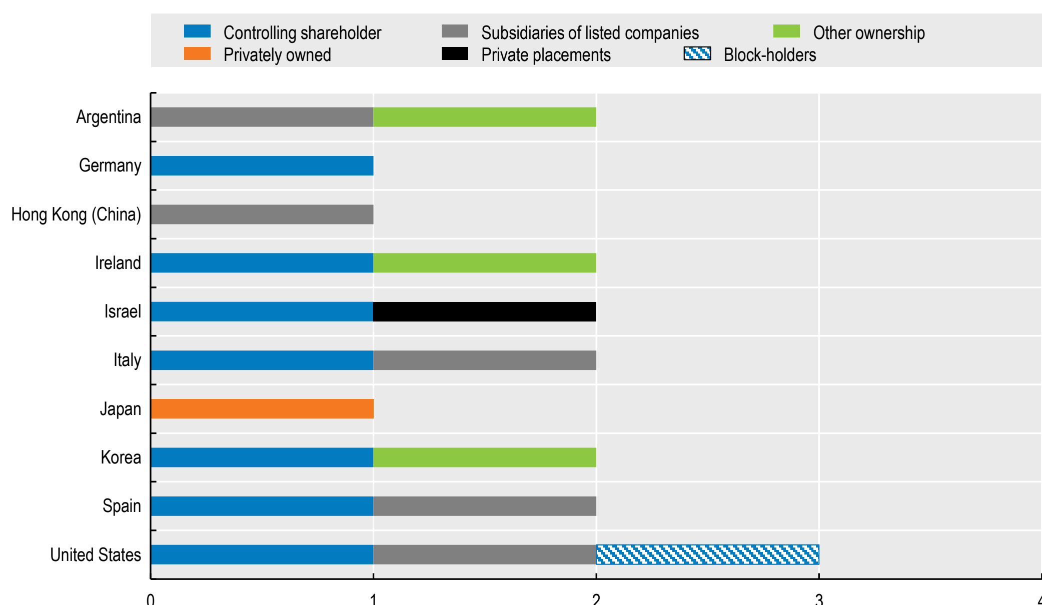
Source: OECD Survey.

The two main definitions of size are *total assets* and *revenues* (net sales) mentioned by seven and five jurisdictions respectively. In addition, total equity in Hungary, *workforce* in Slovenia and *market capitalisation* in the United States are used as quantitative criteria. All four jurisdictions that indicated a different *size* criterion ("*other size*") than the ones listed in the figure use size of the transaction as the criteria for flexibility.

The use of ownership/control structure criterion for flexibility and proportionality

Figure 6.6. summarises the results with respect to use of *ownership and control* criteria across 10 jurisdictions. Italy, Spain and the United States mentioned both *controlling shareholder* and *subsidiaries of listed companies* as flexibility criteria, while Argentina and Hong Kong, China, were indicating only *subsidiaries of listed companies*; and, Germany and Ireland only *controlling shareholder*. *Blockholders* (United States) and *privately owned* (Japan) were also mentioned. Two cases where there are particular rules are Ireland where there are special rules for RPTs between companies and their wholly owned subsidiaries, and Korea where there are special rules for controlling shareholder and in particular for related persons who own more than half of a certain corporation or its subsidiary.

Figure 6.6. Use of ownership/control structure criterion for related party transactions



Source: OECD Survey.

The use of other criteria for flexibility and proportionality

As presented in Table 6.3, there are also a few cases were *legal form*, *maturity of fir*m and *accounting standards* are used as criteria for flexibility. For example in Israel, according to Companies Law, a recurrent transaction with a controlling shareholder should be re-approved every three years. However, a company who offers its securities to the public for the first time may only have to start approving these transactions after five years if they were fully described in the offering prospectus. On the other hand, in Portugal companies that do not follow the international accounting standards pursuant to the European regulation must disclose certain detailed information regarding RPTs as an annex to their financial reports.

Table 6.3. Use of legal form, maturity of firm and accounting standards criteria for related party transactions

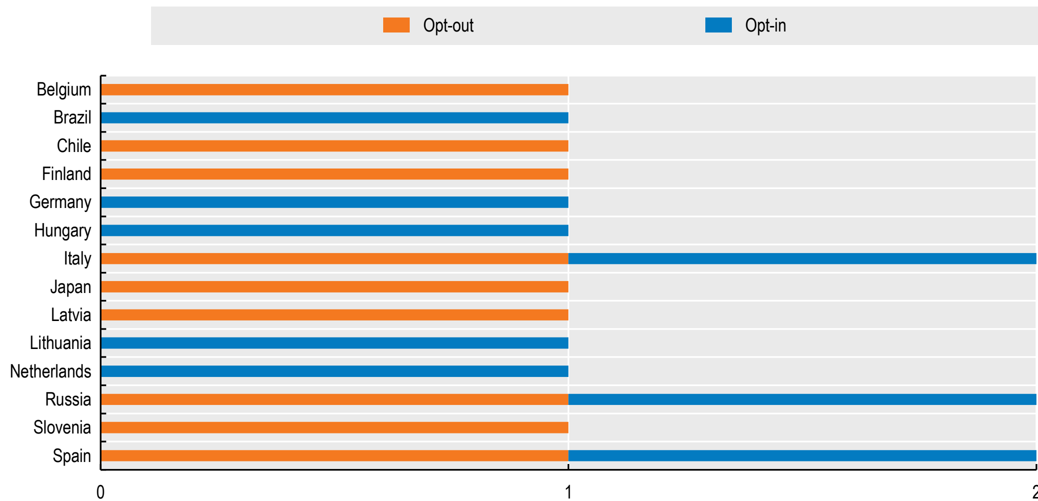
Legal form	Maturity of firm	Accounting standards
Argentina	Hungary	Lithuania
Australia	Israel	Portugal
France	Italy	South Africa
Japan		The Netherlands
Saudi Arabia		
Slovenia		

Source: OECD Survey.

The use of opt-in and opt-out mechanisms for flexibility and proportionality

Figure 6.7. provides an overview of the use of opt-in and opt-out provisions as a flexibility and proportionality mechanisms in 14 countries. Italy, Russia and Spain use both opt-in and opt-out mechanisms, while six countries use only opt-out and five countries only opt-in options. As an example of opt-in provisions, in the Netherlands listed companies can opt-in to the use of IFRS for their non-consolidated annual statements, which includes detailed disclosure requirements for RPTs.

Figure 6.7. Use of opt-in and/or opt-out mechanisms for related party transactions

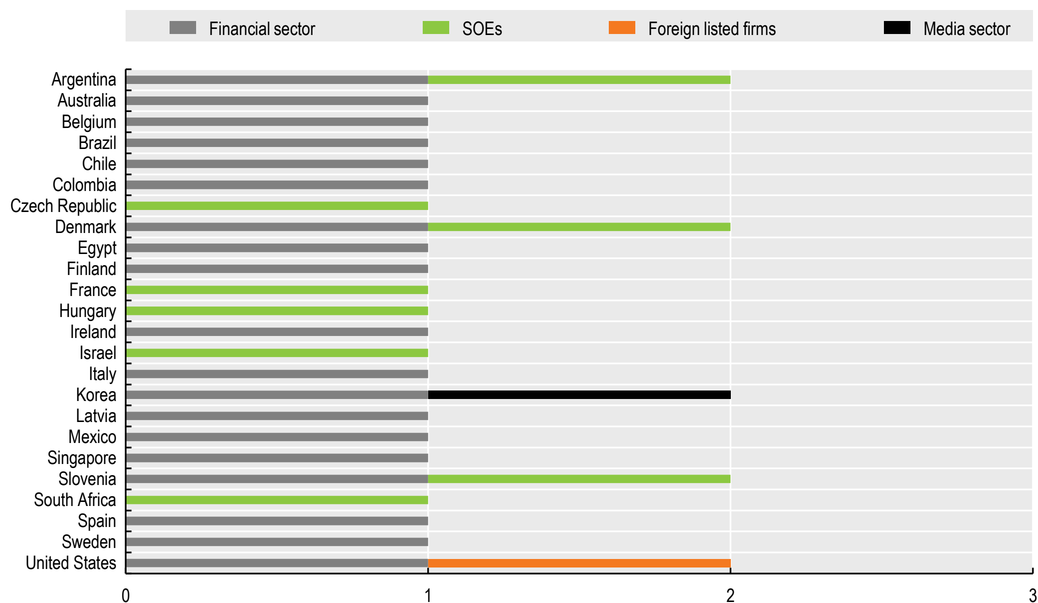


Source: OECD Survey.

The use of sectoral criteria for flexibility and proportionality

An analysis of the results per sector of activity reveals that flexibility and proportionality criteria for related party transactions are used in 24 jurisdictions, with a varying degree of scope (Figure 6.8.). Most jurisdictions that present flexible sectoral regulations report having special regimes for the financial sector and for their State-owned companies.

Figure 6.8. Use of flexibility and proportionality in different sectors for related party transactions



Source: OECD Survey.

Case study: Italy

Overview

Italian listed companies have long been characterized by a high degree of ownership concentration in individual companies and the widespread use of control enhancing mechanisms such as pyramid structures, non-voting shares and coalitions, be they formal or informal.[1] Although such arrangements have been declining over time, the large majority of Italian listed companies today are still under the control of a single shareholder holding the majority of voting rights or being able to control the company with a lower block holding.[2]

A certain degree of concentrated ownership is generally seen to provide strong incentives for ownership engagement, and thus helping overcome the fundamental agency problem between shareholders and managers. However, without an effective regulatory framework, the concentration of ownership and control may also increase the possibilities to extract private benefits through bilateral transactions between the company and its related parties. Italian legislation has traditionally addressed the risks of extraction of private benefits in the context of the transfer of corporate control – applying a mandatory bid rule – while, until recently, payed scant attention to other possible mechanisms for such shortcomings.[3]

Some high-profile corporate scandals[4] in early 2000s caused widespread concern about abusive extraction of private benefits through related party transactions. These concerns led market participants first and policy makers later to take concrete steps for improving the framework for handling RPTs in listed companies, with company law reforms eventually replacing self-regulation. In 2004 policy makers addressed the handling of related party transactions by listed companies with a view to enhance transparency and fairness of such transactions. The new legal framework gives the Italian Securities Regulator (Consob) a key role as rule maker and supervisor.

The OECD's peer review on related party transactions carried out in 2011 included an in-depth analysis of the Italian legal and regulatory framework with a particular focus on the new regulation introduced by Consob in 2010. This case study describes the current regulatory landscape, and the flexibility and proportionally mechanisms therein. It also analyses the progress and challenges in the implementation of the principles-based Consob Regulation adopted since the 2011 review.

The Italian legal and regulatory framework for RPTs

The handling of RPTs by Italian listed companies was first addressed in the Italian Corporate Governance Code (*Codice di autodisciplina,* the Code) in 1999, which provides examples of best practices for Italian listed companies. Since the Code is in the form of self-regulation, the adoption is voluntary. But once adopted, the company must provide information on a “comply or explain” basis.

A revised version of the Code from 2002 provided some best practices aimed at strengthening safeguards on dealing with related parties, primarily by complementing the key role of the board in reviewing RPTs with an independent review provided by the audit committee and/or by independent experts. The same practices were reframed in the 2006 version of the Code, which entrusted the board with a central duty in defining the procedural steps to be followed when entering into significant RPTs and the approval of such transactions.

The self-regulatory nature of the Code resulted in high compliance rates: 86% of Italian listed companies adopted an internal code for dealing with related parties in line with the Code's recommendations and described it in their annual reports on corporate governance (Assonime and Emittenti Titoli, 2007). However, the high rates of compliance were achieved mainly by a "box-ticking" approach.

Consequently, the self-regulatory approach on RPTs proved to be of limited effectiveness. There are several explanations for this. First, the actual content of the Code on RPTs was quite generic. Beyond a detailed explanation of the process concerning the adoption of the internal procedure, safeguards against potential abusive transactions were mainly provided as examples. This left companies with extensive discretion in deciding which safeguards to actually adopt and when to do it.

Second, despite the high compliance rate, an in-depth analysis of effective adoption of each recommended practice revealed that, in most cases, compliance was limited to the minimum recommended practice while the most effective provisions were mostly ignored by companies.[5] [6]

Third, even if certain public enforcement mechanisms exist with respect to the disclosure and monitoring of how corporate governance codes are actually adopted, reputation is the main driver of actual implementation of self-regulation. But reputational sanctions represent an effective driver only if certain conditions are met. First, disclosure by companies should be reliable, free of window-dressing and entail not only procedures on the books but also their actual implementation. Second, investors should be able and willing to effectively evaluate such disclosure and step up pressure on companies or inflict proper sanctions. The time-limited experience of self-regulation between the 2002 revision of the Code and 2010 reform described below with respect to RPTs did not see the two conditions sufficiently met in the Italian market.

The 2010 Reform

In light of the limits of corporate self-regulation in ensuring investor protection when conflicts of interest between majority and minority shareholders arise, corporate and financial law reforms of 2004-2005 granted more specific regulatory powers to Consob in the area of listed companies' corporate governance.[7] Among them, rulemaking on RPTs was of utmost importance not only with respect to the issue itself, but also with respect to the scope of the power that it granted to the regulator. Indeed, the Italian Government amended the company law by introducing a new provision on related party transactions by Italian listed companies that empowers Consob with the authority to adopt rules in the area of governance and decision-making mechanisms.[8]

According to the new provisions in the Civil Code, the Italian securities regulator was granted power to adopt general principles regarding the transparency, and the procedural and substantial fairness of RPTs while companies were entitled to set out their own internal codes in compliance with the principles provided by the regulator. The result is a three-layer system where the Civil Code provides the legal framework and the general goals, while the securities regulator establishes the principles for achieving the regulatory objectives and the companies define consistently the actual steps to be followed when dealing with related parties.

In this framework, Consob holds informative powers (to Consob itself and to the public) on market disclosure and on actual adoption of the rules. It also holds 'second level' enforcement powers on the company's internal board of auditors appointed by the GM

(*collegio sindacale*), who is in charge of monitoring that the internal code correctly adopts the regulation and that RPTs are conducted in compliance with the procedures that are established in the internal code. Enforcement of the rules also relies on market mechanisms and shareholder activism.

The disclosure requirements in the Consob Regulation are proportionate with respect to the materiality of the transaction and go hand in hand with the differentiated governance procedures for on-going transparency: all RPTs exceeding a given threshold must be disclosed, irrespective of their nature. Some RPTs can be exempted by the application of the disclosure rule, but this possibility is limited to "transactions in the ordinary course of business and entered into on terms equivalent to those that prevail in arm's length transactions", which, at least in principle, is a much narrower definition than that of not "unusual and atypical" which allowed non-disclosure under the previous regime.

The Regulation mandates the disclosure of significant (material) RPTs on an *ad hoc* and a periodic basis. Material RPTs are defined as a result of a class test provided by Annex 1 to the Consob Regulation. In general, materiality thresholds are quantitative criteria such as 5% of different balance sheet items. However, in the case of pyramid structures, the ratio is 2.5%. Material RPTs must be disclosed within seven days to the market via the issuance of a circular, which provides the description of the transaction, its terms and impact on the company. The fairness opinion of the committee which is made up of all unrelated and independent directors as well as the independent advisor's opinion, if any, must be attached to the circular. With respect to the periodic reporting, companies must include an analytical description of material transactions in their yearly and intermediate (half-year) financial reporting in line with the requirements of the EU Transparency Directive.

In terms of the review and approval processes, the Regulation opted for the enhancement of the role of the board in terms of both developing internal codes for the procedures and approving transactions on an ongoing basis. A primary role was given to independent directors in the whole negotiation and approval phases, while a direct involvement of shareholders was deemed too burdensome for companies both in terms of cost as well as the efficient and timely management of the company's business, and is therefore limited to some specific cases.[9]

However, the central role assigned to independent directors and, particularly, the possible contradiction between their active engagement and their non-executive role raised some concerns. The regulation addresses these concerns in light of the infrequent nature of material RPTs, for which approval procedure envisages a determining role for independent directors, who play a more or less powerful role in relation to the RPTs materiality. Indeed, the RPT Regulation provides for differentiated review and disclosure requirements according to the materiality threshold met by the transaction, requesting a stronger involvement of independent directors in the *special procedure* and *ad hoc* disclosure required for material ones. In particular, while in the *general procedure* a committee composed of a majority of independent directors provides a preliminary non-binding opinion on the transaction, the *special procedure* designed for material RPTs requires: (i) the involvement of independent directors in the negotiation, as they must receive adequate information from the executives and can express their views; (ii) the approval of material RPTs by the board of directors with the binding favourable opinion of a committee of independent directors, thus granting to the committee of independent directors a *veto* power on material RPTs, which may be overcome only with a positive vote of the majority of the "unrelated" minority shareholders (so-called "whitewash

procedure" or "MOM"). Under both procedures, the committee of independent directors may seek the advice of an independent expert of its own choice at the expense of the company.

Flexibility and proportionality in the regulatory framework

As mentioned above, the corporate and financial law reforms in 2004 and 2005 for the first time gave a mandate to Consob to issue "principles" for transparency and, procedural and substantial fairness of RPTs rather than rules. In implementing the law mandate, a trade-off immediately emerged. On the one hand, provision of high-level principles for dealing with related parties would have been in line with the legislative mandate but, in light of the experience of self-regulation, it could have had limited impact on improving the governance of RPTs. On the other hand, the definition of detailed and in-depth procedural and transparency duties that most likely would have been more effective in terms of implementation, could turn out to be contradictory with the "principle-based" approach if they were not complemented with sufficient flexibility.

From the regulatory perspective, this posed the challenge to provide a regulatory system with a balanced, flexible and proportionate approach in line with the principle-based nature of the mandate and at the same time achieve effective implementation. Moreover, Consob also faced the challenge to identify the specific pillars of procedural tools that are efficient in fulfilling the ambitious goals established in the Civil Code with respect to transparency and fairness taking into consideration the specificities of Italian companies.

Against this background, the 2010 Consob Regulation was designed in order to provide companies with sufficient degree of flexibility in tailoring their own internal codes about procedural steps and transparency obligations to meet their specificities, while at the same time providing certain default provisions which define the minimum requirements to be met. Concerning some of the default provisions in specific cases of RPTs, there is also a matrix of options for companies to opt in or opt out. This means that companies may tailor their internal codes by "opting in for" or "opting out from" the default rules with a view to calibrating actual rules depending on: (i) the potential for misuse of transactions, based on their characteristics; (ii) the presence of alternative review mechanisms; and, (iii) proportionality for firms with lower complexity, namely newly-listed firms and smaller companies (See Table 6.4. below).

The analysis carried out in 2010,[10] just after the entry into force of the new Consob Regulation, highlighted that companies widely used the possibility to tailor their procedures adopting several opt-in and opt-out clauses, confirming their interest for a flexible regulatory approach. The options have been taken advantage of in a variety of ways and the adoption of stricter/looser procedures seems to be linked to certain corporate governance characteristics. While, for example, non-controlled companies have set up better procedures through opting-in, among controlled-companies those where a single shareholder or a coalition holds a stake lower than 50% of voting or cash flow rights preferred to scale down their procedures through opting-out. Moreover, the presence of one director nominated by institutional investors has been positively correlated with stricter procedures.

Table 6.4.Taxonomy of RPTs and applicable disclosure and review/approval provisions

RPTs	Identification	Review	Disclosure
Material RPTs	Class test: exceeding at least one of the three materiality indexes provided in the Regulation (5% of market value/assets or lower threshold defined in internal codes; the threshold is 2.5% in pyramids)	Special procedure: Involvement of a committee of independent directors in the negotiations; Board approval; Binding favourable opinion of the committee of independent directors (veto-power); Possible recourse to independent advisors by the committee at the company's expense.	Ad hoc disclosure: circular within 7 days. Periodic disclosure: information in the annual and half-yearly financial statements.
Non-material RPTs	Residual: under the materiality thresholds (but above a de minimis amount that companies may define)	General procedure: Decision by the board or the executive directors according to the company's distribution of powers; Non-binding opinion of a committee with a majority of independent directors; Possible recourse to independent advisors by the committee at the company's expense.	Quarterly disclosure if the non-binding opinion provided by the committee made up of a majority of independent directors is negative.
RPTs with opt-in or opt-out provisions	(i) lower potential for exploitation		
	Small amount RPTs	Waiver from approval provisions is allowed.	No disclosure applicable.
	RPTs in the ordinary course of business and entered into at arm's length condition		Waiver from ad hoc disclosure provisions for material RPT is allowed. Periodic disclosure if applicable, non-waivable.
	RPTs with subsidiaries or associate companies		
	(ii) presence of alternative review mechanisms		
	Stock-based compensation plans	Waiver from approval provisions is allowed, but Shareholder approval is required by law.	Waiver is allowed but specific disclosure for the general meeting is required by law.
	Directors' and top managers' remuneration	Waiver from approval provisions is allowed, provided that: the remuneration is consistent with a previous remuneration policy; the remuneration policy was defined involving a committee with a majority of independent directors; the remuneration policy was submitted to the shareholder meeting (for approval or an advisory vote)	Ad hoc and periodic disclosure applying according to materiality. Waiver not allowed. In addition, the remuneration report providing yearly detailed information on individual directors' and top managers' remuneration is otherwise required.
	(iii) proportionality for firms with lower complexity		
	RPTs entered into by SMEs and newly-listed firms	Application of the general procedure also for material RPTs is allowed (except for pyramids).	No waiver allowed (i.e. ad hoc and periodic disclosure applying according to materiality.

Source: Author's analysis.

Regarding the potential for misuse of transactions, companies have important degrees of flexibility allowing them to opt-out from both the approval and *ad hoc* transparency requirements:

- Most importantly, RPTs in the ordinary course of business that are done on an arm's length basis can be exempted from the application of procedures and the disclosure regime. Material but "ordinary" RPTs which have not been disclosed by a circular must be notified to Consob within 7 days and described in the half-year or annual report.
- Second, intra-group transactions, i.e. with subsidiaries or associate companies, may be excluded from the disclosure and review regimes on the condition that no other related party holds a significant interest in the transaction. The rationale for this exemption is that there is no incentive for the decision makers of the listed parent company to transfer value to companies where the parent company (or the controlling shareholder) holds a lower economic interest. However, such opting-out is not allowed if another related party of the company (e.g. a director, the controlling shareholder) holds a significant interest in the subsidiary, and consequently in the transaction. This can be the case, for example, if a shareholder holds a higher stake in the subsidiary/associate company than in the listed parent company.
- Third, companies may establish that RPTs below a *de minimis* amount (smaller amount transactions) are excluded from any requirement.

Following a proportionate approach, Consob Regulation envisages also the possibility of a simplified regime for companies characterized by a less complex structure, allowing SMEs (as defined under the EU Accounting Directive) or recently-listed companies (within the third year after the IPO) to opt-out from the procedural requirements for material transactions, but not from its disclosure regime as defined under RPT Regulation for material and non-material transactions. This means that such companies may decide to apply the *general procedure* for related party transactions regardless of the materiality of the transaction (i.e. also to material RPTs) and opt-out from the more burdensome *special procedure* that would require the involvement of independent directors in the early negotiation stage and the binding favourable opinion of a committee of all independent directors.

Looking beyond the regulated market, it is important to note that the same simplified approach has been adopted also by the Italian Stock Exchange with respect to the governance requirements for companies whose shares are traded on AIM Italia, a MTF for smaller growth companies managed by Borsa Italiana.[11]

Nevertheless, the Consob Regulation provides for a proportionate approach also by defining some stricter rules with regard to the company's structure. For example, companies that are controlled by another company listed on the regulated market are excluded from the opt-out option provided for companies with a less complex structure. They are also subject to a different materiality threshold, which is generally defined as 5% of different balance sheet items but set to 2.5% for pyramidal groups.

Challenges in enforcing a flexible and proportionate framework

With the introduction of the quantitative criteria for on-going transparency, the number of material RPTs disclosed surged immediately. In the first three years of the application of the new rules - during the period between 2011 and 2013 - the number of circulars issued

by Italian companies was about 80 documents per year. Between 2014 and 2016 the average number decreased to about 50 circulars per year, possibly due to some changes in the ownership structure of Italian listed companies.[12] Overall between 2011 and 2016, 392 circulars on material RPTs were issued by Italian listed companies, with an annual average of 65 disclosures. As a comparison, during the six years before the introduction of the new Regulation only 25 RPTs per year were disclosed according to the qualitative (negative) criteria in force at the time.

The change in the criteria for disclosure seems to have affected also the "nature" of RPTs disclosed. Almost two third of all RPTs disclosed in the period 2006-2010 were transactions entered into with companies controlled or under significant influence by the issuer. Those transactions accounted for only 10% of total RPTs disclosed in the period 2011-2016. With respect to the more "risky" transactions, which are those entered into with controlling shareholders or directors, the number of disclosed RPTs increased dramatically from less than 10 per year to about 60 per year.[13]

As illustrated above, the six-year experience of the Consob Principles shows a substantive improvement in the procedures and disclosure of RPTs. It also provided several examples of the challenges that are affiliated with establishing a flexible and proportionate framework for related party transactions. In the Italian case, these challenges included the definition of related parties; the assessment of independence; the role of independent directors; implementation of exemptions, and the indirect sanctioning powers of Consob.

Definition and identification of related parties

A first issue concerns the definition of related parties. Consob Regulation adopted the definition of IAS 24 in force at the moment of the approval of the regulation. The decision to refer to a static definition was aimed at ensuring the certainty of the relevant legal framework and was strongly advocated by issuers during the consultation process. The IAS 24 definition for related parties is quite complex and revealed to be particularly problematic for entities that control the company "jointly with others". In a number of the Italian listed companies, it is possible to identify groups of shareholders who coalesce in order to play a relevant role but it is not easy to assess if they are able to "jointly" control the company.

To partially address this problem, Consob Regulation required companies to assess whether to apply RPT provisions also in cases where the counterparty has significant role on company's decision-making without being formally identified as related parties.

The main enforcement challenges here are twofold; (1) since the contracts regulating the coalition (shareholder's agreements) are often complex and tend to privilege weak "formal links" even when clear signals of "strong" coordination is in place, the identification of actual joint control in presence of a coalition may not be possible; (2) the assessment of the company's judgement with respect to identifying other related parties ("substantial related parties") to which RPTs provisions will be applied can be hard, in particular in presence of informal coalitions where the ownership structure is highly disperse.

In a context where shareholder agreements and coalitions play a key role in controlling or influencing the decision-making of companies, it becomes evident that failures in identification of related parties or of "substantial related parties" make the discipline totally ineffective.

The assessment of independence

Since independent board members play a pivotal role in the Consob Regulation, another challenge is related to identifying independent directors.

Taking into account the features of the Italian corporate sector as well as some international experiences[14], the Consob Regulation provides independent board members with a key role both in the negotiation and the approval of the transactions.[15]

The decision to enhance the role of independent directors started from the consideration that a concentrated ownership structure may entail a stronger "dependence" of executive board members on the controlling shareholder. At the same time, the choice to enhance the involvement of independent directors in the RPTs would also bolster their access to all relevant information and reduce the knowledge gap between executive and non-executive directors. In order to strengthen the effectiveness of the independent directors' role, the Regulation gave them the possibility to require the assistance of an independent advisor of their own choice and at the company's expense. Therefore, actual independence of both directors and advisors is crucial to ensure the soundness of the system.

The Regulation gave companies the possibility to choose between the legal definition (set forth by the Consolidated Law on Finance)[16] and the self-regulatory definition (set forth by a Code of Conduct)[17] of independence. Most of the Italian listed companies adopted the latter, whose criteria are more comprehensive than the legal one. Furthermore, the Code's definition of independence relies on the board assessment on a case by case basis of the criteria for independence.

The Code's definition of independence is in principle more effective but it is also more difficult to assess and to challenge, since it is based on the board's qualitative and subjective judgement (like "the absence of *material* economic or financial relationship with the issuer"). Important examples of specific situations that are difficult to assess that emerged in practice are those where a director is a partner of a law or consulting firm that has the company (or a related party) as a client, where the issue was how to define the materiality of those relationships, especially in cases where the director is not directly involved in the relations but can be indirectly benefited by them.

In addition, the assessment of the independence of external advisors supporting independent directors has proved to be difficult. This is particularly true for larger issuers, who usually have business relations with all the main advisory firms operating in the Italian market.

The role of independent directors in material RPTs

As described above, the involvement of independent directors' in the review and approval of related party transactions differ based on the materiality of the transactions. For minor RPTs, their role is limited to giving a non-binding opinion, where a negative opinion may indicate the possibility of tunnelling.[18] In the case of material RPTs, (as a committee[19] made up of all unrelated and independent directors) they are not only required to issue a binding opinion (which give them a true veto power on RPTs[20]) but also to be involved in the negotiation stage of the transaction. This should ensure that they have access to the information they need in order to make a well-founded independent judgment and possibly provide comments or request changes when the negotiations are still in progress.

The involvement of independent directors in the negotiation stage is a distinct feature of the Consob Regulation since it markedly changes the traditional role of independent directors and could affect their "pure" non-executive role. Although their involvement is limited to the right to receive and ask for adequate information from the executive directors conducting the negotiations and to provide comments thereof, it still gives the independent directors a more active role and greater responsibility than traditionally board membership is associated with.

From an enforcement perspective, it may be a challenge to identify the starting date of the negotiations and to correctly assess the actual involvement of independent directors' role, which is expected to be more than a passive "recipient of information". In fact, the effectiveness of this provision depends on the timeliness of the involvement of independent directors[21], i.e. when the negotiation is actually still open and possible to influence. It also depends on the substantial interpretation of the independent directors' role in that phase, which implies a pro-active role in challenging the executives' during the negotiation. For example, by stimulating the search for alternative solutions both with respect to the envisaged transaction and to the counterpart of the transaction.[22]

Implementation of exemptions: the RPTs in the "ordinary course of business"

There have been some specific challenges regarding the assessment of RPTs that are conducted in the ordinary course of business at arm's length, which may be exempted from the application of the rules for procedure and disclosure. The Consob Regulation requires the transactions that fall under the company's ordinary business to be evaluated on the basis of the features of the transaction and be concluded on market terms. In order to benefit from an ordinary course of business exemption for ad hoc disclosure of material RPTs, companies are required to provide Consob with certain information regarding the transactions within seven days. Nevertheless, the transactions remain subject to the periodic disclosure regime and shall therefore be reported in the half-year and annual reports.

Given the complexity of the definition of the exemption clauses and the risk of excessively wide interpretations, the assessment of the objective grounds for granting an exemption might become difficult and demanding as it involves an in-depth assessment both of the business of the individual company and of the specific features of the transaction for which exemption is requested.

The indirect sanctioning powers of Consob

Consob holds informative powers on market disclosure, and on the actual adoption of the rules. It also holds enforcement powers towards the internal board of auditors, which is responsible for the oversight of both the compliance of the internal code with the Consob Regulation and the effective application of the internal code's procedures.

The regulatory approach adopted through the Consob Principles has identified a new role for the securities regulator in monitoring the evaluation and approval of RPTs by the board of directors and its independent members and in verifying that the statutory auditors have effectively supervised the actual application of the rules. Consob's enforcement powers are not directed to the companies themselves (except for breach of disclosure obligations) and their board members, but to the company's board of auditors, which is in charge of directly supervising the implementation of the internal RPTs procedures.[23] This means that, at least in the traditional company model (which is adopted by more than 95% of listed companies), the enforcement powers can be used only with

respect to persons who are not directly involved in the management of RPTs. In fact, Consob's enforcement does not regard the actual "substantial and procedural fairness of RPTs" but rather the effectiveness of the supervisory activity carried out by the board of auditors and, therefore, its oversight on the compliance with the internal procedures ensuring the "substantial and procedural fairness of RPTs".

The principle-based nature of the regulation implies that only a few aspects of the procedures can be assessed according to a binary approach (implemented/not implemented), while the other, and the more relevant, aspects require an assessment of "how" the procedures have been implemented. Indeed, principles are based on qualitative concepts, like "independent" board members, "independent" advisors, "timely involvement" in the management of transactions, "interest of the company" to enter into the transaction, etc., whose assessment cannot be unequivocal. Moreover, given the indirect nature of Consob enforcement power, the object of the supervision is not the implementation of the Consob Regulation but the quality of supervision by the board of auditors with respect to the qualitative concepts mentioned above, multiplying the levels and complexity of questionability.

The way forward for the Italian system

The Corporate Governance peer review in 2011 recognised the considerable progress made in the previous years with respect to shareholder rights and transparency in the Italian legislative and regulatory framework related to RPTs. The six-year of experience of implementation since then has given an opportunity to analyse the progress and challenges of the principles-based system introduced by the Consob Regulation.

As described above, the introduction of the new regulatory system in 2010 lead to a significant increase in material RPT disclosure. The enforcement of transparency requirements by Consob has also become more effective. Consob has used both hard powers (sanctions) and soft sanctions (request for integrating information disclosed) to improve the implementation of the Regulation.

Within companies, the result has been a stronger involvement of all the main actors. The board, as a whole, has been made more accountable through the requirement that they establish and revise internal procedures and through their role in approving or monitoring RPTs. In particular, the independent directors who sit in the RPTs committee play a major role through their mandatory opinion on all RPTs and through their involvement in the negotiation phase. Finally, also the members of the internal board of auditors have developed their duty to check compliance with the internal rules aiming at ensuring the transparency and fairness of RPTs.

Related party transactions have also received a greater interest from institutional investors and proxy advisors. Some active hedge funds have engaged in challenging individual RPTs while proxy advisors started to mention some specific criteria for RPTs in the proxy voting guidelines.[24] However, their interest is still focused on large companies and on specific transactions, while no attention is given to the quality of procedures adopted by individual companies, whose diversity could require a more active and tailor-made monitoring.

Another positive development can be found in the attitude by the main business sector organizations (Assonime, Confindustria, ABI). They have changed their approach from being hesitant about the new rules on RPTs to actually being supportive of the regulatory

model, by also developing specific induction sessions for directors and statutory auditors on RPTs.

Naturally, there is still some potential for improvements with respect to clarifying the rules and the effectiveness of enforcement system. As for the rules, uncertainty about the role of the independent directors' committee that assess the RPTs could be addressed by providing it with the full power of conducting and approving the transactions. This can be complemented by providing individual companies with the possibility to opt-out from such a system through the provision of alternative procedures, for example in the form of a shareholders' vote using the whitewash procedure. To improve the effectiveness of enforcement powers, the sanction system could be changed to include direct sanctioning powers towards directors and stronger elements of private enforcement.

However, as Enriques (2014) pointed out in a recent paper, "*even fervent enforcement by a committed securities regulator, backed, as it may, by law reforms tightening RPT rules, can reveal itself to be no more than a flash in the pan in countries where either no social norm against tunnelling exists (i.e. where "don't engage in tunnelling" is not, broadly speaking, a specification of the prohibition on theft) or market players do not themselves effectively demand high compliance rates and strict enforcement*".

For the overall effectiveness of the system, the general attitude toward tunnelling (social norms) and of market support (both ideologically and technically) by market actors play a key role. And there is broad agreement that the reform of RPTs in Italy has greatly contributed to creating an anti-tunnelling culture. After the reform, there has been an increased general awareness about the relevance of RPTs, both in terms of their actual importance in a company's business and in terms of the risks that they may imply. Notwithstanding this greater awareness, the anti-tunnelling culture within companies still suffers from a lack of professional skills for independent directors to effectively pursue their role. Particularly with respect to the negotiation phase. Another issue has been the over-reliance both by the board as a whole and by the independent directors on the independent advisors' opinion, which is usually focused more on the fairness of the conditions than on the interest of the company to enter into the transaction.

The flexible approach adopted by the Italian regulator can contribute to support the evolution of the general attitude toward tunnelling creating a room for "better practices" and more generally pushing all the actors to play a role not only at a systemic level but also at level of individual companies. The possibility of the opting-in and opting-out clauses provided in the regulation allows companies to tailor the internal procedures to their specific features (in terms of dimension, maturity, ownership structure) and also to signal to the market their attitude toward the management of conflict of interest involved in RPTs. And, considering the effects of the law in action and the wide use of such clauses, the introduction of the Consob Regulation revealed a room (and maybe a need) for a flexible regulatory approach in some corporate governance issues, such as related party transactions.

Conclusions

The survey results show that flexibility and proportionality are important elements of the corporate governance framework in most jurisdictions. It has also highlighted that flexibility and proportionality rules have been widely applied in the governance of related party transactions both in terms of disclosure and the review process. Similar to other areas of regulations, listing status is the most used criterion for flexibility, followed by

size of the transaction (mainly as a ratio to the size of assets or revenues) as well as of the size of the company and, ownership and control structure (with strengthened rules for pyramids).

There is nothing wrong per se with entering into transactions with related parties and these transactions can be economically beneficial, especially in a company group structure. However, there is also a risk of abuse by insiders, such as controlling shareholders. To mitigate this risk, many jurisdictions have chosen to strengthen their corporate governance frameworks by introducing flexibility and proportionality rules. Except for a limited number of special cases, prohibiting RPTs has not been seen as a solution to manage the risks that they contain. Instead, there has been a general trend to strengthen shareholder rights. Particularly by empowering the shareholder meeting in the corporate decision-making process. In most jurisdictions, independent directors have also been given a key role in the review and approval processes of the material RPTs.

As demonstrated by the Italian example, there is today an increased focus on the quality of supervision and enforcement. The need to support the legal and regulatory framework by effective supervision and enforcement mechanisms is also emphasised in the G20/OECD Principles. In the area of related party transactions, one challenge is to find the right balance between strengthening public enforcement authorities, such as securities regulators and prosecutors, and private enforcement by shareholders and self-regulatory organisations. Private enforcement has traditionally been weak in countries with concentrated ownership structures and large corporate groups, where there is also a high potential for abusive related party transactions. The empowerment of shareholders that can benefit from a strong disclosure regime can help establishing the right balance.

Notes

[1] Bianchi and Bianco (2007).

[2] Consob, Corporate Governance Report (2016).

[3] As Gilson and Gordon (2003) pointed out "A controlling shareholder may extract private benefits of control in one of three ways: by taking a disproportionate amount of the corporation's ongoing earnings, by freezing out the minority, or by selling control. Our thesis is that the limits on these three methods of extraction must be determined simultaneously, or at least consistently, because they are in substantial respects substitutes".

[4] The most known examples of abusive RPTs in the Italian market are represented by the Parmalat and the Cirio cases in the early 2000, both being examples of outright expropriation by the controlling family in which RPTs played a major role in exploiting minority shareholders by dragging financial resources to the controlling shareholder or in concealing the company's distress. More recently in the Ligresti Group the insurance listed companies Fondiaria-Sai and Milano Assicurazioni engaged in a number of RPT with some privately-held side businesses belonging to their controlling shareholder, the Ligresti family; such transactions have been recently challenged in light of the transfer of wealth they realized to the detriment of the listed insurance companies.

[5] In the consultation paper accompanying the proposal of the regulation on RPTs, Consob carried out an analysis of the adoption of the relevant best practices provided by self-regulation. The results showed that the recourse to independent experts for the provision of legal e/o fairness opinions (especially in Italian blue chips) was envisaged in nearly 60% of cases while a leave or abstain duty for the director having an interest in the transaction was set out in less than half of the market (Consob, 2008).

[6] Bianchi et al. (2011) evaluate compliance with the corporate governance code by building an ad hoc indicator (CoRe) to assess the actual levels of compliance with the recommendations regarding related party transactions. The authors report that the companies' level of effective compliance with regard to RPTs is considerably lower than their publicly reported levels of formal compliance. The authors also find that higher levels of effective compliance tend to be found in companies where minority shareholders have appointed one or more directors; independent directors serve on important committees; and institutional investor- particularly foreign - hold major stakes and attend general shareholder meetings.

[7] In parallel with the corporate law reform which introduced Article 2391-*bis*, the Italian Parliament approved the so called "Law on Savings" (d.lgs. 262/2005), which substantially amended financial market law in the area of corporate governance of listed companies. Among the major changes, the Italian legislator provided for specific rules regarding the composition of the board of Italian listed companies, such as a minimum requirement for independent directors and the introduction of the so-called slate voting system ("*voto di lista*") for the appointment of board members, thus allowing minority shareholders to appoint at least one director of their own proposal.

[8] The provision also covers companies issuing shares which, even if not listed on a regulated market, are widely held by the public according to quantitative criteria.

[9] The role of shareholders is basically limited to two specific cases. First, in case the committee of independent directors exerts its veto power on a material transaction and the company's internal code and bylaws so provide, the transaction can still be entered into if non-related shareholders approve it. Second, where the decision-making power of a related party transaction lies with the GM and independent directors rejected the proposal to be submitted to shareholders. Also in such case the whitewash procedure might find application in case of a negative opinion by the committee of independent directors.

[10] Bianchi et al. (2014) analysed how Italian companies have implemented the 2010 RPTs Regulation, particularly looking at whether and if so how they opted in for or out from some of the default provisions set forth in the regulation, by building an ad hoc firm-specific indicator which focuses on five key provisions.

[11] See Borsa Italiana AIM Regulation, available at
www.borsaitaliana.it/borsaitaliana/regolamenti/aimitalia/aimitalia.en.htm.

[12] To be sure, the number of pyramids in Italy has decreased over the last years, mostly because of intra-group mergers of companies in the pyramid or of change of control transactions affecting the listed subsidiary.

[13] According to the statistics yearly published by Consob13, material RPTs are more often entered into by smaller and financial companies. Looking at the nature of the resource transferred in a given transaction, in line with the tunnelling taxonomy developer by Atanasov et al. (2009), the majority of RPTs entered into since 2011 has consisted of financing contracts and less frequently sponsorships or other contracts which affected the company's cash flow. About one material transaction out of four has involved the transfer of major long-term assets, thus influencing firms' cash generating capacity. Finally, equity tunnelling, i.e. transactions enabling the related party to rearrange her/his ownership claims over the firm such as reserved capital increase, mergers and other transactions that increase the relative importance of the insider's shareholding, has regarded nearly one transaction out of five. The related counterparty of the transactions has been the controlling shareholder or a shareholder exerting significant influence over the company. Nearly 11% of all transactions have been entered into with subsidiaries or associate companies and 5% with a (non-shareholder) director or her/his businesses. Additionally, Consob provides statistics on the number of material RPTs in the ordinary course of business and entered into at arms' length condition, the disclosure of which was waived in line with applicable rules. In 2011-2016, 163

ordinary RPTs were reported to Consob, mainly by large companies (57% of RPTs regarded companies in the FTSE Mib market Index).

[14] E.g. in the US a committee of independent directors plays a relevant role not only in the approval of the RPT but also during its negotiation stage.

[15] Independent directors' role arises already during the drafting of the company's internal procedures and continues during the negotiations (for material RPTs) and the approval of the transactions (with a different weight in relation to the RPT's materiality).

[16] See Art. 147-*ter* CLF, with the reference to independence criteria set for Statutory Auditors in Art. 148 CLF.

[17] In practice, the reference is linked to the Italian Corporate Governance Code, issued, updated and monitored by the Italian Corporate Governance Committee. The independence criteria are defined in Art. 3 of the Code. More information about the Code and the Committee are available at www.borsaitaliana.it/comitato-corporate-governance/homepage/homepage.en.htm.

[18] See Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)*, ECGI Law WP n° 267/2014, p. 21.

[19] In case of an insufficient number of independent directors (at least three), the fairness opinion may be provided by the existing independent board member or by an independent advisor, but, in the latter case, the opinion is not binding.

[20] The opinion represents a veto-power of independent directors inasmuch the material RPT can only be approved by the whole board upon their favourable advice (and a negative opinion may be overcome only with the whitewash procedure).

[21] The timely involvement may be also delegated to an individual director. Nevertheless, their involvement in the negotiations should be timely, inasmuch "the later they get involved in the RPT the more likely a lower number of alternatives will no longer be viable". See Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)*, p. 21.

[22] This point has been deeply discussed during the first consultation process for the adoption of the Consob Regulation.

[23] The internal Board of Auditors, who is appointed by the GM, represents the control body within companies adopting the so-called traditional or Latin corporate governance model. For companies adopting the two-tier or one-tier corporate governance model (both introduced, through an opt-in clause, with the Company Law reform in 2003), such oversight duties are demanded to the Supervisory Board, in the former case, and to the Audit Committee, in the latter one.

[24] E.g. for resolutions that seek shareholder approval, PA may recommend voting on a case-by-case basis; for transactions that were not put to a shareholder vote, if they are deemed problematic, PA may recommend voting against the election of the director involved in the related-party transaction or the full board. See ISS (2017) Proxy Voting Guidelines.

References

Assonime, and Emittenti Titoli (2007), "Analisi dello stato di attuazi¬one del Codice di Autodisciplina delle società quotate (anno 2007)", Assonime Note e Studi, No. 112

Atanasov, V., Black, B., Ciccotello, C. (2009), Unbundling and measuring tunneling, U. Ill. L. Rev., 1697-1738.

Barca, Fabrizio and Marco Becht (2001), The Control of Corporate Europe (Oxford: Oxford University Press).

Bebchuk, Lucian A. and Assaf Hamdani (2009), The Elusive Quest for Global Governance Standards, University of Pennsylvania Law Review, Vol. 157, pp. 1263-1317.

Bebchuk, Lucian A., Alma Cohen and Scott Hirst (2017), The Agency Problems of Institutional Investors, Journal of Economic Perspectives, 2017, vol. 31, issue 3, 89-102.

Becht, Marco, Patrick Bolton and Ailsa Röell (2002), "Corporate Governance and Control", ECGI - Finance Working Paper, No. 02/2002.

Bianchi, Marcello and Magda Bianco (2007), La Corporate Governance in Italia negli ultimi 15 anni: dalle Piramidi alle Coalizioni?, in Claudio Gnesutta, Guido Rey and Gian Cesare Romagnoli, Eds., Capitale Industriale e Capitale Finanziario nell'Economia Globale, (Bologna: il Mulino)

Bianchi, Marcello, Angela Ciavarella, Valerio Novembre and Rossella Signoretti (2011), "Comply or Explain: Investor Protection Through the Italian Corporate Governance Code." Journal of Applied Corporate Finance, 23: 107–121

Bianchi, Marcello, Angela Ciavarella, Luca Enriques, Valerio Novembre and Rossella Signoretti (2014), Regulation and self-regulation of related party transactions in Italy, Consob Quaderni di Finanza No. /2014.

Bianchi, Marcello, Luca Enriques and Mateja Milic (2017), Enforcing Rules on Related Party Transactions in Italy: One Securities Regulator's Challenge, October (Unpublished paper).

Consob (2008), "Disciplina Regolamentare di Attuazione dell'art. 2391-bis del Codice Civile in Materia di Operazioni con Parti Correlate," http://www.consob.it/main/documenti/Regolamentazione/lavori_preparatori/consultazione_emittenti_20080409.htm?hkeywords=&docid=19&page=0&hits=94, Documento di Consultazione.

Consob (2016), Report on corporate governance of Italian listed companies.

Cox, James D. and Randall S. Thomas (with the assistance of Dana Kiku) (2003), "SEC Enforcement Heuristics: An Empirical Inquiry", Duke Law Journal, 737-779.

Dyck, Alexander and Luigi Zingales (2004), "Private Benefits of Control: An International Comparison", The Journal of Finance, Vol. 59, No. 2, pp. 537-600.

Enriques, Luca and Paolo Volpin (2007), "Corporate Governance Reforms in Continental Europe", Journal of Economic Perspectives, Vol. 21, No. 1, pp. 117-140.

Enriques, L. and Gilotta, S. (2014), "Disclosure and Financial Market Regulation", https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2423768.

Enriques, Luca (2014), "Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)" (October 3, 2014). European Corporate Governance Institute (ECGI) - Law Working Paper, No. 267/2014.

Faccio, Mara and Larry H.P. Lang, (2002), "The Ultimate Ownership of Western European Corporations", Journal of Financial Economics, Vol. 65, No. 3, pp. 365-395.

Frydman, C. and D. Jenter (2010), "CEO Compensation", http://www.nber.org/papers/w16585.pdf.

Gilson, Ronald J. and Jeffrey N. Gordon (2003), "Controlling Controlling Shareholders", Columbia Law and Economics Working Paper, No. 228, Columbia Law School. http://ssrn.com/abstract=417181.

Institutional Investor Services (ISS) (2017), Europe Summary Proxy Voting Guidelines. 2017 Benchmark Policy Recommendations, http://www.issgovernance.com/file/policy/2017europe-proxy-voting-summary-guidelines.pdf.

Isaksson, M. and S. Çelik (2013), "Who Cares? Corporate Governance in Today's Equity Markets", OECD Corporate Governance Working Papers, No. 8, OECD Publishing, Paris, http://dx.doi.org/10.1787/5k47zw5kdnmp-en.

Lekvall, P. et al. (2014), The Nordic Corporate Governance Model, http://dx.doi.org/10.1787/5k47zw5kdnmp-en.

OECD (2007), Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion, Steering Group on Corporate Governance, http://www.oecd.org/daf/ca/40038351.pdf.

OECD (2009), Guide on Fighting Abusive Related Party Transactions in Asia, OECD Publishing.

OECD (2012), Related Party Transactions and Minority Shareholder Rights, OECD Publishing.

OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, https://doi.org/10.1787/9789264236882-en.

OECD (2017), "OECD Corporate Governance Factbook 2017", http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.

Nenova, Tatiana (2003), "The Value of Corporate Voting Rights and Control: A Cross-Country Analysis", Journal of Financial Economics, Vol. 68, pp. 325–351.

Zingales, Luigi (1994), "The Value of the Voting Right: A Study of the Milan Stock Exchange Experience", Review of Financial Studies, Vol. 7, pp. 125-148.

Chapter 7. Disclosure of periodic financial information and ad-hoc information

This chapter presents the results of the review in the area of disclosure of periodic financial information and ad-hoc information. It takes stock of the criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating to the area across the 39 jurisdictions that responded the survey used for the review. It also includes a case study of the U.S. corporate governance framework in the area submitted by the staff of the U.S. Securities and Exchange Commission.

Introduction

Regulations: background and context

Disclosure regulations are an important policy tool for securities regulators. In most jurisdictions, companies are subject to three types of disclosure requirements. Firstly, when a company wants to offer its securities to the public, the company is required to disclose information – in particular with regard to its financial status – prior to public offerings. Secondly, the company is subject to periodic disclosure – at least on an annual basis – as long as its securities are held by the public. Thirdly, the Principles support timely disclosure – i.e., ad-hoc disclosure – of all material developments that arise between regular reports.

Disclosure regulations can also be categorised depending on whether they are mandatory or not. Mandatory disclosure regulation is generally stipulated in company law, securities law and listing requirements[1]. On the other hand, voluntary disclosure regulation is often stipulated in corporate governance code that adopts "comply or explain" approach. As pointed out in the G20/OECD Principles, companies often make voluntary disclosure that goes beyond minimum disclosure requirements in response to market demand.

The key objective of disclosure regulations is to provide shareholders and potential investors with information necessary for their decision making. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of the markets to function, increase the cost of capital and result in a poor allocation of resources.

It has been pointed out that policy makers tend to make extensive use of disclosure-based techniques in the area of financial market regulation.[2] Some may believe that securities regulation is motivated by the assumption that more information is better than less[3]. Another reason may be that disclosure is a less burdensome regulatory tool, in the sense that extending its scope or content does not usually entail any direct government expenditure. This tendency of policy makers explains the need for adopting flexibility and proportionality mechanisms in disclosure regulations so as not to place an undue burden on companies.

Issues and trends

The OECD's survey has found that the United States and some European stock markets today have between 30 to 40 percent fewer publicly traded companies than they had at the turn of the century[4]. This decline is to a large part explained by a structural decline in the number of initial public offerings. In particular, as pointed out in the OECD Equity Markets Review: Asia 2017[4], IPOs by smaller companies (below USD 50 million) have declined in the European Union and the United States during the last ten years.[5]

Partly in response to this decline in IPOs, scaled disclosure for smaller companies has been adopted in some jurisdictions. For example, in the United States, the Jumpstart Our Business Start-ups (JOBS) Act provides scaled disclosure provisions for emerging growth companies, including permitting them to include only two years of audited financial statements in the registration statement for an IPO of common equity securities. In Japan, the Financial Instruments and Exchange Act was amended to exempt smaller companies

– for three years after listing – from the obligation of having their internal control reports audited by a Certified Public Accountant.[6]

Another important trend in the area of disclosure regulations is that some have criticised quarterly disclosure requirements. “The Kay Review of UK Equity Markets and Long-term Decision Making”[7] published in July 2012 recommends to reduce the pressures for short-term decision making that arise from excessively frequent reporting of financial and investment performance, including quarterly reporting by companies. In its response to the Kay Review[8], the UK government supported the recommendation with a view to reducing the regulatory burden of reporting for companies and addressing concerns that rigid quarterly reporting requirements may be promoting a short-term focus by companies, investors and market intermediaries.

In 2013, the EU Transparency Directive[9] was amended and the requirement to publish interim management statements was abolished based on the idea that “the obligations to publish interim management statements or quarterly financial reports represent an important burden for many small and medium-sized issuers whose securities are admitted to trading on regulated markets, without being necessary for investor protection. Those obligations also encourage short-term performance and discourage long-term investment”.

The view of the G20/OECD Principles

The G20/OECD Principles devote an entire chapter to disclosure and transparency. The outcome advocated by the chapter is transparency which is central to (i) shareholders ability to exercise their ownership rights on an informed basis; (ii) market integrity; and (iii) the accountability of the company to its shareholders. The chapter specifies the type of material information which should be disclosed, how and to whom this information should be communicated and the processes by which confidence in the quality of the information can be ensured.

The G20/OECD Principles emphasise the importance of a strong disclosure regime that promotes real transparency since it is a pivotal feature of market-based monitoring of companies and is central to shareholders’ ability to exercise their rights on an informed basis. The G20/OECD Principles state that a strong disclosure regime can help to attract capital and maintain confidence in the capital markets, while weak disclosure and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole.

With regard to periodic disclosure, the G20/OECD Principles point out that public disclosure is typically required, at a minimum, on an annual basis though some jurisdictions require periodic disclosure on a semi-annual or quarterly basis, or even more frequently in the case of material developments affecting the company. The G20/OECD Principles also support timely disclosure of all material developments that arise between regular reports.

It is worth noting that the G20/OECD Principles state that disclosure requirements are not expected to place unreasonable administrative or cost burdens on enterprises. This may be one of the reasons why most jurisdictions apply flexibility and proportionality mechanisms when designing disclosure regulations.

Flexibility and proportionality for disclosure of periodic financial information

The key objective of disclosure regulations is to provide shareholders and potential investors with sufficient information so that they can make well-informed decision. At the same time, as mentioned in the G20/OECD Principles cited above, disclosure regulations should be designed so as not to place an undue burden on companies. Thus, disclosure regulation is an area where policy makers can make use of flexibility and proportionality mechanisms in order to strike a right balance between those two objectives.

One way to achieve this goal is to use flexibility and proportionality mechanisms in a way that relaxes disclosure requirements for certain types of companies (e.g. small companies). When relaxing disclosure requirements, policy makers typically choose either to exempt companies from disclosure itself (e.g. when companies offer its securities to a limited number of investors), to reduce the frequency of reporting (e.g. exemption from quarterly reporting) or to exempt companies from disclosing certain items or documents (e.g. small companies are exempt from disclosing its internal control system), among others.

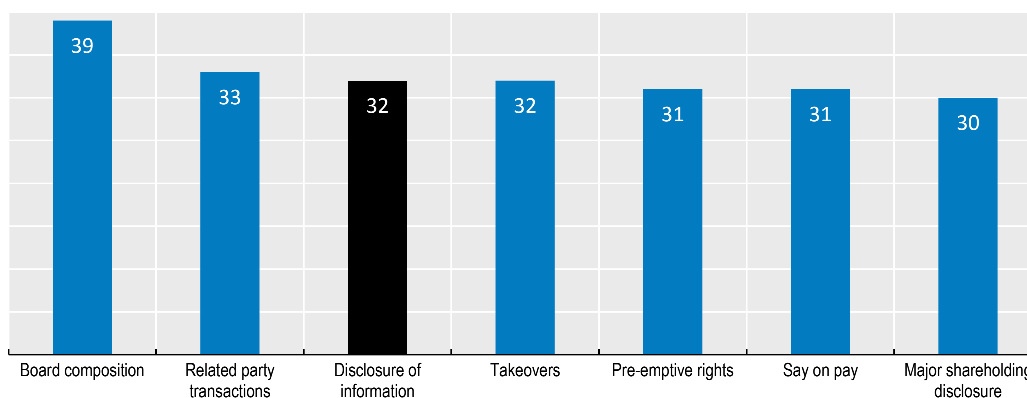
Another way is to use flexibility and proportionality mechanisms in a way that strengthens disclosure requirements for certain types of companies (e.g. large companies or companies with complex risk factors). When strengthening disclosure requirements, policy makers usually increase the frequency of reporting (e.g. opt-in for quarterly reporting) or oblige companies to disclose additional items or documents.

The following section presents the main results from the survey responses as to how these are implemented.

Survey results

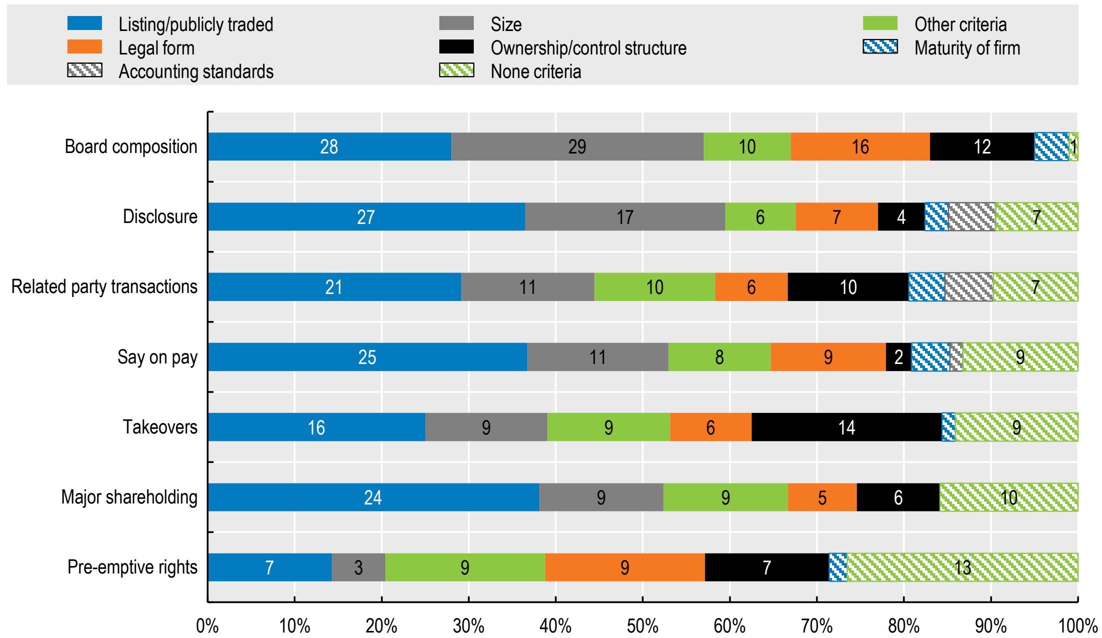
Out of the 39 jurisdictions included in the survey, 32 jurisdictions reported at least one criteria or optional mechanism that allow for flexibility and proportionality with respect to disclosure of periodic financial information and ad-hoc information (Figure 7.1.). Seven jurisdictions report that they are not using any flexibility and proportionality criteria or optional mechanism in the area of the disclosure of periodic financial information and ad-hoc information.

Figure 7.1. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation



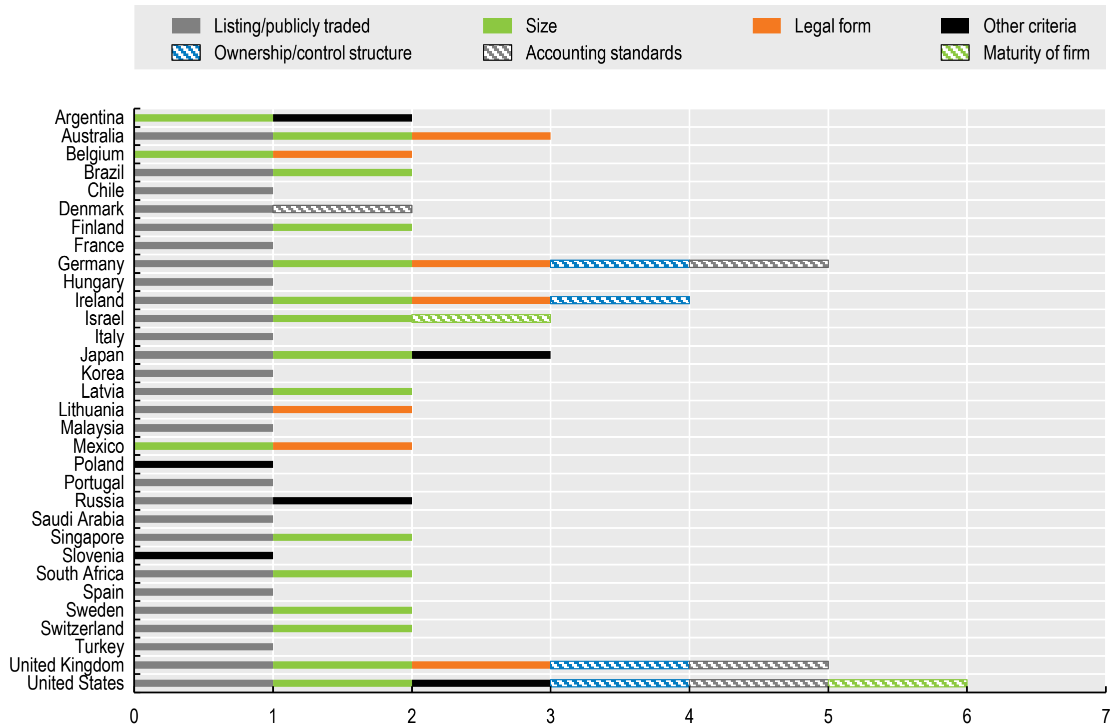
Source: OECD Survey.

Figure 7.2. Overall use of criteria across all areas of regulation



Source: OECD Survey.

Figure 7.3. Use of criteria for disclosure of information across jurisdictions



Source: OECD Survey.

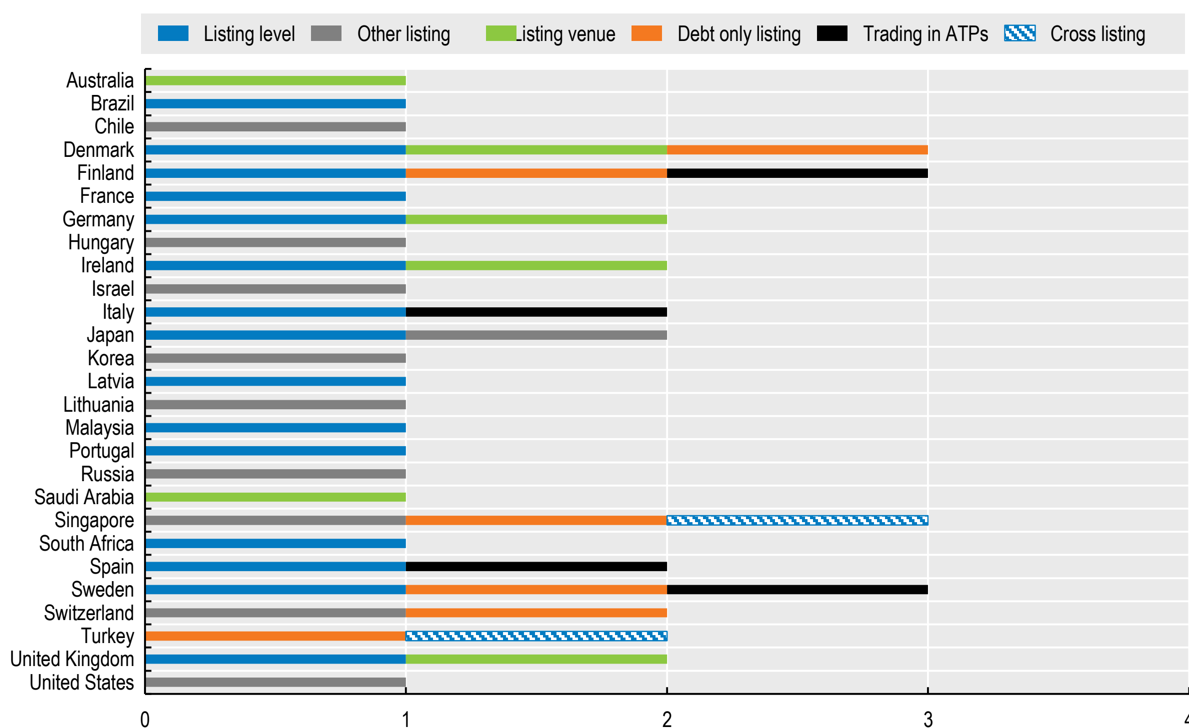
As described in the main chapter of this thematic review, among all the criteria that jurisdictions employ to promote flexibility and proportionality in their corporate governance frameworks, the criterion of *listing/publicly trading* and the criterion of *size* are by far the most used when considering all areas of practice. This is also the case in the area of disclosure of periodic financial information and ad-hoc information (Figure 7.2.). Figure 7.3 shows the frequency and distribution among different types of criteria that jurisdictions have reported.

The use of listing/publicly traded as criteria for flexibility and proportionality

Listing/publicly traded is used in the area of the disclosure of periodic financial information and ad-hoc information by all but 13 jurisdictions and is present in the corporate governance framework in several dimensions, with the *listing level* being the most common policy consideration (Figure 7.4.).[7]

Most jurisdictions report that they use *listing/publicly traded* as a criterion in the sense that non-listed companies are not subject to the same disclosure regulations as listed companies. Typical example of additional requirements for listed companies is that they are required to file a financial report more frequently than annually. This is the case in Australia; Denmark; Finland; Italy; Japan; Korea; Latvia; Lithuania; Malaysia; Portugal; Saudi Arabia; Singapore; Spain; and Switzerland, among others.

Figure 7.4. Use of the listing/publicly traded criterion for disclosure of information



Source: OECD Survey.

Some jurisdictions differentiate between *listing levels*. For example, in Italy, listed companies belonging to the STAR segment – the market segment comprising medium-sized companies which comply with enhanced disclosure and governance requirements – are required to publish interim reports. In Japan, companies listed on either MOTHERS segment or JASDAQ segment – the market segment comprising mainly start-up companies – are required to comply with only five General Principles of the Corporate Governance Code and are not required to comply with detailed Principles of the Code including those on disclosure and transparency. In Malaysia, listed companies in the LEAP Market – the market segment which aims to facilitate fund raising and growth of SMEs – are not required to have their own website or issue an annual report.

Whether the company lists only debt instruments or not (*debt only listing*) is also a relevant consideration used to introduce flexibility and proportionality by a number of jurisdictions. This is the case in Denmark, Finland, Singapore, Sweden, Switzerland and Turkey.

For example, in Singapore, issuers which only have a debt listing need only to disclose certain information relevant to debt holders, such as immediate announcements on the redemption or cancellation of debt securities[8] and details of any interest payments to be made. In Switzerland, the listing rules require semi-annual financial reporting, while the Additional Rules for the listing of bonds exempt debt-only issuers from this requirement for semi-annual financial reporting.

Other dimensions of the *listing/publicly traded* criterion used include a consideration for *trading in ATPs*. This is the case in Finland, Italy, Spain and Sweden. *Cross listings* are also considered, and for example Singapore exempts listed companies on SGX from its periodic financial information provisions if those companies' home exchange is from a developed jurisdiction and those companies comply with their home exchange's regulations.

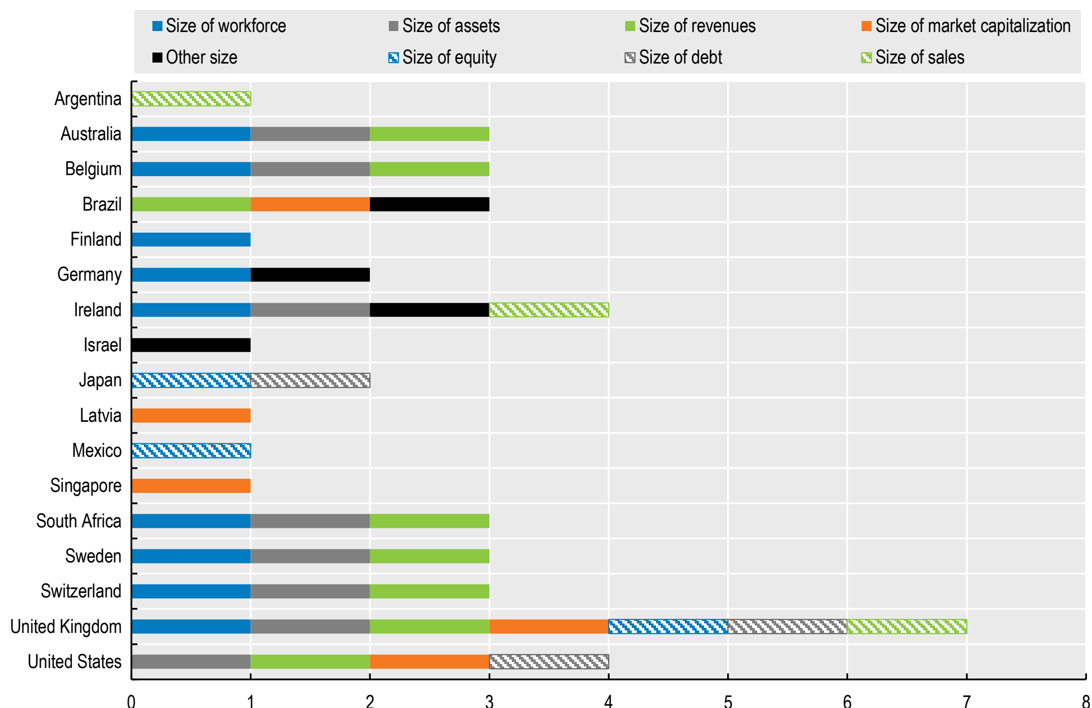
The use of size as criterion for flexibility and proportionality

As shown in Figure 7.5., *size* also appears to be an important criterion used in the disclosure of periodic financial information and ad-hoc information. Seventeen jurisdictions report using it in different dimensions.

The *size* criterion is often used to introduce flexibility and proportionality for SMEs, using the dimensions of *size of assets* (eight jurisdictions), *size of revenues* (eight jurisdictions) and *size of workforce* (nine jurisdictions) as the most common policy considerations to define a company as small or medium. Some jurisdictions use a multiple test and require two or more positive answers to consider a company as a SME. For example, in Belgium, Finland and Germany, the test involves a 2-out-of-3 analysis depending on size of workforce, size of turnover, and size of balance sheet.

Once SMEs are identified based on the dimensions mentioned above, usually scaled disclosure regulations are applied to them. For example, in Belgium, drawing up a management report is not applicable to small companies. In Finland, the obligation to publish principles concerning the diversity of the board of directors and the supervisory board in the Corporate Governance Statement is not applied to SMEs. In Germany, small companies only have to draw up abridged balance sheets showing only certain items and they are also exempt from certain disclosure requirements in the notes to the financial statement. In Ireland, micro companies and small companies may file abridged financial statements and qualify for the audit exemption. In Israel, small companies are exempt from certain regulatory requirements including the ISOX regime[9] and Galai Report.[10]

Figure 7.5. Use of the size criterion for disclosure of information



Source: OECD Survey.

Some jurisdictions define large companies and impose tighter regulations on them. For example, in Japan, Companies Act defines a large company as a company of which amount of the stated capital on the balance sheet is 500 million JPY or more, or a company of which total sum of the amounts in the liabilities section of the balance sheet is 20 billion JPY or more. These large companies[11] must prepare consolidated financial statements. In Singapore, listed companies with a market capitalisation of more than 75 million SGD are required to issue quarterly financial statements.

The use of legal form as criterion for flexibility and proportionality

Seven jurisdictions (Australia, Belgium, Germany, Ireland, Lithuania, Mexico and the UK) use the criterion of the *legal form* to introduce flexibility and proportionality in this area of regulation. In Australia, a disclosing entity[12] and public company[13] are required to file an annual report, while a proprietary company is required to file an annual report when it is a large proprietary company. In Germany, only certain stock corporations, partnerships limited by shares and European Corporations have to include a corporate governance statement in their management report.

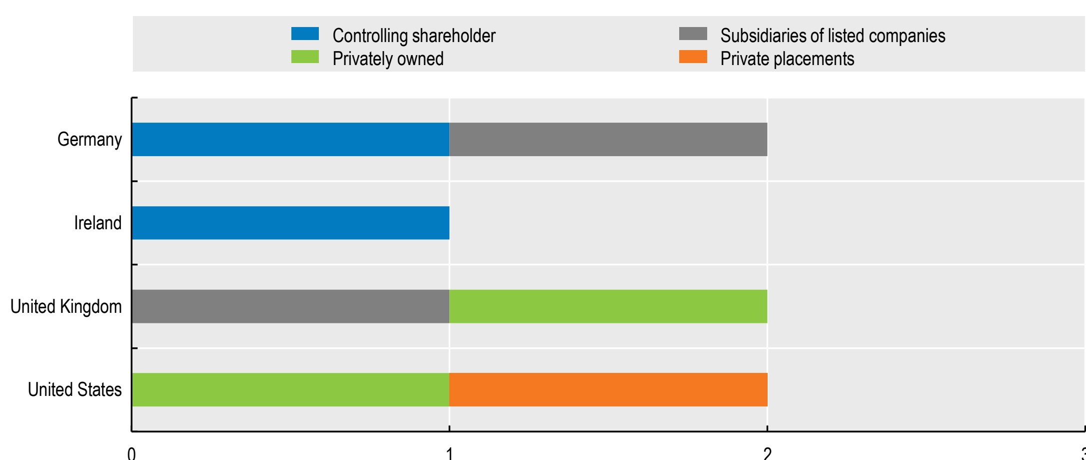
In the UK, while Limited Liability Partnerships[14] (LLPs) are subject to very similar registration and filing requirements to those applicable to limited companies, the Limited Liability Partnerships Act 2000 does not regulate the internal management of the LLP. Consequently, their financial reporting requirements are similar but remain subject to a discrete set of regulations that reflect their structure. Another significant legal entity in the UK is the Community Interest Company (CIC).[15] CICs are required to have a higher duty of transparency than private companies and are subject to additional

legislation/regulation. As part of the CIC regulations, these entities are required to report on their activities and impact for previous 12 months to check if they have been providing community benefit.

The use of ownership/control structure as criterion for flexibility and proportionality

The *ownership/control structure* criterion is used less often for the disclosure of periodic financial information and ad-hoc information. Four jurisdictions report using it (Figure 7.6.). For example, in Ireland, a subsidiary is allowed to file the consolidated financial statements of its parent company.

Figure 7.6. Use of the ownership/control structure criterion for disclosure of information



Source: OECD Survey.

The use of accounting standards as criterion for flexibility and proportionality

Four jurisdictions (Denmark, Germany, the UK and the US) use the criterion of *accounting standards* to introduce flexibility and proportionality in this area of regulation. For example, in Denmark, if a company has chosen to use the International Financial Reporting Standards (IFRS) even though it is not forced to do so, then the company can opt for preparing interim financial statements as well, but it is not obliged to do so. In Germany, a parent company that prepares and publishes a consolidated financial statement in accordance with the IFRS is exempt from many national disclosure requirements stipulated in the German Commercial Code.

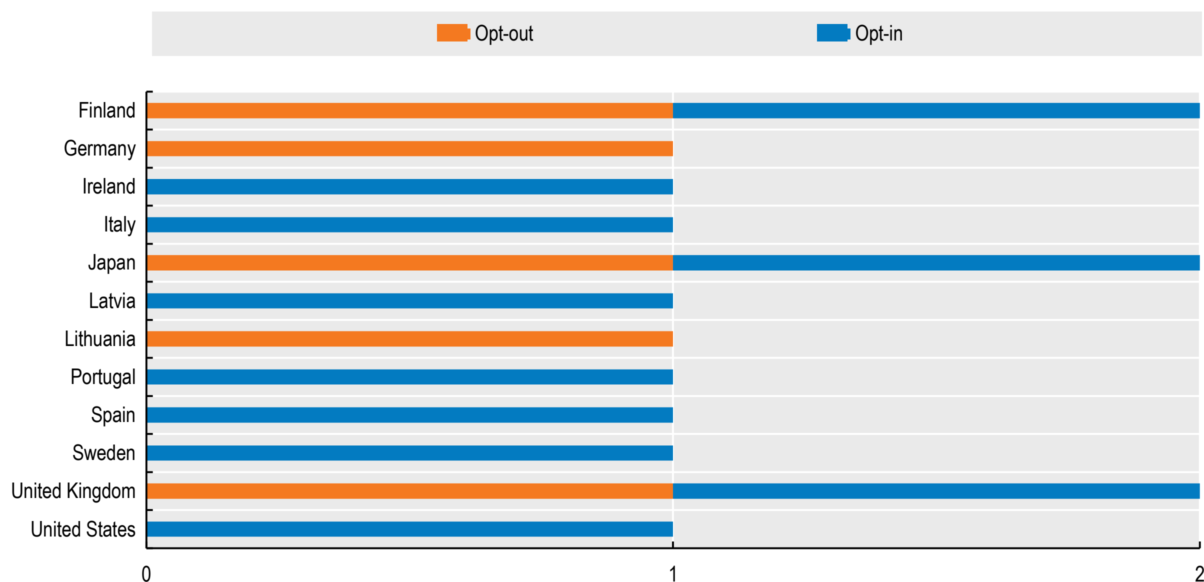
The use of maturity of firm as criterion for flexibility and proportionality

Two jurisdictions (Israel and the US) use the criterion of *maturity of firm* to introduce flexibility and proportionality in this area of regulation. For example, in Israel, a company that offers its securities to the public for the first time is required to provide comparative numbers in the financial report for the last two years (rather than three) for a period of five years (rather than three) while in the US, an emerging growth company will lose accommodations available to it on the last day of the fiscal year following the fifth anniversary that it first sold equity securities.

The use of opt-in and opt-out mechanisms

Opt-in and opt-out mechanisms are used for the regulation of the disclosure of periodic financial information and ad-hoc information by 12 jurisdictions (Figure 7.7.).

Figure 7.7. Use of opt-in and/or opt-out mechanisms for disclosure of information



Source: OECD Survey.

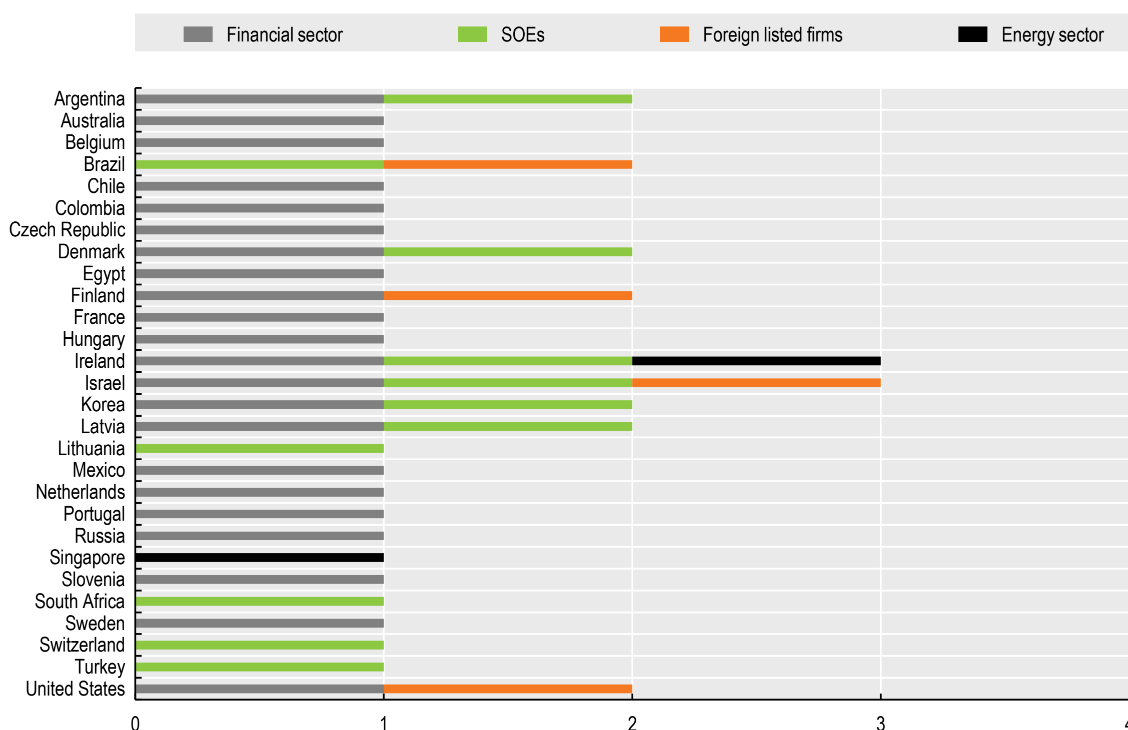
A typical way of using opt-in mechanisms is to allow listed companies to opt-in more frequent reporting. For example, in Italy and Spain, listed companies are subject to half-year reporting, while they can opt-in on interim reporting on a quarterly basis. In Latvia, listed companies are allowed to disclose either a shortened version of three- and nine-months financial report or expand it to a full report.

Opt-out mechanisms are used in five jurisdictions. In Germany, companies are entitled to omit certain disclosures in the notes to the financial statements under special circumstances, for example where the disclosure of that information would be seriously prejudicial to the company.

The use of sectoral criteria for flexibility and proportionality

An analysis of the results per sector of activity reveals that flexibility and proportionality criteria for the disclosure of periodic financial information and ad-hoc information are used in a majority of jurisdictions (28), with a varying degree of scope (Figure 7.8.). Most jurisdictions that present flexible sectoral regulations report having special regimes for the financial sector and for their State-owned companies.

Figure 7.8. Use of flexibility and proportionality in different sectors for disclosure of information



Source: OECD Survey.

Case study: United States

Overview

The U.S. capital markets are the deepest and most liquid in the world. U.S. and non-U.S. businesses access these global markets by offering and selling securities in transactions that are registered with the U.S. Securities and Exchange Commission (Commission or SEC) and in transactions that are exempt from the federal securities laws' registration requirements. Companies that register transactions with the Commission, choose to list their securities on a national securities exchange, or become subject to the Commission's other jurisdictional requirements are subject to the ongoing disclosure requirements of the federal securities laws.

Compared to other capital markets, U.S. markets have a relatively high degree of dispersed share ownership.[16] Many other jurisdictions tend to have more concentrated ownership with a controlling shareholder or group.[17]

U.S. corporate governance framework

In the United States, corporate governance requirements generally are within the purview of the states and, for companies listed on national securities exchanges, those national securities exchanges. Each of the 50 states comprising the United States as well as the District of Columbia have statutes that provide for the formation of corporate entities and the terms of governance among shareholders, the board of directors, and management.

State corporate law consists of both the statutory provisions and judicial decisions interpreting those provisions. Those judicial decisions, which comprise each state's "common law," have established several key components of the U.S. corporate governance framework.

With respect to any specific U.S. company, the law of the particular state in which it is established and relevant judicial decisions of that state will provide the requirements for the entity's corporate governance. The majority of companies incorporated in the United States that are listed on U.S. exchanges have elected to incorporate in Delaware, and Delaware corporate law statutes and related jurisprudence are well-developed and followed closely by a number of other states.

The U.S. federal securities regulatory system is based on the principle of full and fair disclosure to investors by companies. Because this regulatory system is not based on merit regulation, the federal securities laws do not prescribe how a company structures itself or its transactions. Rather, the federal securities laws are based on the premise that investors should have the material information necessary to make informed investment decisions. The Commission is charged with protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. Although state law provides the primary corporate governance framework, certain corporate governance matters are governed by the federal securities laws through a combination of federal statutes and the SEC's rules and regulations. For companies listed on national securities exchanges, corporate governance requirements also are within the purview of the national securities exchanges.

While the corporate governance framework in the United States is based on the various sources described above, this case study will discuss the periodic and current disclosure requirements under the U.S. federal securities laws.

Legal and regulatory framework for periodic and current disclosure requirements

This principle of full and fair disclosure applies to offers and sales of securities, the listing and registration of classes of securities, and periodic and ongoing reporting under the U.S. federal securities laws. Companies that are subject to the ongoing reporting requirements of the Securities Exchange Act of 1934 (Exchange Act) are required to file annual, quarterly, and current reports with the Commission among other reporting requirements. Generally, a company may become subject to the ongoing reporting requirements by raising capital in a transaction registered under the Securities Act, listing its securities on a national securities exchange, or when the company has a class of equity securities that is held of record by more than 2 000 persons or 500 non-accredited investors and the company has more than $10 million in total assets.[18]

Under the federal securities laws, the disclosure requirements for companies that are subject to the Exchange Act's periodic and current reporting requirements differ based on the company's status as a domestic company or foreign private issuer,[19] an emerging growth company,[20] a smaller reporting company,[21] or whether the company is a large accelerated filer,[22] an accelerated filer,[23] or a non-accelerated filer.[24] Companies are subject to different regulatory requirements depending on their status as one type of company versus another. The baseline regulatory requirements of the federal securities laws generally presume the company status to be a domestic company that is not an emerging growth company or a smaller reporting company. Different regulatory requirements also apply to companies that rely on an exemption from registration to offer

and sell securities under Regulation A (offerings up to $50 million per year by U.S. and Canadian companies) or Regulation Crowdfunding (certain crowdfunded offerings of up to $1.07 million per year by U.S. companies).

Companies that are subject to the baseline requirements are required to file an annual report on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K. The disclosure requirements for these reports are located in the forms, Regulation S-K for the non-financial disclosure requirements, and Regulation S-X for the financial disclosure requirements. These companies are required to comply with U.S. generally accepted accounting principles. The Commission recognizes the financial accounting and reporting standards of the Financial Accounting Standards Board as generally accepted for the purposes of the federal securities laws.[25]

In addition to specific line-item disclosure requirements, a prospectus, registration statement, and periodic and current reports must include "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."[26] To help assure that companies disclose material information to investors in connection with a registered public offering of securities and in ongoing reports, the federal securities laws provide for the liability of certain parties if the documents "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[27]

The Commission enforces the federal securities laws by investigating and bringing civil enforcement actions against individuals and companies for violations of the securities laws. In some cases, the federal securities laws are subject to both public and private enforcement. The Commission's Division of Corporation Finance (Division) selectively reviews periodic reports of each reporting company at least once every three years and the Division reviews many companies more frequently. The Division also selectively reviews transactional filings.

The federal securities laws take into consideration proportionality and flexibility as they relate to smaller issuers, foreign private issuers, and companies that offer and sell securities based on exemptions from registration. These requirements are balanced with the Commission's mission of protecting investors.

The disclosure requirements for companies that are subject to the Exchange Act's periodic and ongoing reporting requirements can differ based on the company's status. The following describes the regulatory requirements for companies outside of the baseline to highlight the principles of flexibility and proportionality present in the U.S. regulatory framework.

Flexibility and proportionality in the U.S. federal regulatory framework

Emerging growth company

In 2012, the Jumpstart Our Business Startups Act (JOBS Act) was enacted to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[28] The JOBS Act created a new category of issuer called an emerging growth company.[29] If a company qualifies as an emerging growth company, it may comply with scaled disclosure requirements in its IPO and subsequent periodic reports. An emerging growth company is a company that has total annual gross revenues of less than $1.07 billion[30] during its most recently completed

fiscal year. By identifying itself as an emerging growth company in its prospectus or in other forms, the issuer's disclosure informs investors that the issuer is eligible to use the scaled disclosure requirements permitted for those issuers. Under the JOBS Act provisions, this scaled disclosure includes:

- permitting the issuer to provide two years of audited financial statements for an IPO of common equity securities instead of the baseline of three years of audited financial statements;
- requiring the issuer to provide selected financial data only for the periods it included in the registration statement for the IPO and for subsequent periods in documents it files after its IPO whereas others issuers are required to provide five years of such data unless they have been in existence for fewer than five years;
- complying with reduced executive compensation disclosure requirements permitting the issuer to omit a Compensation Discussion & Analysis section (CD&A) and not subjecting the issuer to the requirement to conduct the shareholder advisory votes;
- exempting the issuer from the requirement under Section 404(b) of the Sarbanes-Oxley Act for auditor attestation of internal controls over financial reporting; and
- permitting the issuer not to comply with new or revised accounting pronouncements until the date that a private company would be required to comply.

Under the regulatory relief provided by the JOBS Act, there are provisions:

- allowing the issuer not to comply with any rule the Public Company Accounting Oversight Board (PCAOB) issues with respect to mandatory audit firm rotation or the auditor reporting model; and
- that provide that any new PCAOB auditing standard will not apply to the issuer unless the SEC finds it necessary and appropriate in the public interest, after considering the protection of investors, and the promotion of efficiency, competition, and capital formation.

These scaled disclosure requirements and other regulatory relief apply as long as the issuer is an emerging growth company. An issuer will no longer qualify as an emerging growth company on the earliest of:

- the last day of the fiscal year following the fifth anniversary that it first sold equity securities;
- the last day of the fiscal year in which its total annual gross revenues are $1.07 billion or more;
- the date on which it becomes a large accelerated filer; or
- the date on which it has issued more than $1 billion in non-convertible debt in the previous three years[31].

Smaller reporting company

The SEC has adopted scaled disclosure requirements for smaller reporting companies. Smaller reporting companies generally are companies that have a public equity float of less than $250 million or, the annual revenues of the company are less than $100 million and either it had no public float or a public float of less than $700 million.[32] The scaled disclosure requirements permit smaller reporting companies to:

- include less extensive narrative disclosure than required of other reporting companies, particularly in the description of executive compensation, which does not require smaller reporting companies to provide CD&A; and
- provide audited financial statements for two fiscal years, in contrast to other reporting companies, which must provide audited financial statements for three fiscal years.

In addition, smaller reporting companies that are non-accelerated filers are exempt from the requirement to provide an auditor attestation of internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act.

Different due dates for periodic reports based on public float

The SEC has different due dates for filing annual and quarterly reports depending on, among other things, the public float of a company. The due dates for a company's annual report and quarterly reports vary depending on its filer status as a large accelerated filer, an accelerated filer, a non-accelerated filer, or a foreign private issuer. Large accelerated filers, accelerated filers, and all other U.S. filers must file annual reports within 60, 75, and 90 days, respectively, of the fiscal year-end covered by the report. Foreign private issuers must file annual reports on Form 20-F within four months of the fiscal year-end covered by the report.

Large accelerated filers and accelerated filers must file a quarterly report within 40 days after the end of the fiscal quarter covered by the report. All other domestic filers must file within 45 days after the end of the fiscal quarter covered by the report. Foreign private issuers are not required to file quarterly reports.

Foreign private issuer

The SEC has a separate disclosure regime specifically tailored to foreign private issuers. While this regime largely elicits equivalent disclosures in connection with public offerings of securities and annual reports as for U.S. companies, the SEC's disclosure system for foreign private issuers contains targeted disclosure accommodations that promote participation by foreign private issuers in the U.S. public capital markets in a manner consistent with investor protection.

In general, foreign private issuers must provide financial statements prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) or which contain reconciliation to U.S. GAAP. Foreign private issuers also may provide financial statements prepared in accordance with IFRS, as issued by the International Accounting Standards Board (IASB), without a reconciliation to U.S. GAAP. Some of the specific disclosure requirements for foreign private issuers that differ from those for U.S. issuers are:

- foreign private issuers are exempt from the requirements to file proxy or information statements under the Exchange Act;
- foreign private issuers' securities are exempt from Section 16 of the Exchange Act;
- foreign private issuers are not subject to the Exchange Act requirements to file quarterly reports on Form 10-Q and current reports on Form 8-K. Instead, foreign private issuers must furnish certain information on Form 6-K;[33]
- foreign private issuers are not subject to Regulation FD, which prohibits selective disclosure of material non-public information;

- foreign private issuers are permitted to follow home country requirements for disclosure of executive compensation;
- foreign private issuers are required to provide in their annual reports a concise summary of any significant ways in which its corporate governance practices differ from those followed by domestic companies under the listing standards of the exchange; and
- eligible Canadian foreign private issuers may file reports under the multijurisdictional disclosure system and satisfy certain securities registration and reporting requirements of the Commission by providing disclosure documents prepared in accordance with the requirements of Canadian securities regulatory authorities.

Exempt offerings

In addition to registering the offer and sale of securities, companies may offer and sell securities under an exemption from the Securities Act registration requirements[34]. The offering exemptions described below require issuers to provide some level of financial and non-financial information to investors about the offering and, in some case, on an ongoing basis.

Regulation A

The JOBS Act amended the small issues exemption under the Securities Act. The Commission implemented the provision by expanding the exemption into two tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period.[35]

Companies that rely on Regulation A to offer and sell securities are required to provide financial and non-financial disclosure in offering materials. This disclosure is based on the specific requirements of the offering tier that an issuer elects to follow when conducting a Regulation A offering. This information is scaled as compared to companies that engage in registered offerings.

With the exception of securities that will be listed on a national securities exchange upon qualification, purchasers in Tier 2 offerings must either be accredited investors or be subject to limitations on their investment. Tier 2 issuers that list their securities on an exchange become subject to the Exchange Act reporting requirements. Tier 2 issuers are not subject to state securities law registration and qualification requirements. This may lead to a more simplified review process and reduce the costs associated with the offering.

Regulation A is available to companies organized in and with their principal place of business in the United States or Canada. This exemption is not available to companies that have ongoing Exchange Act reporting obligations.[36] Bad actor disqualification provisions prohibit the issuer, directors, executive officers, more than 20% beneficial owners, promoters, and persons compensated for soliciting investors from engaging in a Regulation A offering if they were subject to certain disqualifying events.

Under Regulation A, the ongoing reporting regime varies according to type of offering. Tier-1 issuers are not required to engage in any ongoing reporting other than disclosure about sales in offerings and to update certain issuer information by electronically filing a Form 1-Z exit report with the Commission not later than 30 calendar days after

termination or completion of an offering. Tier 2 issuers are required to file electronically their annual, semi-annual, and current reports.

The annual report on Form 1-K provides scaled disclosure requirements for non-financial information and financial information. A company is required to provide scaled information about its business; directors and executive officers; executive compensation; beneficial ownership of voting securities held by executive officers, directors, and owners of more than 10% of any class of the issuer's voting stock; and related party transactions. A company also is required to provide two years of audited financial statements and a management's discussion of the company's liquidity, capital resources, and results of operations for those periods.

The annual report is due within 120 calendar days from the issuer's fiscal year end. Unlike reporting companies, issuers of securities under Regulation A are not required to file quarterly reports. They are required to file semi-annual reports, which are due 90 calendar days after the end of the first six months of the issuer's fiscal year. The due dates are longer than those for reporting issuers. The current report also includes fewer item requirements than the current report for reporting issuers. The requirement to file current reports is based on a fundamental change standard as opposed to a materiality standard. Current reports are due within four business days after the occurrence of a triggering event.

Regulation A financial statement requirements

Tier 1 and Tier 2 issuers are required to file balance sheets and other required financial statements as of the two most recently completed fiscal year ends (or for such shorter time that they have been in existence) for offerings of securities. This is in contrast to the three-year requirement for issuers in registered offerings that are not emerging growth companies.

Issuers in Tier 1 offerings are not required to file audited financial statements, unless the issuer already has audited financial statements available, while issuers in Tier 2 offerings are required to file audited financial statements.

Financial statements for U.S.-domiciled issuers are required to be prepared in accordance with U.S. GAAP, while Canadian issuers may prepare financial statements in accordance with either U.S. GAAP or IFRS as issued by the IASB.

Additionally, consistent with the treatment of emerging growth companies under the JOBS Act, Regulation A issuers, where applicable, may delay the implementation of new accounting standards to the extent such standards provide for delayed implementation by non-public business entities.

Regulation crowdfunding

In 2015, the SEC adopted Regulation Crowdfunding to implement the requirements of the JOBS Act.[37] Regulation Crowdfunding is an exemption from the Securities Act registration requirements and permits non-reporting companies to raise up to $1.07 million[38] in a 12-month period by offering securities on the Internet through crowdfunding. These crowdfunding transactions must be conducted through a registered intermediary that complies with SEC requirements. The rules provide limitations on the amount that individual investors may invest in all crowdfunding issuers in a 12-month period. Securities purchased in a Regulation Crowdfunding offering generally may not be resold for one year.

Disqualification rules prohibit bad actors from participating in these offerings as a director, officer, 20% or more beneficial owner of the company's voting equity securities, promoter, or solicitor if they have been involved in disqualifying events. Only issuers incorporated in the United States and its territories may rely on Regulation Crowdfunding. Reporting companies may not use the Regulation Crowdfunding exemption.

Regulation Crowdfunding requires companies that rely on these rules to file annual information with the Commission and the rules provide scaled disclosure requirements.[39] The Commission adopted separate reporting forms for companies that engage in crowdfunding offerings. These companies are required to provide an annual report on Form C-AR. The annual report is due no later than 120 days after the end of the fiscal year. The disclosure forms permit both scaled financial and non-financial disclosures.

The financial statements requirements in the offering document are based on the amount of securities offered and sold in reliance on Regulation Crowdfunding within the preceding 12-month period:

- For issuers offering $107 000[40] or less: Financial statements of the issuer and certain information from the issuer's federal income tax returns, both certified by the principal executive officer. If, however, financial statements of the issuer are available that have either been reviewed or audited by a public accountant that is independent of the issuer, the issuer must provide those financial statements instead and will not need to include the information reported on the federal income tax returns or the certification of the principal executive officer.
- Issuers offering more than $107 000 but not more than $535 000: Financial statements reviewed by a public accountant that is independent of the issuer. If, however, financial statements of the issuer are available that have been audited by a public accountant that is independent of the issuer, the issuer must provide those financial statements instead and will not need to include the reviewed financial statements.
- Issuers offering more than $535 000:
  - For first-time Regulation Crowdfunding issuers: Financial statements reviewed by a public accountant that is independent of the issuer, unless financial statements of the issuer are available that have been audited by an independent auditor.
  - For issuers that have previously sold securities in reliance on Regulation Crowdfunding: Financial statements audited by a public accountant that is independent of the issuer.

The financial statements must cover the shorter of the two most recently completed fiscal years or the period since the company's inception. Companies are required to provide certified comparable financial disclosure in their annual reports, but such disclosure does not have to be reviewed or audited.

Regulation Crowdfunding also provides scaled disclosure requirements for narrative, non-financial disclosures. These scaled disclosure requirements apply to all disclosure about the company, risk factors, use of proceeds, legal proceedings, related party transactions, and its officers, directors, and more than 20% beneficial owners. For example, the disclosure of related party transactions in Regulation Crowdfunding is based on the size of the offering that an issuer is conducting. Similarly, the beneficial ownership disclosure requirements apply to more than 20% beneficial owners as compared to the more than 5% beneficial ownership disclosure requirements for companies that have sold

securities in transactions registered under the Securities Act or registered their equity securities under the Exchange Act.

Conclusions

As shown in the survey results, many jurisdictions use flexibility and proportionality mechanisms in the area of disclosure of periodic financial information and ad-hoc information, mainly to reduce the reporting burden for smaller companies and thereby promoting their access to capital. In designing these mechanisms, jurisdictions are mindful of not impairing the key objective of disclosure regulations, i.e., to provide shareholders and potential investors with sufficient information so that they can make well-informed decisions.

The case study illustrates that the United States has adopted numerous measures that provide for flexibility and proportionality as it relates to the reporting of periodic and current financial and non-financial information. The case study demonstrates that there are different ways to adopt flexibility and proportionality into corporate governance frameworks. The framework in the United States has developed over many years and is complemented by both public and private enforcement actions and the SEC staff's selective review of certain types of company filings.

Notes

[1] This survey focuses mainly on the mandatory elements of the corporate governance framework, typically comprising company law, securities law and listing requirements.

[2] See Enriques and Gilotta (2014), 2[1].

[3] See also Paredes (2003), 418[2].

[4] See Çelik and Isaksson (2017)[3].

[5] Ferrarini and Ottolia (2013)[5] pointed out that "Corporate governance reforms over the last decade, with their emphasis on financial information and related controls, have significantly increased the direct and indirect costs of disclosure. As a result, they are often held responsible for slowing down the pace of SMEs' recourse to capital markets and determining a dramatic fall in the number of IPOs in recent years".

[6] See Report by the Financial System Council (2013)[6].

[7]It should be noted that in the United States, non-reporting companies – rather than non-listed companies – may use the Regulation Crowdfunding exemption. Please refer to the case study of the United States for the details.

[8] Immediate announcements on the redemption or cancellation of debt securities are required when every five percent of the total amount of those securities is redeemed or cancelled.

[9] The ISOX regime is an implementation of an Israeli version of the SOX. The regulations require reporting entities to attach (1) a management representation letter regarding the accuracy of the reports and information contained therein; (2) a management report regarding the effectiveness of internal control system over financial reporting and disclosure; and (3) an independent auditor's opinion regarding the effectiveness of internal controls.

[10] In Galai Report, companies are required to describe their exposure to financial risks and the way companies deal with such risks.

[11] Limited to those required to submit an annual securities report under the Financial Instruments and Exchange Act.

[12] A company whose securities are listed and/or held by 100 or more persons.

[13] A company that has more than 50 non-employee shareholders and/or engages in activity requiring disclosure to investors.

[14] A Limited Liability Partnership (LLP) is a UK specific legal form with similarities to both a partnership and a limited company. LLPs were formed under the Limited Liability Partnership Act 2000.

[15] CICs were formed by the Community Interest Companies Regulations 2005 ("The CIC 2005 Regulations"). Under the Act, a company which is to become, or be formed as, a community interest company must satisfy the "community interest test".

[16] OECD Corporate Governance Factbook (2017)(2)].

[17] *Id.*

[18] Companies that have registered a class of equity securities under the Exchange Act or as a result of meeting the jurisdictional thresholds based on asset size and the number of record holders are required to file proxy or information statements for annual shareholder meetings among other matters. Greater than 5% holders of a company's class of equity securities are subject to beneficial ownership reporting requirements. Officers, directors, and greater than 10% holders of a company's class of equity securities are subject to the Section 16 reporting regime. These disclosure requirements are beyond the scope of this case study. This case study will focus on the periodic and current disclosure requirements under the Exchange Act and under certain exemptions from registration.

[19] A foreign company is defined as a "foreign private issuer" unless: i) more than 50% of its outstanding voting securities are held of record (directly or indirectly) by residents of the United States; and ii) any one of the following is true: a) the majority of its executive officers or directors are U.S. citizens or residents; b) more than 50% of the issuer's assets are located in the United States; or c) the issuer's business is administered principally in the United States.

[20] See discussion of emerging growth company status and requirements below.

[21] See discussion of smaller reporting company status and requirements below.

[22] A large accelerated filer is an issuer that: i) had aggregate worldwide public float of $700 million or more, as of the last business day of its most recently completed second fiscal quarter; ii) has been subject to the periodic and current reporting requirements of the Exchange Act for a period of at least twelve calendar months; and iii) has filed at least one annual report.

[23] An accelerated filer is an issuer that: i) had aggregate worldwide public float of $75 million or more and less than $700 million, as of the last business day of its most recently completed second fiscal quarter; ii) has been subject to the periodic and current reporting requirements of the Exchange Act for a period of at least twelve calendar months; and iii) has filed at least one annual report.

[24] A non-accelerated filer is an issuer that is neither an accelerated filer nor large accelerated filer.

[25] See Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, SEC Release No. 33-8221 (Apr. 25, 2003), available at www.sec.gov/rules/policy/33-8221.htm.

[26] Rule 408 of Regulation C and Rule 12b-20 under the Exchange Act.

[27] Section 11(a); cf. Section 12(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.

[28] Pub. L. No. 112-106, 126 Stat. 306 (2012).

[29] Emerging growth companies are permitted to make confidential submissions of draft registration statements for initial public offerings (IPOs). They also are subject to less restricted communications to certain sophisticated investors before and after filing a registration statement. In 2015, the Fixing America's Surface Transportation Act extended additional relief to emerging growth companies (Pub. L. No. 114-94 (2015)). This relief permitted companies to file publicly with the SEC 15 days before commencing a road show or seeking effectiveness for their IPO, which shortened the public filing requirement to 15 days from the 21 days required under the JOBS Act. It also permitted emerging growth companies to omit financial information from their confidential draft submissions if that information would not be required at the time of the offering. SEC staff subsequently permitted all companies (not only emerging growth companies) to submit draft registration statements for non-public review by the SEC staff for IPOs and initial listings and for the first year after the IPO or initial listing. Since the 1980s, SEC staff has afforded foreign private issuers the ability to make non-public submissions for their first registration statements. The SEC also accepts non-public submissions of initial draft offering statements under Regulation A.

[30] The JOBS Act requires the Commission to adjust this amount for inflation every five years.

[31] See Section 2(a)(19) of the Securities Act and Section 3(a)(80) of the Exchange Act.

[32] In 2018, the Commission adopted amendments that increased the financial thresholds in the smaller reporting company definition. See Amendments to Smaller Reporting Company Definition, SEC Adopting Release 33-10513 (Jun. 28, 2018), available at www.sec.gov/rules/final/2018/33-10513.pdf.

[33] The information and documents furnished on Form 6-K are not deemed to be "filed" for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of Section 18.

[34] These companies may or may not be subject to the Exchange Act ongoing reporting requirements, depending on the circumstances.

[35] See Amendments to Regulation A, SEC Adopting Release No. 33-9741 (Mar. 25, 2015), available at www.sec.gov/rules/final/2015/33-9741.pdf.

[36] The Economic Growth, Regulatory Relief, and Consumer Protection Act requires the Commission to amend Regulation A to allow reporting companies to use Regulation A. Pub. L. No. 115-174 (May 29, 2018).

[37] See Crowdfunding, SEC Adopting Release No. 33-9974 (Oct. 30, 2015), available at www.sec.gov/rules/final/2015/33-9974.pdf.

[38] The Commission adjusts this amount for inflation every five years.

[39] The securities that companies issue in reliance on the securities-based crowdfunding exemption are conditionally exempted from the record holder count under Exchange Act Section 12(g), subject to being current in their ongoing annual reports and compliance with other conditions.

[40] The Commission is required to adjust the offering amounts described in this paragraph for inflation every five years.

References

Ferrarini, G. and Ottolia, A. (2013), "Corporate Disclosure as a Transaction Cost: The Case of SMEs",.

Kay, J. (2012), "The Kay Review of UK Equity Markets and Long-term Decision Making", http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.

OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, https://doi.org/10.1787/9789264236882-en.

OECD (2017), "OECD Corporate Governance Factbook 2017", http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.

Paredes, T. (2003), "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation", https://openscholarship.wustl.edu/cgi/viewcontent.cgi?article=1287&context=law_lawreview.

UK Department for Business Innovation & Skills (2012), "Ensuring Equity Markets Support Long-Term Growth: The Government Response to the Kay Review", http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253457/bis-12-1188-equity-markets-support-growth-response-to-kay-review.pdf.

Chapter 8. Disclosure of major shareholdings

This chapter presents the results of the review in the area of disclosure of major shareholdings. It takes stock of the criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating to the area across the 39 jurisdictions that responded the survey used for the review. It also includes a case study of the Japanese corporate governance framework in the area submitted by Akito Konagaya.

Introduction

Regulations of disclosure of major shareholdings; background and context

As stated in the G20/OECD Principles, one of the basic rights of investors is to be informed about the ownership structure of listed companies. To ensure that this information is provided to investors, many jurisdictions have established two pillars of regulations regarding disclosure of major shareholdings.

The first pillar of regulation requires companies to disclose their major shareholders. Definition of major shareholders differs across jurisdictions. Some jurisdictions set thresholds[1] of holding ratio above which shareholders are regarded as major shareholders. Other jurisdictions define major shareholders as, for example, top 10 shareholders[2].

The second pillar of regulation requires shareholders to disclose their shareholdings. Disclosure requirements for shareholders are usually linked to certain thresholds. For example, the EU's Transparency Directive (2004/109/EC) sets the thresholds of 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% (Box 8.1.). EU member states require shareholders to notify the issuer of their proportion of voting rights where that proportion reaches, exceeds or falls below the thresholds set in accordance with the Transparency Directive. On the other hand, some jurisdictions such as Japan and the US set the sole threshold[3] above which shareholders are obliged to file a report, and also require them to file an amendment when there is a material change[4] to their holding ratio.

There are a couple of rationales for the mandatory disclosure regulation of major shareholdings. First of all, acquisition of large blocks of shares conveys information about the issuer, and the sooner the public is informed about the information, the more accurate the share prices are and the more liquid the market is.

The second rationale is that large blocks of shares define the free float so that disclosure of major shareholdings will provide shareholders and investors with a better sense of shares' liquidity.

The third rationale is that large blocks of shares have an impact on corporate governance. It may be an indication that a change of control will take place – for example through a hostile takeover. In addition, large blocks may be a signal that the company is better managed through monitoring on managers. Large blocks can also be an indication of higher expropriation risk – large block holder may use its influence to expropriate minority shareholders.

The view of the G20/OECD Principles

The G20/OECD Principles state that disclosure should include material information on major share ownership including beneficial owners and voting rights.

The G20/OECD Principles further state that "disclosure of ownership data should be provided once certain thresholds of ownership are passed. Such disclosure might include data on major shareholders and others that, directly or indirectly, significantly influence or control or may significantly influence or control the company through, for example, special voting rights, shareholder agreements, the ownership of controlling or large blocks of shares, significant cross shareholding relationships and cross guarantees".

Box 8.1. Excerpts from the EU's Transparency Directive (2004/109/EC)

CHAPTER III - **ONGOING INFORMATION -** *Section I* - ***Information about major holdings*** *Article 9*

Notification of the acquisition or disposal of major holdings

1. The home Member State shall ensure that, where a shareholder acquires or disposes of shares of an issuer whose shares are admitted to trading on a regulated market and to which voting rights are attached, such shareholder notifies the issuer of the proportion of voting rights of the issuer held by the shareholder as a result of the acquisition or disposal where that proportion reaches, exceeds or falls below the thresholds of 5 %, 10 %, 15 %, 20 %, 25 %, 30 %, 50 % and 75 %.

The voting rights shall be calculated on the basis of all the shares to which voting rights are attached even if the exercise thereof is suspended. Moreover this information shall also be given in respect of all the shares which are in the same class and to which voting rights are attached.

2. The home Member States shall ensure that the shareholders notify the issuer of the proportion of voting rights, where that proportion reaches, exceeds or falls below the thresholds provided for in paragraph 1, as a result of events changing the breakdown of voting rights, and on the basis of the information disclosed pursuant to Article 15. Where the issuer is incorporated in a third country, the notification shall be made for equivalent events.

3. The home Member State need not apply:

(a) the 30 % threshold, where it applies a threshold of one-third;

(b) the 75 % threshold, where it applies a threshold of two-thirds.

It should be noted that the G20/OECD Principles point out the importance of information about beneficial ownership particularly for enforcement purposes, stating that “in cases where major shareholdings are held through intermediary structures or arrangements, information about the beneficial owners should therefore be obtainable at least by regulatory and enforcement agencies and/or through the judicial process”.

Flexibility and proportionality with respect to disclosure of major shareholdings

As discussed by the Committee in 2017 as part of a roundtable on flexibility and proportionality of corporate governance framework, the notion of flexibility and proportionality is not an end in itself. And it is by no means a way to weaken the effectiveness of the corporate governance framework. On the contrary, flexibility and proportionality is a necessary prerequisite for creating an effective legal environment that can support the ultimate policy objectives of the G20/OECD Principles, namely to improve investment, economic growth and financial stability.

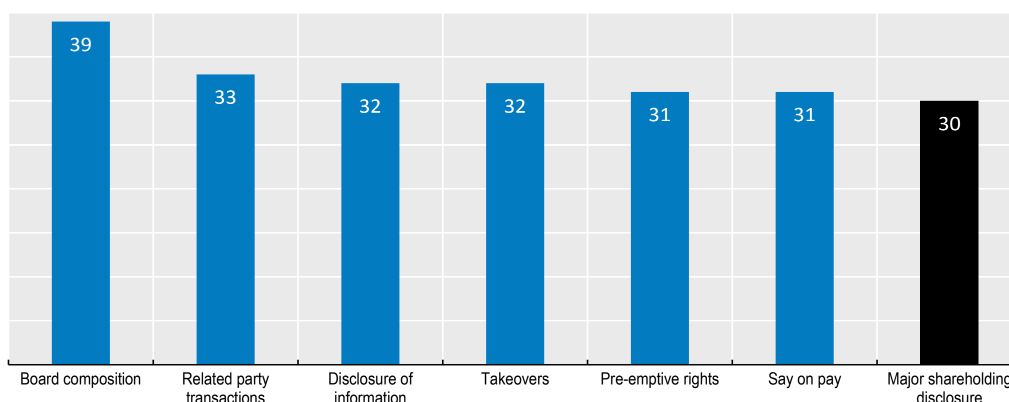
In order to achieve these policy objectives, jurisdictions have established various flexibility and proportionality mechanisms. One way of doing this is to exempt certain types of companies and/or shareholders from reporting itself – for example, in many jurisdictions non-listed companies and their shareholders are exempt from disclosure regulations of major shareholdings taking into consideration that the liquidity of non-listed companies’ shares is low and there is less need for disclosing ownership of those shares. Also, some jurisdictions

set different thresholds or reporting frequency according to the types of issuers and/or shareholders.

Survey results

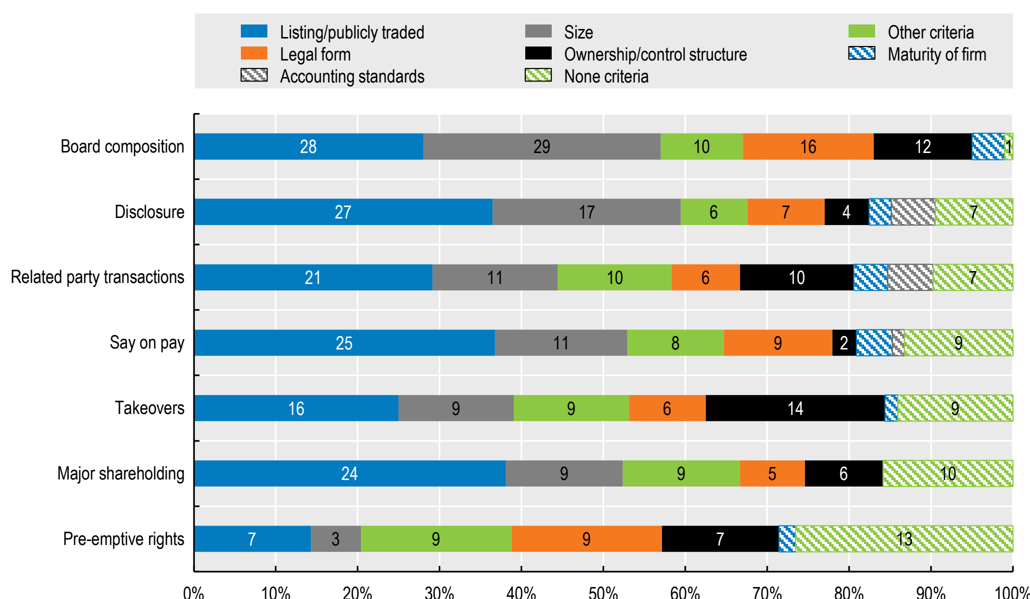
Out of the 39 jurisdictions included in the survey 30 jurisdictions reported at least one criteria or optional mechanism to allow flexibility and proportionality with respect to disclosure of major shareholdings (Figure 8.1.). From those, 29 use flexibility and proportionality criteria (Figure 8.2.).

Figure 8.1. Jurisdictions with at least one criteria or optional mechanism in the areas of regulation



Source: OECD Survey.

Figure 8.2. Overall use of criteria across all areas of regulation

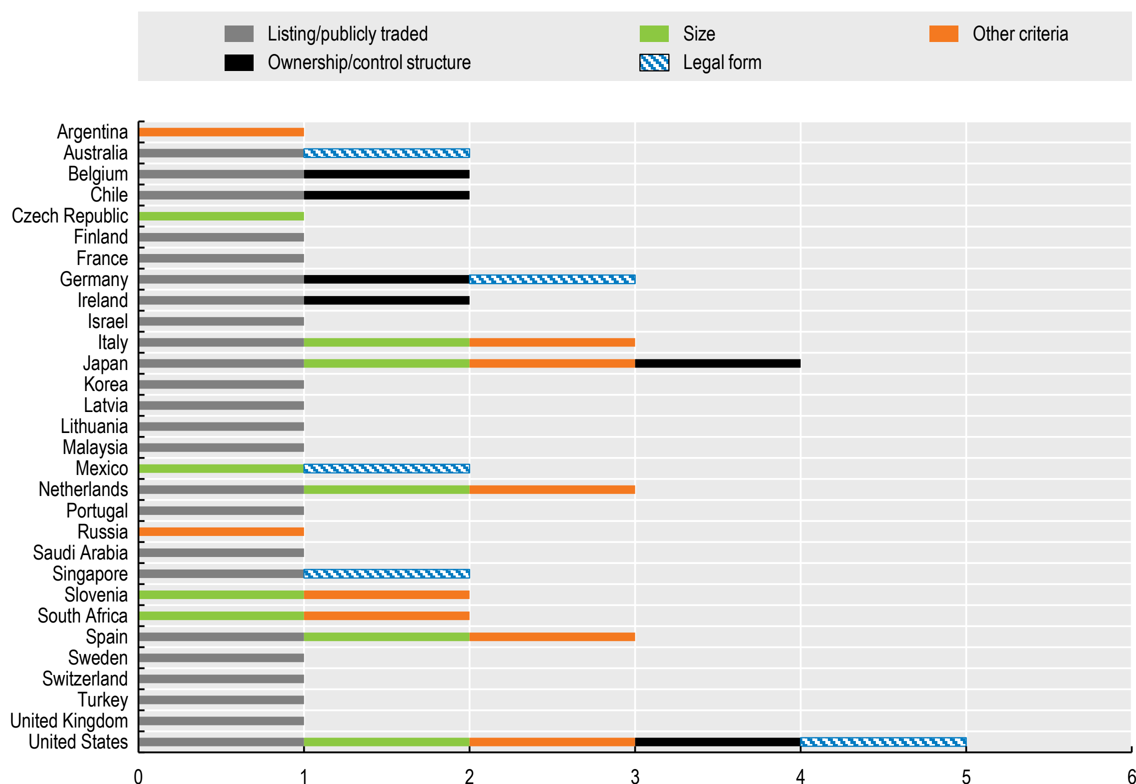


Source: OECD Survey.

As described in the main chapter of this thematic review, among all the criteria that jurisdictions employ to promote flexibility and proportionality in their corporate

governance frameworks, the criterion of *listing/publicly trading* and the criterion of *size* are by far the most used when considering all areas of practice. This is also the case in the area of disclosure of major shareholdings. Figures 8.3. presents the use of criteria by jurisdiction.

Figure 8.3. Use of criteria for disclosure of major shareholdings across jurisdictions



Source: OECD Survey.

The use of listing/publicly traded as criterion for flexibility and proportionality

Listing/publicly traded is used as criterion for flexibility and proportionality in the regulatory area of disclosure of major shareholdings by 24 jurisdictions (Figure 8.4.).

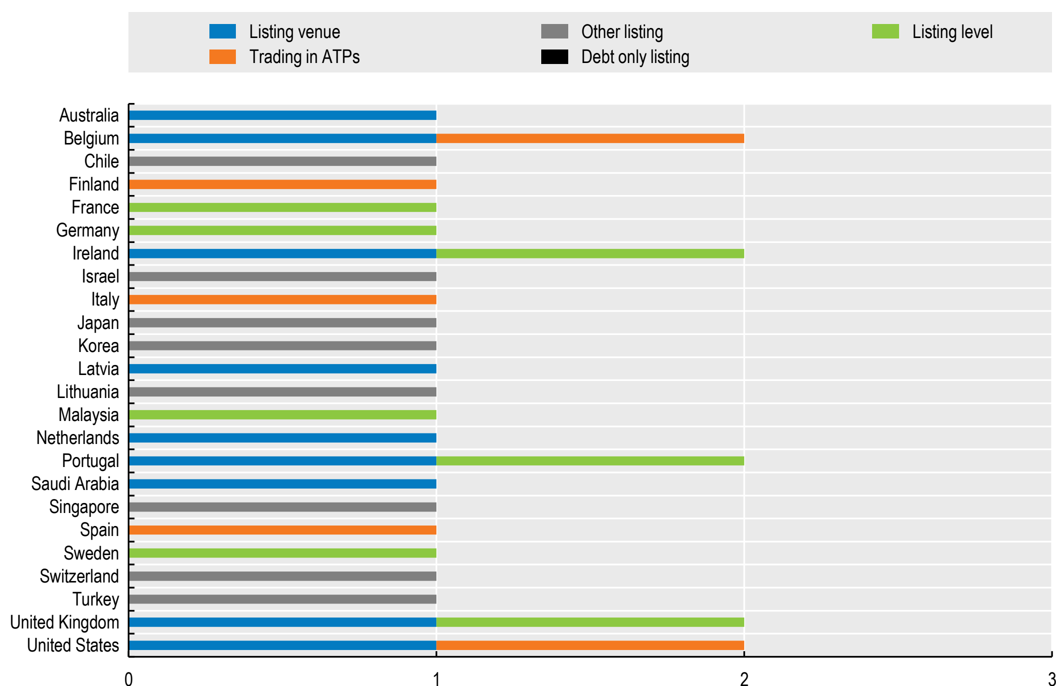
Although the dimensions of *listing/publicly traded* criterion differ across jurisdictions (*listing venue*, *listing level* and *trading in ATPs* are used in nine, seven and five jurisdictions respectively), most jurisdictions report that they use *listing/publicly traded* as a flexibility and proportionality criterion in the sense that non-listed companies are not subject to disclosure regulations of major shareholdings. The exception is Germany[5] and Switzerland,[6] where shareholders are subject to disclosure regulations when their shareholdings of non-listed companies' shares exceed certain thresholds.

Nine jurisdictions discriminate between *listing venue*. For example, in Belgium, the notification thresholds for shareholders are set at 25%, 30%, 50%, 75% and 95% – instead of 5% and all multiples of 5% – when issuers are listed on the MTF Euronext Growth Brussels. In Saudi Arabia, companies listed on Nomu-Parallel Market[7] are exempt from major shareholding disclosure requirements.

Seven jurisdictions discriminate between *listing level*. For example, in Malaysia, a corporation listed on the Main Market and ACE Market is required to provide the details

of its major shareholders in the annual report,[8] whereas a listed corporation on the LEAP Market is not required to provide such information.

Figure 8.4. Use of the listing/publicly traded criterion for disclosure of major shareholdings



Source: OECD Survey.

Debt only listing is used as a dimension of *listing/publicly traded* criterion only in Singapore, where companies that list only debt instruments do not need to comply with major shareholding disclosure requirements imposed by the Stock Exchange. *Cross listing* is not mentioned as a dimension of *listing/publicly traded* criterion in the area of disclosure of major shareholdings.

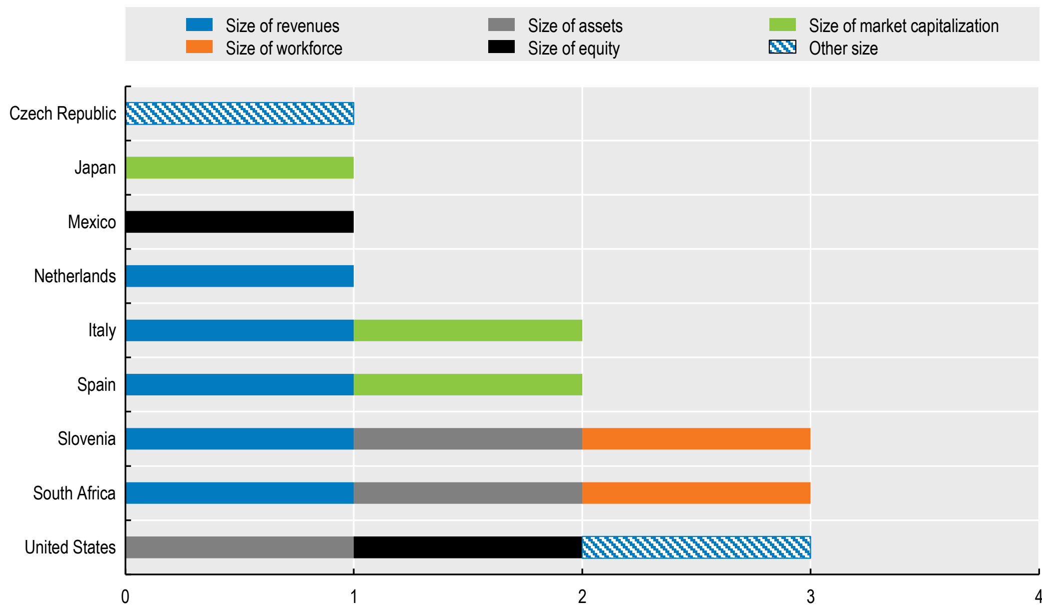
The use of size as criterion for flexibility and proportionality

As shown in Figure 8.5., *size* also appears to be an important criterion used in disclosure of major shareholdings. Nine jurisdictions report using it in different dimensions.

The most common dimension is *size of revenues*, used in Italy, the Netherlands, Slovenia, South Africa and Spain. Beyond the seven dimensions of size listed in the survey, Czech Republic uses size of registered capital and the United States uses number of holders of securities.

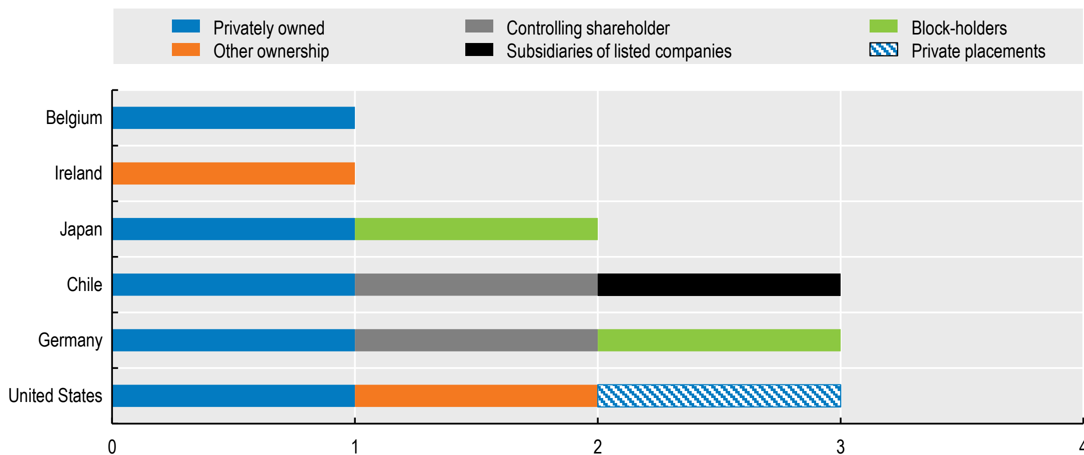
Some jurisdictions differentiate the initial threshold which triggers disclosure of major shareholdings according to the size of companies. For example, in Czech Republic, the minimum threshold of 1% or 3% applies to listed joint stock companies whose registered capital exceeds CZK 500 million or CZK 100 million, respectively, while the minimum threshold of 5% applies to other listed joint stock companies. In Italy, the initial threshold is 5% when the issuer is an SME, while the general rule requires disclosure of major shareholdings when the holding ratio is higher than 3%.

Figure 8.5. Use of the size criterion for disclosure of major shareholdings



Source: OECD Survey.

Figure 8.6. Use of ownership/control structure criterion for disclosure of major shareholdings



Source: OECD Survey.

The use of legal form as criteria for flexibility and proportionality

Five jurisdictions (Australia, Germany, Mexico, Singapore and the US) use the criterion of *legal form* to introduce flexibility and proportionality in this area of regulation. For example, in Australia, proprietary companies – companies that do not engage in activities that require disclosure to investors and of which number of non-employee shareholders is no more than 50 – are required to notify the securities regulator of a change to its top 20 shareholders. In Germany, disclosure regulations only apply for stock corporations (both

listed and non-listed) but not for private limited liability companies. In Mexico, SAPIBs[9] are exempt from providing the information on their major shareholders.

The use of other criteria for flexibility and proportionality

Respondents were also invited to mention any "other" criteria for flexibility and proportionality than those listed in the survey. One important example of such criteria is the category of investors (Italy, Japan,[10] Spain and the US). In these jurisdictions, disclosure requirements for certain type of investors such as fund managers are relaxed with respect to the initial threshold, deadline or frequency of disclosure of major shareholdings.

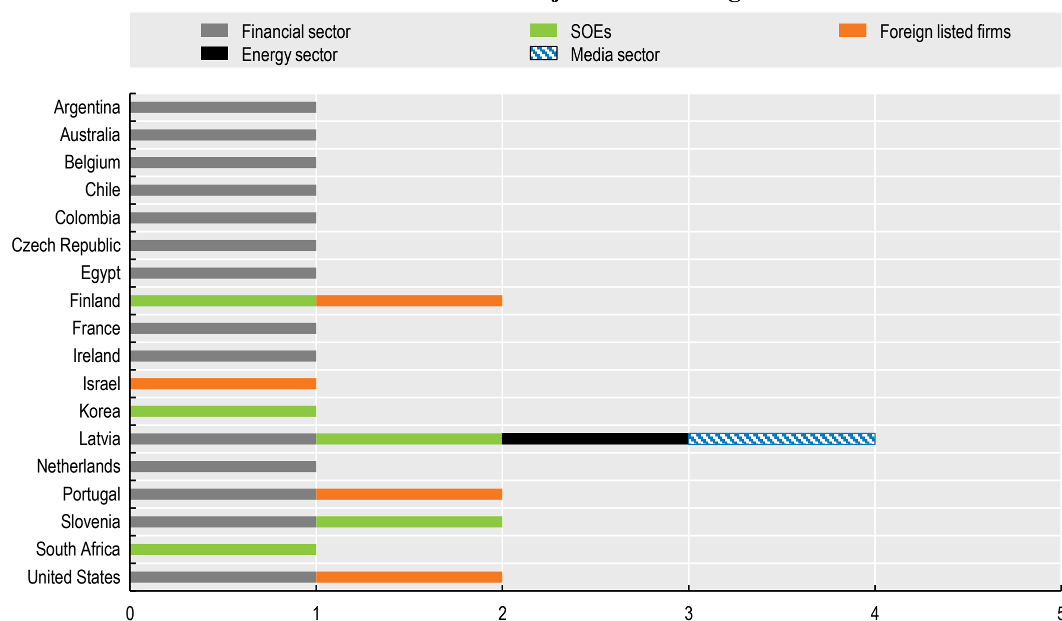
The *maturity of firm* criterion and the *accounting standards* criterion are not used in the regulatory area of disclosure of major shareholdings.

The use of opt-in and opt-out mechanisms for regulating disclosure of major shareholdings

Four jurisdictions (Germany, Italy, Lithuania and Spain) use opt-out mechanisms for the regulation of disclosure of major shareholdings. For example, in Italy and Spain, the regulation provides specific opt-out from the disclosure of the initial threshold of 3% if the shareholder is an asset manager, private equity, or venture capital firm/fund. In Germany, a shareholder reaching or exceeding the threshold of 10% has to notify the issuer about the aims underlying the purchase of the voting rights and of the origin of the funds used to purchase the voting rights, however, the articles of association of the issuer may stipulate for an opt-out from this requirement.

Opt-in mechanism is not mentioned in any jurisdiction for the regulation of disclosure of major shareholdings.

Figure 8.7. Use of flexibility and proportionality in different sectors for disclosure of major shareholdings



Source: OECD Survey.

The use of sectoral criteria for flexibility and proportionality

An analysis of the results per sector activity reveals that flexibility and proportionality criteria for disclosure of major shareholdings are used in 18 jurisdictions (Figure 8.7.). Most jurisdictions that present flexible sectoral regulations report having special regimes for the financial sector.

Case study: Japan

Overview

This case study describes how the disclosure of major shareholdings is regulated in Japan and the different flexibility and proportionality mechanisms that can be used when implementing these regulations. The study is structured in two parts. The first section presents an outline of the different regulations with respect the disclosure of major shareholdings that exist in Japan while the second section introduces the various flexibility and proportionality mechanisms that can be used.

Regulations on the disclosure of major shareholdings

Two types of regulations

Like in many other jurisdictions, Japan has two pillars of regulations regarding disclosure of major shareholdings. The first pillar of regulation requires companies to disclose their major shareholders. For example, under the Companies Act, a public company[11] is required to disclose in its business report the names of its top 10 shareholders and the number and percentage of shares held by each of them. Also, under the Financial Instruments and Exchange Act, companies that are obliged to file an annual securities report[12] are required to disclose in that report similar information on its top 10 shareholders as required under the Companies Act.

The second pillar of regulation requires shareholders to disclose their shareholdings. This type of regulation is stipulated in the Financial Instruments and Exchange Act and is known as "Large Shareholding Reporting System".

The Large Shareholding Reporting System

The Large Shareholding Reporting System was established in 1990. The purpose of the System is to provide investors with timely information on large holdings of listed shares and thereby increasing market fairness and transparency.

Under the Large Shareholding Reporting System, any person or corporation who directly or indirectly holds more than 5% of the voting shares[13] of a listed company (hereafter "Large Shareholder") must file a "Large Shareholding Report" within five business days of becoming a Large Shareholder.[14] In this Report, a Large Shareholder is obliged to disclose, among other things, the size of the holding as per cent of all shares (hereafter "holding ratio"), financial resources for acquiring shares, purpose of holding shares, and transactions of the shares in the recent 60 days.

In addition, a Large Shareholder must file an "Updated Report" within five business days from the day when there is a significant change to the entries in the most recently submitted Large Shareholding Report/Updated Report.[15] A typical example of a significant change is an increase or decrease by 1 percentage point (hereafter "pp") or more in the holding ratio.

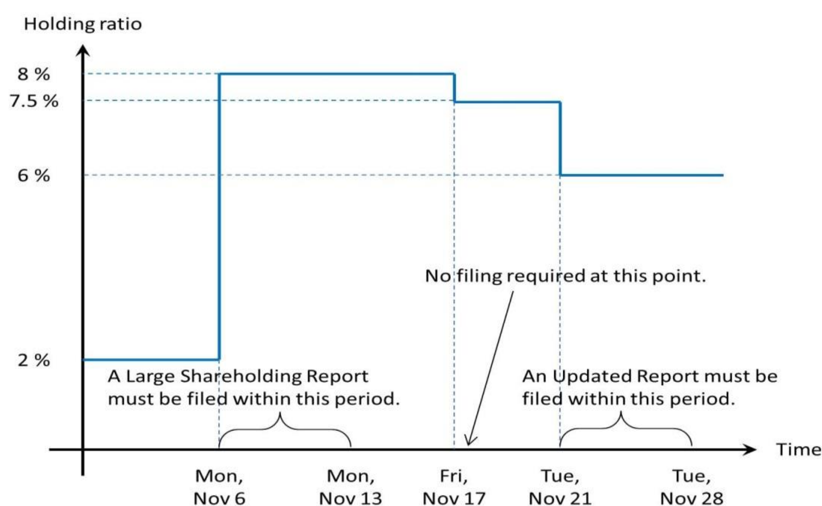
When a Large Shareholder has Joint Holders, a Large Shareholder is required to add Joint Holders' holding ratios to its holding ratio. A Joint Holder[16] includes a spouse (when a Large Shareholder is a person), a corporation controlling, controlled by or under common control with a Large Shareholder (when a Large Shareholder is a corporation) and a person or corporation that acts in concert with a Large Shareholder, among others.

Figure 8.8. shows an example of when a Large Shareholding Report or an Updated Report must be filed. Suppose that a person holds 2% of the shares of a listed company. On Monday, November 6, the person acquired an additional 6% of the company's shares so that the person's total holding ratio rose to 8%. Since the holding ratio becomes greater than 5%, the person must file a Large Shareholding Report within five business days from that date (i.e., by Monday, November 13).

Then, the person sold 0.5% of the company's shares on Friday, November 17. At this point, the person is not required to file an Updated Report, since the new holding ratio (7.5%) is only 0.5pp smaller than that in the most recently submitted Report (8%).

Subsequently, the person sold 1.5% of the company's shares on Tuesday, November 21. In this case, the person must file an Updated Report within five business days from that date (i.e., by Tuesday, November 28) since the holding ratio (6%) has decreased by 2pps compared to that in the most recently submitted Report (8%).

Figure 8.8. Timing for filing Reports



Source: Author's analysis.

Flexibility and proportionality in the Large Shareholding Reporting System

The Large Shareholding Reporting System has a number of different flexibility and proportionality mechanisms.

Special Reporting System

Financial institutions such as securities companies and fund managers engage in share trading repeatedly and continuously in their daily business operations. If the Large Shareholding Reporting System were applied to financial institutions without exception, they would be forced to file an Updated Report very frequently and be exposed to

excessive paperwork which, in turn, may hinder smooth transaction of listed shares by those financial institutions.

As a consequence, there is an exemption called the "Special Reporting System"[17] which relaxes the frequency and deadline of filing Reports for financial institutions that are specified in the Cabinet Office Ordinance[18] and satisfy the following two conditions:

- The institution will not use its large shareholding to make suggestions that may influence the corporation's business in important ways.[19]
- The institution will conduct its share trading within a holding ratio range that does not exceed 10%.

The first condition is a key in the Special Reporting System, since the exemptions from reporting under the Special Reporting System should not facilitate financial institutions to acquire control or substantial influence of listed companies without disclosing their shareholdings. As mentioned above, the rational is rather to reduce the burden of excessive filing for financial institutions and promote their smooth transactions of listed shares. From the viewpoint of preventing the use of the Special Reporting System in a way that distorts its purpose, financial institutions are not allowed to use the system when the purpose of holding shares is to make suggestions that would influence the company in important ways.

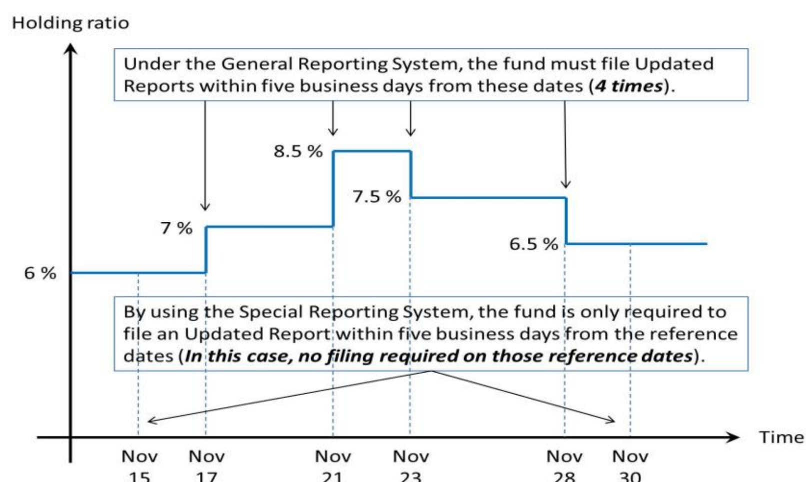
As mentioned above, Large Shareholding Reports and Updated Reports must in principle be filed within five business days from the day when the cause of filing occurs (this principle is called "General Reporting System" in contrast to the Special Reporting System). However, financial institutions that are allowed to use the Special Reporting System need to judge only twice a month whether they must file a Large Shareholding Report or not. In this case, the Large Shareholding Report should be filed within five business days of a preregistered reference date if the holding ratio is above 5% on that date. These reference dates can be either the combination of the second Monday and the fourth Monday of each month, or the combination of 15th and the last day of the month. Eligible financial institutions are allowed to file their subsequent Updated Reports within five business days from the reference date, based on the increase/decrease of the holding ratio on the reference date (i.e., eligible financial institutions must file an Updated Report when the holding ratio on the reference date is larger/smaller than that in the most recently submitted Report by 1pp or more). In addition, with regard to the content of disclosure, eligible financial institutions are not obligated to disclose financial resources for acquiring shares and transactions of the shares during the last 60 days.

The example in Figure 8.9. illustrates how the Special Reporting System relaxes the frequency and deadline of filing Reports and help financial institutions execute share trading smoothly. Suppose a fund manager has 6% of the shares of a listed company and the fund has already submitted a Large Shareholding Report in October disclosing that it holds 6% of the company's shares. It then buys 1% and 1.5% of the company's shares on November 17 and 21 respectively, and sells 1% of the company's shares on November 23 and 28.

Under the General Reporting System, these trades would require the fund to file an Updated Report at four different times between November 15 and 30. By using the Special Reporting System and choosing 15th and the last day of each month as the reference dates, however, the fund is only required to file an Updated Report within five business days from the reference dates based on the increase/decrease of the holding ratio on those dates. As a consequence, the fund in this case does not have to file any Updated

Report with respect to the reference date because the holding ratio in the most recently submitted Report and the ratio on November 15 remain the same at 6%. Neither is the fund required to file an Updated Report on November 30, since the holding ratio on that date (6.5%) is only 0.5pp larger than that in the most recently submitted Report (6%).

Figure 8.9. Timing for filing Reports under the Special Reporting System



Source: Author's analysis.

Thus, the Special Reporting System is a typical example of flexibility and proportionality mechanisms which uses the characteristic of a large shareholder (financial institutions or not), purpose of holding shares (whether or not to make important suggestions that influence the target listed company) and scale of share trading (whether share trading is conducted within a holding ratio range not exceeding 10% or not) as criteria.

Type of shares excluded from the Large Shareholding Reporting System

As mentioned above, any person or corporation who holds more than 5% of "listed shares" must, in principle, file a Large Shareholding Report. However, several types of listed shares are exempt from this principle. The rational for this flexibility is to avoid an undue burden on shareholders.

First of all, as is the case in many other jurisdictions, shares issued by unlisted companies are not subject to the Large Shareholding Reporting System as they are not widely traded and need not be disclosed to the market.

Treasury shares held by listed companies were originally subject to the Large Shareholding Reporting System. However, it was pointed out in the Financial System Council of the Financial Services Agency that disclosure of treasury shares under the Large Shareholding Reporting System might not be useful for investors, since the Companies Act stipulates that treasury shares cannot have any voting rights. It was also pointed out that the Large Shareholding Reporting System had hindered listed companies from carrying out trading in treasury shares smoothly. In light of these discussions, the Financial Services Agency amended the Financial Instruments and Exchange Act in 2014 and exempted treasury shares from the Large Shareholding Reporting System.

Also, the following types of listed shares are exempt from the Large Shareholding Reporting System, among others.[20]

a) Listed shares held by trust business operators as trust property[21]

b) Listed shares held by securities companies which engage in underwriting of listed shares[22]

c) Listed shares owned by securities companies through margin trading

d) Listed shares that are agreed to be sold but have not yet been transferred[23]

Thus, these exemptions, which are established not to place an undue burden on shareholders, are examples of flexibility and proportionality mechanisms based on the criterion of how the listed shares are held.

Example of flexibility and proportionality mechanisms designed for growth companies

As mentioned above, whether or not a person or corporation must file a Report is, in principle, not determined by the number of shares an owner holds, but on its holding ratio.

However, certain problems would arise if the obligation for filing a Report were determined only with respect to the holding ratio. Take the example when a listed company has increased its capital through a public offering in which existing shareholders do not participate and as a consequence all existing shareholders' holding ratios have decreased by more than 1pp. If we apply the principle literally to this case, existing shareholders who have already filed a Large Shareholding Report would be required to file an Updated Report even though they have not done any share trading and the number of shares they hold has not changed. This kind of case could occur especially when a listed company is small in terms of capital (such as growth companies).

In order to address this problem, it is stipulated under the Large Shareholding Reporting System that a person or corporation does not have to file a Report when the number of shares the person or corporation holds does not change, even though the holding ratio changes.[24]

This exemption can be regarded as a flexibility and proportionality mechanism designed for growth companies and their shareholders, although it does not explicitly use the company's size or stage of development as a criterion.

Sanctions for non-compliance with the Large Shareholding Reporting System

Under the Financial Instruments and Exchange Act, failure to submit Large Shareholding Reports/Updated Reports and false or missing statements of material items in those Reports are subject to criminal punishments and administrative monetary penalty.

The amount of administrative monetary penalty for violating the Large Shareholding Reporting System is set at one hundred thousandth (1/100 000) of the total market value of the target listed company. Since, the administrative monetary penalty is related to the market value of the target listed company. This arrangement of sanctions can also be regarded as an example of proportionality mechanisms.

Large volume transfers in a short period

This is an example of proportionality mechanisms by which regulations are strengthened rather than relaxed when certain conditions are met.

In the mid-1980s, there was a growing trend in Japan that some corporations engaged in the act of buying a certain amount of listed companies' shares and then requiring listed companies to buy those shares back at a price higher than the market price (Kotani, 2017). This kind of behaviour, so called "Greenmailing" or "Kata-gawari" in Japanese, aimed to make a profit in a short period rather than to build a long-term relationship with listed companies for the sake of long-term profit.

In order to address this issue and thereby increase fairness and transparency in the equity market, Japan designed a mechanism to address "Large Volume Transfers in a Short Period".[25]

In short, this mechanism applies when the holding ratio in an Updated Report (i) is less than half of the largest holding ratio reported in the 60 days prior to the transfer date and (ii) decreases by more than 5pps from the largest reported holding ratio. When a Large Shareholder conducts a share trading which satisfies the above conditions,[26] the Large Shareholder must disclose in its Updated Report additional information[27] such as to whom the Large Shareholder sold its shares and the sale price.

Figure 8.10. illustrates a case which satisfies the conditions of "Large Volume Transfers in a Short Period". Suppose a corporation acquired 10% of the shares of a listed company on November 6, and then sold 7% of the company's shares on January 1. In this case, the holding ratio on January 1 is less than half of the highest holding ratio (3% < 5% = 10%/2) reported in the 60 days prior to the transfer date and decreases by more than 5pps from the highest holding ratio (10%-3% = 7pps > 5pps). Therefore, in the Updated Report submitted within five business days from January 1, the corporation must disclose to whom it sold 7% of the listed company's shares and how much the prices were. An example of how this disclosure is presented is shown in Table 8.1.

Figure 8.10. A case which satisfies the conditions of "Large Volume Transfers in a Short Period"

Source: Author's analysis.

Table 8.1. Example of disclosure on large volume transfers in a short period

Date	Type of shares	Quantity	Ratio	Venue of the transaction	Buy/Sell	Counterparty of the transaction	Unit price
Jan 1, 2018	Common shares	100 000	5%	Off-market	Sell	X Company limited	2 000
Jan 1, 2018	Common shares	40 000	2%	Off-market	Sell	Mr. Y	2 000

Source: Author's analysis.

In this way, the Large Shareholding Reporting System has a proportionality mechanism that strengthens disclosure requirements from the viewpoint of providing necessary information for investors and shareholders.

Conclusions

The survey results show that flexibility and proportionality are important elements of the corporate governance framework in most jurisdictions. They also reveal that flexibility and proportionality mechanisms are widely applied in disclosure regulations of major shareholdings.

While receiving information about major share ownership is one of the basic rights of investors as stated in the G20/OECD Principles, simply imposing disclosure regulations of major shareholdings on listed companies and their shareholders might not be a right solution since such regulations could sometimes hinder smooth transactions of securities.

As demonstrated by the case study of Japan, flexibility and proportionality mechanisms can be used in the area of disclosure of major shareholdings in many ways such as to relax disclosure obligations for certain types of investors or to impose tighter regulations on investors when certain conditions are met. Those mechanisms can help policy makers strike the right balance between securing transparency, minimizing the regulatory burden and securing market efficiency in the area of disclosure of major shareholdings.

Notes

[1] For example, the threshold of 5% is used in Argentina, Lithuania, Switzerland and the US. The threshold of 10% is used in Mexico for Sociedades Anónimas Bursátiles (SABs).

[2] For example, in Japan, a public company is required to disclose in its business report the names of its top 10 shareholders and the number and percentage of shares held by each of them.

[3] 5% in the case of Japan and the US.

[4] In the case of Japan and the US, a material change includes an increase or decrease by 1 percentage point or more in the holding ratio.

[5] In Germany, under the Stock Corporation Act, enterprise shareholders that hold more than 25% or majority of shares of a non-listed company (having its registered office in Germany) are required to disclose their ownership.

[6] In Switzerland, any person who, alone or by agreement with third parties, acquires shares in a company whose shares are not listed on a stock exchange, and thus reaches or exceeds the threshold of 25% of the share capital or votes must within one month give notice to the company

of the first name and surname and the address of the natural person for whom it is ultimately acting (i.e., the beneficial owner).

[7] Nomu-Parallel Market is an alternative equity market with lighter listing requirements compared to the Main market.

[8] Such as the names of the substantial shareholders and their direct and deemed interests.

[9] Listed firms in the equity market of Mexico can have the legal status of Sociedades Anónimas Bursátiles (SAB), or Sociedades Anónimas Promotoras de Inversión Bursátil (SAPIB), and these types of firms have different requirements for listing, board composition, and information disclosure.

[10] The case of Japan is elaborated in the following section (Special Reporting System designed for financial institutions).

[11] A public company is a company of which articles of incorporation do not require approval of the company for acquisition of shares by transfer, as a feature of all or part of its shares (Article 2 (v) of the Companies Act).

[12] Type of companies which assume obligations for filing an annual securities report is defined under Article 24 (1) of the Financial Instruments and Exchange Act. Listed companies are included in this category.

[13] In this report, we limit the scope of our discussion to shares and do not go into details of the types of securities that are subject to the Large Shareholding Reporting System for simplicity's sake. In the actual regulations, securities such as convertible bonds are subject to the System if the shares issued in exchange for convertible bond s are voting shares.

[14] Article 27-23 (1) of the Financial Instruments and Exchange Act.

[15] Article 27-25 (1) of the Financial Instruments and Exchange Act.

[16] A Joint Holder is defined under Article 27-23 (5) and (6) of the Financial Instruments and Exchange Act.

[17] Article 27-26 of the Financial Instruments and Exchange Act.

[18] Following corporations are listed in Article 11 of the Cabinet Office Ordinance on the Disclosure of Large Shareholdings: (1) Securities companies, (2) Investment management business operators (so called fund managers fall into this category), (3) Banks, (4) Trust companies, (5) Insurance companies, (6) The Norinchukin Bank, (7) Shoko Chukin Bank, (8) Corporations who conduct securities businesses, investment management businesses, banking businesses, trust businesses or insurance businesses in a foreign country in accordance with the laws and regulations thereof, (9) Banks' Shareholdings Purchase Corporation, (10) Bank of Japan, (11) Deposit Insurance Corporation of Japan, and (12) A person or corporation who is a Joint Holder of (1) to (11) above.

[19] An act of making important suggestions is an act of suggesting the following items (listed in Article 14-8-2 (1) of the Order for Enforcement of the Financial Instruments and Exchange Act) that are a material change in business activities or a material influence on the business activities of listed companies: (1) Disposition or acceptance of transfer of important properties, (2) Borrowing in a significant amount, (3) Selection or removal of a representative director, (4) Important changes in the constitution of officers, (5) Appointment or dismissal of managers or any other important employees, (6) Establishment, change in, or abolition of a branch office or any other important organisation, (7) Share exchanges, stock transfers, or split or merger of the company, (8) Transfer, acceptance, suspension, or abolition of the business in whole or in part, (9) Important changes in the policy concerning dividend distribution, (10) Important changes in the policies concerning the increase in or reduction of the amount of stated capital, (11) Listing or delisting on

the stock market, (12) Important changes in capital policy, (13) Dissolution, (14) Petition for the commencement of bankruptcy proceedings, rehabilitation proceedings, or the start of reorganisation proceedings.

[20] Article 27-23 (4) of the Financial Instruments and Exchange Act and Article 4 of the Cabinet Office Ordinance on the Disclosure of Large Shareholdings.

[21] Listed shares held by trust business operators are not exempt from the Large Shareholding Reporting System in cases where trust business operators have the authority to exercise voting rights for the purpose of controlling the business activities of the target listed company, or in cases where trust business operators have the authority to make a decision to invest in the target listed company.

[22] Listed shares held by those securities companies after the payment due date for the new shares issued are not exempt from the Large Shareholding Reporting System.

[23] Limited to listed shares that will be transferred within five business days from the sales contract.

[24] Article 27-23 (1) and 27-25 (1) of the Financial Instruments and Exchange Act and Article 3 (i) of the Cabinet Office Ordinance on the Disclosure of Large Shareholdings.

[25] Article 27-25 (2) of the Financial Instruments and Exchange Act.

[26] These conditions are stipulated under Article 14-8 of the Order for Enforcement of the Financial Instruments and Exchange Act.

[27] It should be noted that the mechanism of "Large Volume Transfers in a Short Period" does not aim to prohibit the act of "Kata-gawari" directly. Rather, the purpose of the mechanism is to inform investors and shareholders of transactions that may potentially be "Kata-gawari".

References

Financial System Council (2013), "Report by the Working Group on the Provision of Risk Money to Emerging and Growing Companies", http://www.fsa.go.jp/en/refer/councils/singie_kinyu/20131225/01.pdf.

Kotani, Toru, 2017, "Securities Fraud and Regulations (in Japanese)," Journal of Osaka University of Economics, 67-5.

Machida, Yukihito, 2016, A Detailed Explanation of Large Shareholding Reporting System (in Japanese), Shojihomu.

Nemoto, Toshimitsu, 2017, Theory and Practice for Large Holding Report System (in Japanese), Shojihomu.

OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, https://doi.org/10.1787/9789264236882-en.

The Securities Exchange Council of the Government of Japan, 1989, Report on the design of disclosure regulations of major shareholdings (in Japanese).

Chapter 9. Takeovers

This section presents the results of the review in the area of takeovers. It takes stock of the criteria and mechanisms that may motivate and allow flexibility and proportionality in the implementation of rules and regulations relating across the 39 jurisdictions that responded the survey used for the review. It also includes a case study of the Portuguese corporate governance framework in the area submitted by Juliano Ferreira from CMVM.

Introduction

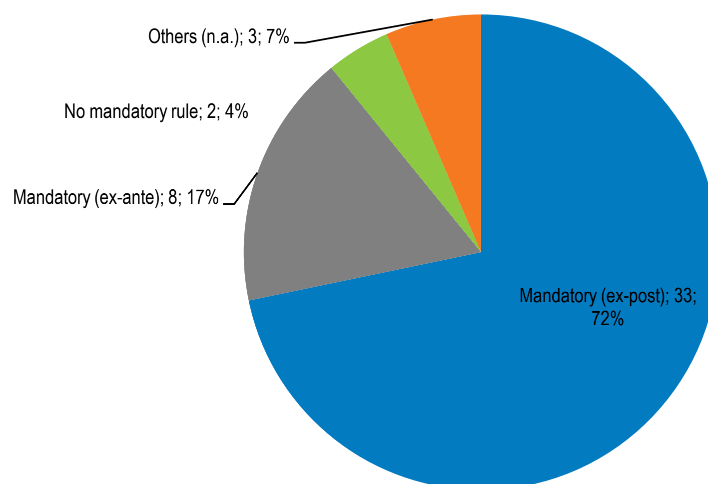
Takeover regulations

As discussed by the Committee in 2016,[1] a takeover is conventionally identified as an offer by a third party, made to the shareholders of a company, to acquire their shares in sufficient quantity to give the acquirer control of the firm. In short, this triggers two main regulatory concerns that takeover regulation tends to address, both arising from the fact that the transaction is organised as a deal between the third party buyer and the shareholders of the target firm. First, since the board and managers of the target firm are not part of the transaction, their own incentives to promote or oppose the deal and the tools they may have at their disposal to intervene constitute one important set of issues to be dealt with. Second is the range of issues with respect to the fairness of the terms of the offer made by the buyer to the shareholders of the target firm. The impact of the acquisition on the market and its effects on competition and related issues is another area of concern, but that is often analysed beyond the scope of corporate governance rules.

The OECD Corporate Governance Factbook keeps track of takeover regulations in the 47 jurisdictions covered by the report. In 2016, 41 of them had introduced mandatory takeover bid rules. Others had opted for regulating voluntary takeover bids but not requiring mandatory ones (New Zealand). The United States is a particular case, as neither statutes nor rules impose a requirement that a bidder conduct a mandatory tender offer, leaving it to the bidder's discretion as how to approach the transaction.

Four-fifths of the jurisdictions imposing takeover regulations take an ex-post approach, where a bidder is required to initiate a bid after acquiring shares exceeding a certain threshold (e.g. after obtaining what is considered control of the target company), and another eight take an ex-ante approach, where a bidder is required to launch a bid in order to acquire shares which would allow her to obtain control (Figure 9.1). The control threshold is most commonly set around a 30-33% ownership, considering also the shares held by all affiliated parties to the buyer.[2]

Figure 9.1. Takeover bids rules



Note: This Figure shows the number of jurisdictions in each category.
Source: OECD 2017 Corporate Governance Factbook.

From those jurisdictions with mandatory takeover bid rules, more than four-fifths establish a fairness mechanism to determine the minimum bidding price for the remaining outstanding shares, which is often determined by the highest price paid by the offeror for the shares of the target within the last 3 to 12 months; the average market price of the shares at within 1 to 12 months; or a combination of the two.[3]

Issues and trends

From an economic perspective, takeover regulations play a key role in setting the stage for a market for corporate control that can ensure an effective use and continuous reallocation of an economy's productive resources. An effective market should allow that control can be transferred to those shareholders that believe that they can, and are willing to pay for, improving the use of the corporation's assets. In order to gain such control, the buyer is typically willing to pay all or part of existing shareholders a premium over existing stock price. This premium reflects, in principle at least, the increase in the net present value of the firm after the more efficient use of its assets has taken place less the private benefits for the aspiring new controller, whatever they may be.

As already discussed by the Committee, the market for corporate control is an ever-present, and often necessary, disciplinary complement to other corporate governance mechanisms. Because of this, the quality of takeover regulation and the use of flexible and proportional means in takeover regulation could have an important effect in the quality and the effectiveness of the framework for changes in corporate control.

As discussed in one of the background reports for the 2016 Committee roundtable on the topic,[4] an important development over the last decades has been the increase in cross-border activity on takeovers (and more generally on mergers and acquisitions, "M&A"). An annual average of 3 433 cross-border deals seeking to acquire a listed company were completed in the period between 2008 and 2015, representing a 15% increase over the period 2000 to 2007.

This increase in cross border M&A activity is partly explained by a shift in the nationality of the acquirer and the target companies towards emerging markets. During the second half of the 1990s, transactions where both the acquirer and the target were located in emerging markets represented less than 10% of the total of transactions. In about 80% of cases, both were located in advanced markets. In recent years, the number of deals within emerging markets has reached almost 35% of all transactions, even if the transactions involving larger volumes are still predominantly taking place in developed markets.

These developments, taken together with the trend in ownership concentration towards more institutional and more foreign ownership discussed in the chapter on related party transactions of this report, offer a background against which a flexible and proportional approach may offer national frameworks an ability to accommodate the differences in corporate ownership and stock market structures needed by an efficient market for corporate control.

The view of the G20/OECD Principles

The G20/OECD Principles argue that the markets for corporate control should be allowed to function in an efficient and transparent manner and take the position that anti-takeover devices may be an impediment to their functioning. For this, they state that

> *The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of*

> *substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class (OECD, 2015).*

The annotations further clarify that both investors and stock exchanges have expressed concern over the possibility of widespread use of anti-takeover mechanisms, which may shield the management or the board from shareholder monitoring and accountability. Even if they may help in some cases to overcome short termed or opportunistic bids that could destroy value, in others they may allow for the entrenchment of bad management. Because of this, the Principles recommend that when implementing any anti-takeover mechanisms and in dealing with takeover proposals, the board must be guided by its fiduciary duty to shareholders and the company.

Flexibility and proportionality with respect to takeovers

Most of the policy interventions in takeover regulation tend to force someone to do something that they may not voluntarily choose to do on their own. In some cases is a matter of preventing the managers and board of the target company from deploying anti-takeover measures that could save their jobs at the expense of the firm's interest. In others is to force the buyer to give all other shareholders a chance to tender their own shares on fair terms. In this context the use of flexibility and proportionality may seem counter intuitive, but it is not. It may be argued that precisely because the takeover regulations impose important burdens on their targets, at critical times in their activity, a flexible and proportional approach may be the best way to ensure that the policy objectives are met without causing large unintended consequences.

In the EU, the 2004 Takeover Directive[5] takes a similar approach by carefully listing the options that member states can adopt in its implementation at the national level (Box 9.1).

Box 9.1. Optional rules under EU Takeover Directive

Member States may opt out of two important provisions of the EU Takeover Directive (the frustrating action and breakthrough rules described below) in respect of companies with their registered offices in the respective Member State. If a Member State chooses to opt out, it must allow companies in its jurisdiction the opportunity to opt back in by a shareholder resolution.

A company opting back in will (if the rules of its State Member provide) be subject to disapplication of the opt-in (so that the frustrating action and/or breakthrough rules do not apply to it) if it is the subject of an offer from a company which itself does not apply the frustration action and/or breakthrough provisions to the same extent as the target company.

Frustrating action: Target companies shall not take action to frustrate a bid without shareholder approval. The directive requires Member States to apply this prohibition from no later than the announcement of a bid, though they are permitted to apply this prohibition from an earlier stage such as when the target board becomes aware that a bid is imminent. In either case, the prohibition continues until the bid completes or lapses.

"Breakthrough" rules: During the period of acceptance or an offer: (i) restrictions on transfers of shares, whether constitutional or in shareholder agreements, may not be applied vis-à-vis the bidder; and (ii) restrictions on voting rights and the use of multiple voting rights do not apply at any general meeting to approve any frustrating action.

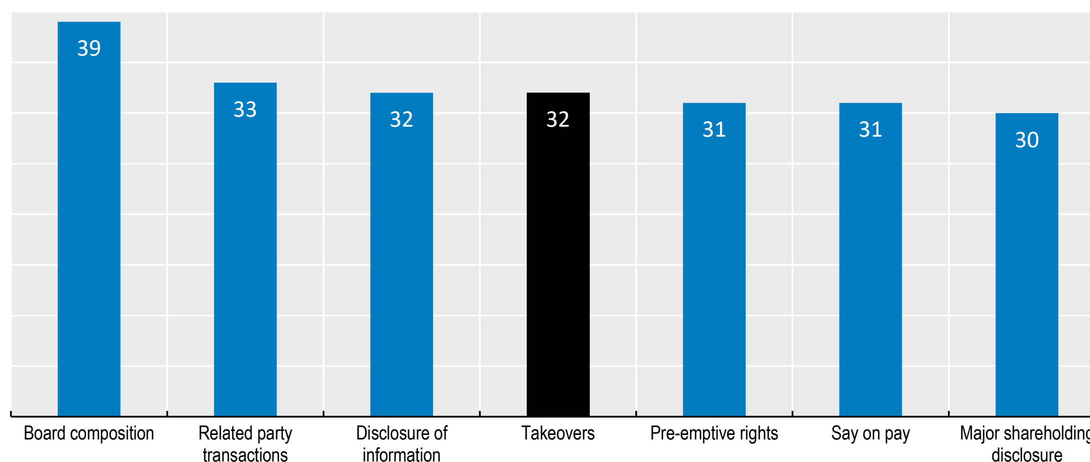
Moreover, once a bidder has acquired 75% of the capital carrying voting rights in the target, any special arrangement for appointing board members cease to apply and multiple voting rights are ignored at the first general meeting called by the bidder following closure of the bid. Shareholders deprived of rights under these provisions are entitled to compensation on an equitable basis on terms to be determined by Member States. None of these requirements apply to state-held "golden shares".

In the United States, on the other hand, the securities regulatory and legal framework, state corporate laws, and exchange listing standards address the rights, equitable treatment of shareholders, and how takeover transactions take place without imposing a mandatory bid rule, which is another manifestation of the flexible and proportional approach. Since the law does not define the term “takeover” nor “tender offer,” the determination of whether any acquisition attempt is a tender offer and consequently subject to the U.S. federal securities laws is therefore ultimately dependent upon the facts and circumstances, which allows for a degree of flexibility and proportionality in the application of the framework, with the aim to provide disclosure and certain procedural safeguards to shareholders whose shares are the subject of the offer.[6]

Survey results

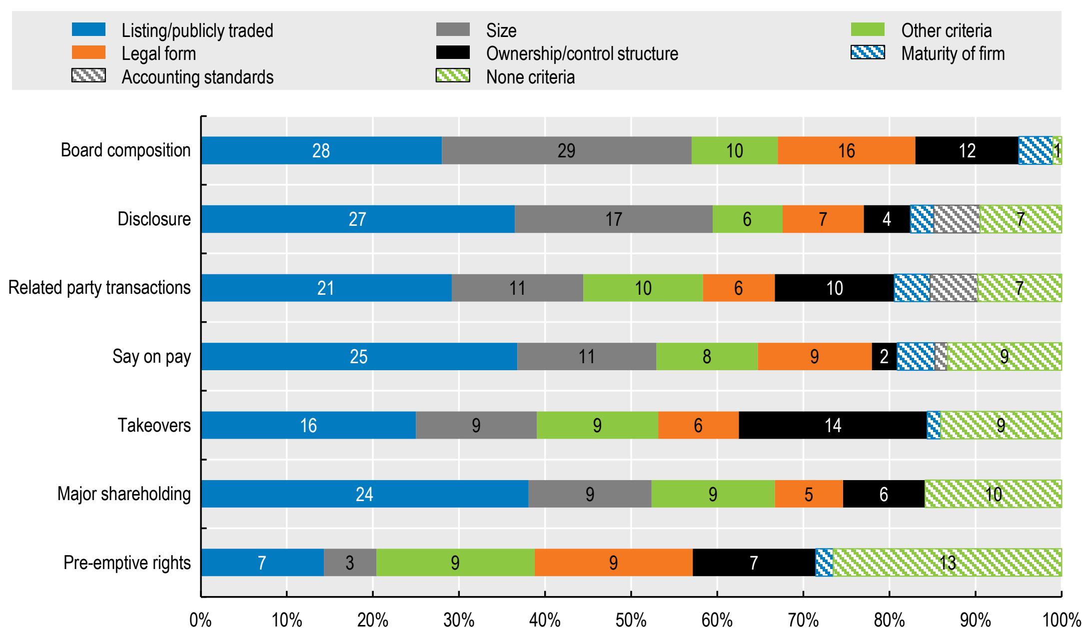
Out of the 39 jurisdictions included in the survey, 32 reported at least one criterion or optional mechanisms to allow flexibility and proportionality in the area of takeovers (Figure 9.2.).

Figure 9.2. Jurisdictions with at least one criteria of optional mechanism in the areas of regulation



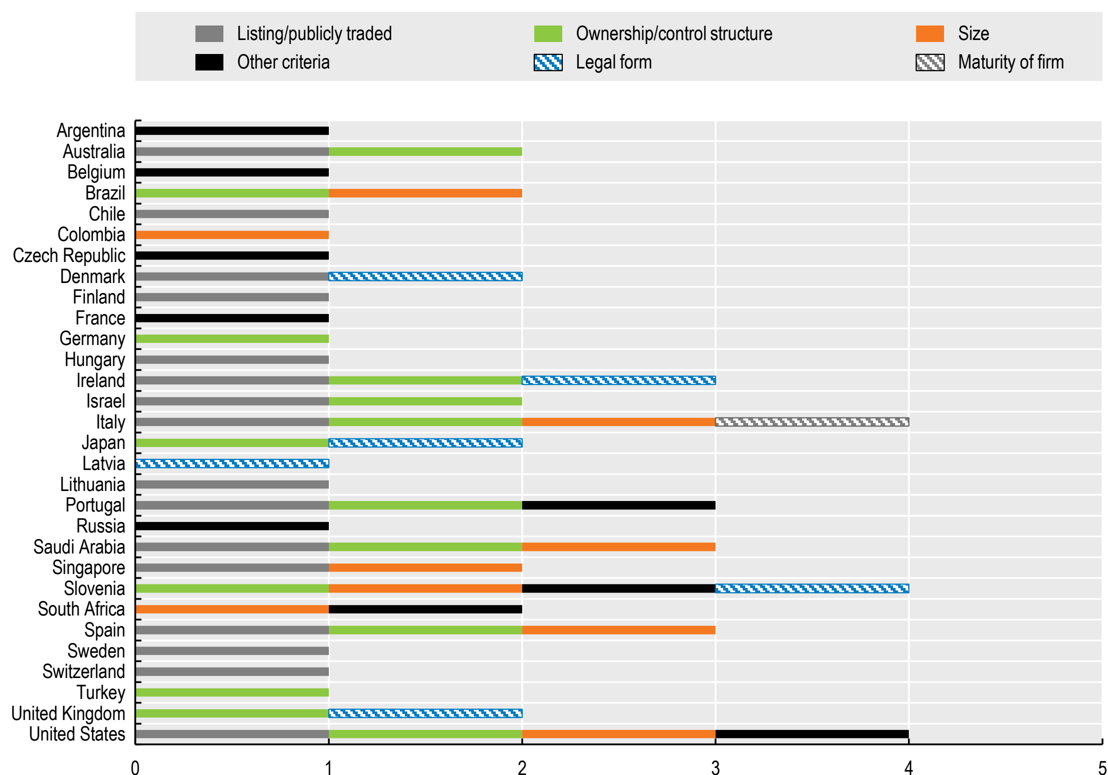
Source: OECD Survey.

Figure 9.3. Overall use of criteria across all areas of regulation



Source: OECD Survey.

Figure 9.4. The use of criteria with respect to takeovers across jurisdictions



Source: OECD Survey.

As described in the main chapter of this thematic review, among all the criteria that jurisdictions employ to promote flexibility and proportionality in their corporate governance frameworks, the criterion of *listing/publicly trading* and the criterion of *size* are by far the most used when considering all areas of practice. Aligned with the general results, the *listing/publicly traded* criterion is also the most used in the area of takeovers, followed closely by *ownership/control structure* (Figure 9.3.). Figure 9.4 shows the frequency and distribution among different types of criteria that jurisdictions have reported.

The use of listing/publicly traded as criterion for flexibility and proportionality

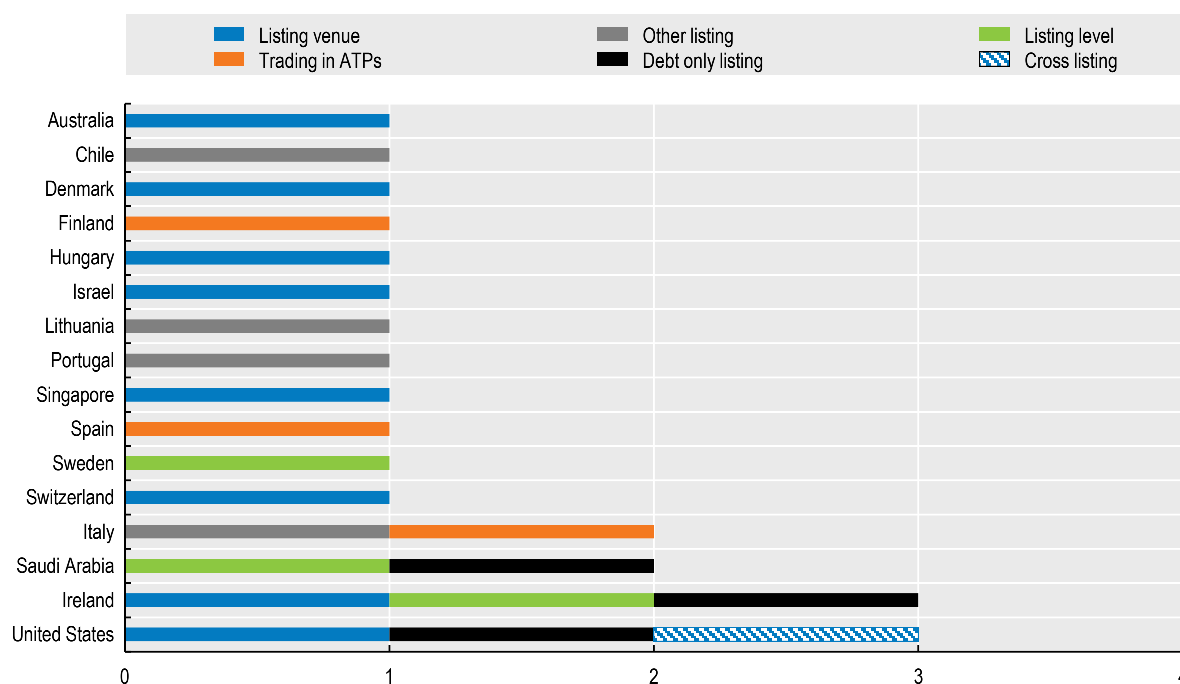
Listing/publicly traded is used in the area of takeovers by 16 jurisdictions and is present in the corporate governance framework in several dimensions, with the *listing venue* as the most common dimension used to introduce flexibility and proportionality (Figure 9.5.).

Most jurisdictions report that they use *listing/publicly traded* as a criterion in the sense that only listed companies are subject to the takeover regulations. That is the case in Chile; Denmark; Russia; South Africa; Slovenia; and Switzerland.

However, several jurisdictions also introduce differentiated rules for companies whose shares are *traded in regulated markets* or in alternative trading platforms (ATPs). This is the case in Australia; France; Hungary; Lithuania; Portugal; Spain, and Sweden.

In Italy and Spain, firms whose shares are admitted to trading in the alternative trading markets (AIM Italy and AIM Spain) are required by the exchange to consider the adoption of a mandatory takeover bid rule in their by-laws as the law prescribes for listed firms.

Figure 9.5. Use of the listing/publicly traded criterion for takeovers



Source: OECD Survey.

Debt only-listings are also subject to more flexible rules in some jurisdictions, including Ireland; Saudi Arabia, and the United States. In some jurisdictions, like Singapore, in cases of cross-listing a firm primarily listed in a foreign jurisdiction is excluded from the requirements for a mandatory bid under domestic rules.

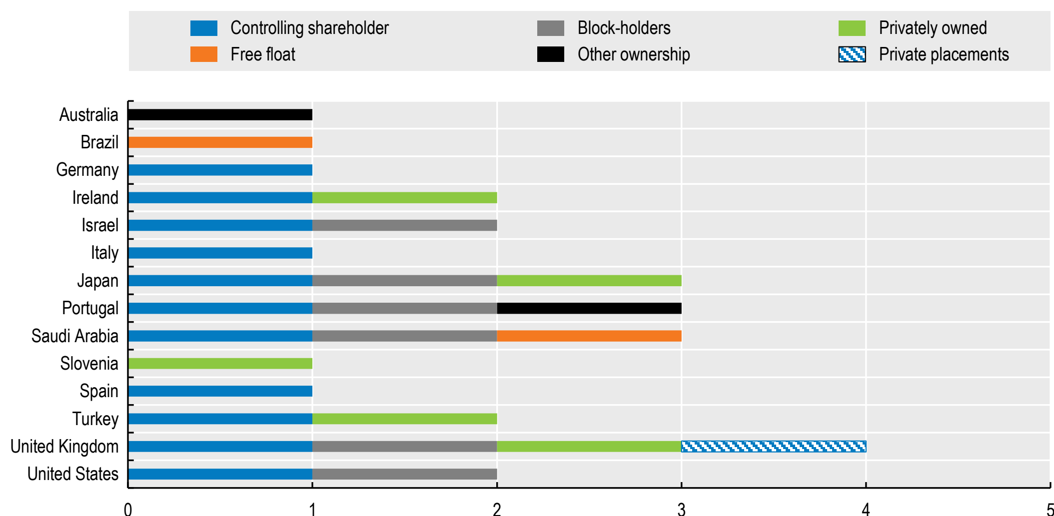
Non-listed firms may also be subject to takeover regulations when they are the holding company for a listed firm, as it is the case in Chile, where the acquisition of the shares of the privately-held holding trigger a mandatory bid for the shares of the listed subsidiary, or in South Africa, where the requirement is extended to private firms that are large enough to be required to conduct external audits.

The use of ownership/control structure as criterion for flexibility and proportionality

The *ownership/control structure* criterion is used by 14 jurisdictions (Figure 9.6.), mostly in relation to the presence of a *controlling shareholder*, in which case the rules may deem that the acquisition does not pertain to a real change of control but rather to a change of the degree of existing control, therefore relaxing some of the requirements.

That is for example the case in Italy, but the controlling shareholder dimension is also used in Germany; Ireland; Portugal; Saudi Arabia; Spain; Turkey; the UK, and the United States.

Figure 9.6. Use of the ownership/control structure criterion for takeovers



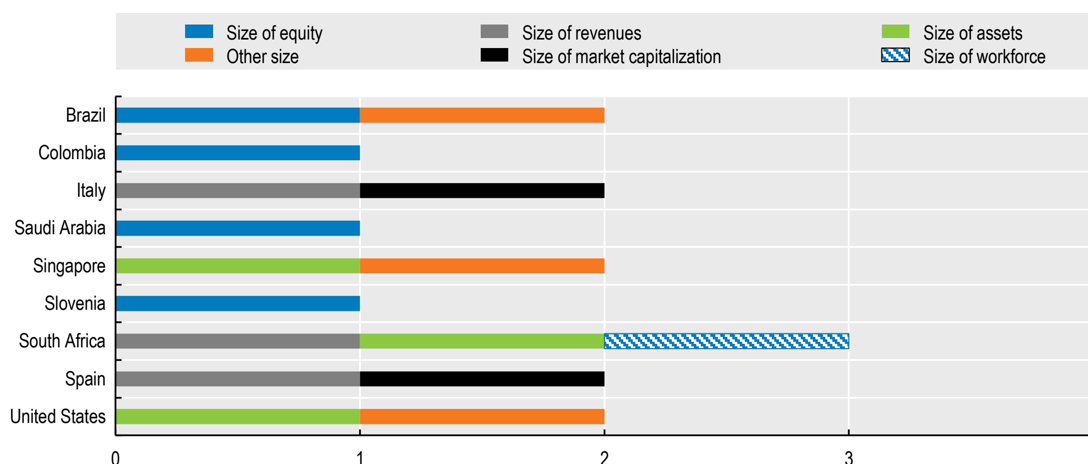
Source: OECD Survey.

The use of size as criteria for flexibility and proportionality

Nine jurisdictions report using *size* as a criterion for flexibility and proportionality for takeovers (Figure 9.7).

In some cases, the *size* criterion is used in relation to the number of shareholders, in the sense that when the number of shareholders is bigger than a given size, often around 50 shareholders, the takeover rules apply even if the company is not listed. That is for example the case in Australia; Singapore, and Slovenia. In others it is related to the *size of the equity*, the *revenues*, or of the *assets* of the company, allowing the application of rules that either extend the mandatory bid requirement to *large private companies* or that carve out exceptions that grant more flexibility for small and medium sized firms.

Figure 9.7. Use of the size criterion for takeovers



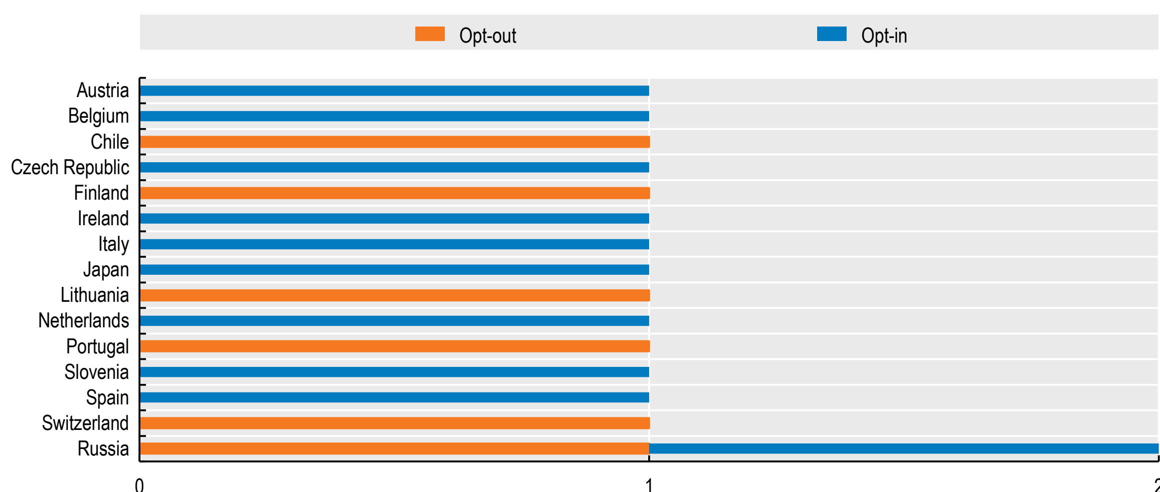
Source: OECD Survey.

A large number of jurisdictions also described that an important source of flexibility and proportionality in their takeover regulations is achieved by granting authority to their Takeover panels and/or regulatory agencies to allow for derogations based on a large range of criteria, including many of those listed in the survey. This is reported in the case in Austria; Belgium; Brazil; Finland; Ireland; Sweden, and the UK.

The use of opt-in and opt-out mechanisms for regulating takeovers

Opt-in and opt-out mechanisms are used for the regulation of takeovers by 15 jurisdictions (Figure 9.8.), many of which are members of the EU, which included optional rules that jurisdictions could include in their national implementation of the 2004 Takeover Directive (Box I.1. offers an overview of some of these options, which were reported by several jurisdictions).

Figure 9.8. Use of opt-in and/or opt-out mechanisms for takeovers

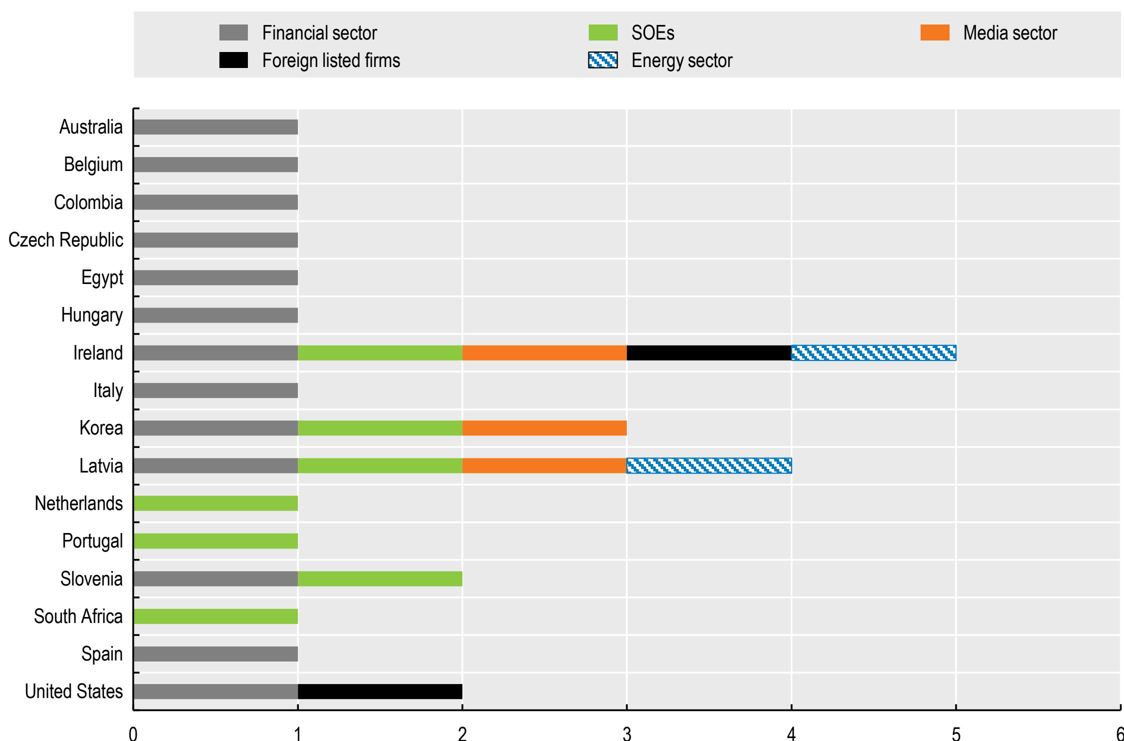


Source: OECD Survey.

The use of sectoral criterion for flexibility and proportionality

An analysis of the results per sector of activity reveals that flexibility and proportionality criteria for takeovers are used by less than half of the jurisdictions (16), with a varying degree of scope (Figure 9.9.). Most jurisdictions that present flexible sectoral regulations report having special takeover rules for the financial sector and for their State-owned companies.

Figure 9.9. Use of flexibility and proportionality in different sectors for takeovers



Source: OECD Survey.

Case study: Portugal

Overview

Following approximately 15 years of negotiations and tied votes in the EU Parliament, the Takeovers Directive was finally approved on April 2004. In the end, several compromises were made in order to approve the Directive, and therefore, its initial goal to create a level playing field for takeovers in Europe was not entirely met. This means also, therefore, that the Directive allows for significant flexibility to the EU member states, thanks to the alternative granted to opt-in/opt-out in respect of certain provisions of the Directive. Portugal, as an EU member state, has transposed the Takeover Directive into the Portuguese law by the end of 2006.

Given the relatively small size of the Portuguese market (with only 45 companies with shares admitted to trading on a regulated market), takeover bids are not very common; nevertheless, since the transposition of the Takeover's Directive at the end of 2006 and until 2018, 35 takeovers were registered by the CMVM, at an average of 3 per year, the

majority of which corresponding to mandatory takeovers. This trend shows that, in a small market with listed companies with a highly concentrated shareholder structure and low levels of free float, takeovers are not primarily looked at as means to acquire control, but as a legal consequence with the purpose to legitimate control acquisitions (deriving from private negotiations with the previous controlling shareholder).

Table 9.1. Overview of takeovers in Portugal 2007-2017

	Total number of takeovers launched[1]	Mandatory takeovers	Auditor appointed to determine the consideration
2007	12	5	3
2008	2	2	2
2009	4	4	3
2010	2	0	0
2011	1	1	1
2012	3	3	1
2013	0	0	0
2014	4	2	2
2015	1	0	0
2016	0	0	0
2017	6	2	1
Total	35	19	13

1. Excluding tender offers of debt instruments and acquisitions of own shares
Source: CMVM.

In most of the mandatory takeovers launched during said period the consideration initially offered was deemed non-equitable (considering the applicable regime detailed below) and an independent auditor was appointed to determine the applicable minimum consideration. This circumstance is intimately connected with the way change of control usually occurs in the Portuguese markets: once the control is acquired from the previous controlling shareholder, the consideration paid is suspected to be inequitable or unfair, given the private negotiations leading to the referred change in control. In this case, the intervention of an independent auditor is the only measure provided by law to prevent the risk of the parties to establish among them a fictionally low consideration, expecting this price to be the one offered to minority shareholders.

In the context of proportional and flexible legal mechanisms, the Portuguese regime provides for certain derogations to the mandatory bid rule, if the control over a given company is acquired as a result of (and provided that certain additional requirements are met):

- Prior voluntary bid,
- Merger, approved by the shareholders of the companies involved,
- Financially distressed situation of the target company.

A few cases over the past ten years met the criteria mentioned above, as follows.

Table 9.2. Derogations in Portugal 2007 – 2017

	Due to a prior voluntary takeover	Approved merger	Due to a financially distressed situation
2007	-	-	-
2008	-	2	1
2009	-	-	-
2010	-	-	-
2011	-	-	-
2012	-	-	-
2013	-	1	-
2014	1	-	-
2015	1	-	-
2016	-	-	-
2017	1	-	-
Total	3	3	1

Source: CMVM.

In addition, a suspension from the mandatory bid rule may also apply, provided that a compromise to put an end to the situation triggering the mandatory bid rule is submitted to the CMVM. From 2007 until the date hereof, two announcements of suspension from the mandatory bid rule were presented to the CMVM.

Description of law and practice on the Mandatory Bid Rule (MBR)

The Portuguese Securities Code

The mandatory bid rule (MBR) was foreseen in Portuguese law way before the Takeover Directive,[7] but was adapted to the later in due time. Its aim is well known, and actually quite simple: protection of minority shareholders in case of a change of control. Nevertheless, it is still very hard to find two Member States with the same legal provisions, the same perspective on its grounds and even more difficult to achieve harmonization on the circumstances under which the exemptions to the MBR shall apply.[8] In fact, under its apparently simple configuration, the MBR implementation can be very challenging, especially with regards to the determination of the triggering event and the adequate circumscription of its exemptions.

Portugal law, duly interpreted from a systematic and teleological point of view, includes mechanisms that ensure flexibility and proportionality. It should be read as imposing a bid only when a *change of control actually occurs*, and not in an exclusively formal perspective. The starting point is article 5 of the Takeover Directive, which clearly states that «[w]here a natural or legal person (…) holds securities of a company (…) giving him/her control of that company, Member States shall ensure that such a person is required to make a bid as a means of protecting the minority shareholders of that company».

The rationale for such duty lies, according to the wording of the Directive itself, in the need to protect minority shareholders against the emergence of a new controlling position. The reference to the crossing of certain percentages of voting rights has led most Member States to solely rely on a *formal* and *quantitative* perspective of control, assuming that it exists when fixed thresholds are exceeded.

However, this path may lead to results which are contradictory to the spirit of the Directive, imposing this duty in cases where there is no control, and stopping short to impose it on cases where it actually exists. Therefore, the MBR should be read as requiring a *qualitative* and *material* assessment of a change of control, based on a *formal* and *objective* verification of a *quantitative* sum up of voting rights, crossing a predetermined relevant threshold.

The crossing of a certain percentage of voting rights should, thus, be taken as part of a broader set of circumstances that point to an actual acquisition of control. For this purpose, control should be construed as holding voting power that allows its holder to determine the path of the company.

The Takeover Directive states that «[t]he percentage of voting rights which confers control (…) shall be determined by the rules of the Member State in which the company has its registered office». In Portugal, the percentage was set at 1/3 and 1/2 of voting rights. This can be seen as a mechanism of flexibility and proportionality. Depending on the specific shareholding structure and free float of the target company, one may assess whether controlling 1/3 of voting rights actually confers the power to exercise dominant influence over the company or if that power only comes up with the crossing of the 1/2 threshold.

The criteria are to determine when a controlling position emerges are: i) holding the majority of voting rights, ii) having the power, by virtue of a shareholder's agreement, to determine how the majority of voting rights are exercised, or iii) having the power to appoint or dismiss the majority of the members of the board of directors or of the supervisory board. In companies with a widespread free float and historically absent shareholders', control is quite often achieved below the ½ threshold of the company's share capital.

In short, the MRB should be read as based on a *qualitative* assessment that follows the crossing of *quantitative* thresholds. Control lies on whoever has the voting power to determine the company's will through shareholders' resolutions. Differently, in some other European Member States, the MBR is based solely on *quantitative* thresholds, complemented by a series of derogations and/or by the power of the National Competent Authority to derogate the MBR, on a case by case basis. That was also the case for Portuguese Law until the enactment of the Securities Code in 2000.

Derogations to the MBR were then significantly reduced, promoting a higher level of predictability and transparency as to when the MBR is actually triggered and, at the same time, ensuring the protection of minority shareholders. Recently, the European Commission has addressed this issue in its report. The attention was drawn to the fact that setting forth a long list of exemptions to the MBR would probably not be in accordance with the strict requirements imposed by the Takeover Bids Directive on Member States.

With the enactment of the Securities Code in 2000, CMVM´s powers to grant exemptions was suppressed, as it constituted a source of uncertainty to whether the MBR would actually become enforceable. Investors always seek an exemption, leaving minority shareholders uncertain as to whether they would be able to sell their shares or note. The powers of the CMVM are thus limited to the assessment of whether a legal derogation applies or not in each specific case (see section 3.2. below).

Currently, the Portuguese Securities Code foresees three derogations, applicable only in circumstances where it has been proved that a change of control has already occurred.

They are an *ex post* tool to mitigate or correct certain inequities that could arise from the strict application of the MBR. The rule is derogated when:

- Someone acquires control as a consequence of a voluntary bid to acquire all shares of the company, complying with the price requirements of the MBR;
- Someone acquires control as result of a merger where the controlling position had been clearly pointed out and effectively approved at general shareholders' meetings; and
- Someone acquires control in the context of a financial recovery plan, when the company is in a financial distressed situation.

These derogations are complemented by other mechanisms to correct potential iniquities. E.g.: a person who has acquired control unintentionally and did not exercise said control may be exempt from the MBR if it renders control within a certain period. All these mechanisms promote flexibility and proportionality.

CMVM's intervention

CMVM is the Portuguese authority responsible for the supervision of securities market and for the enforcement of the Takeovers' Directive, namely with regards to the mandatory bid rule. CMVM exercises its supervisory powers in accordance with a set of principles established by law, the most important of which is investors' protection. In this context, the CMVM supervises the takeover bids' procedure, from the disclosure of the preliminary announcement to the publication of the offer's results.

The CMVM is legally empowered to decide on a wide range of key issues, including the assessment of whether a change of control actually occurred and other aspects of the enforcement of the MBR. Therefore, investors who think the MBR is not applicable in a specific case must prove it to the CMVM. Likewise, investors who seek a derogation to the MBR, must prove to the CMVM the fulfilment of the corresponding requirements.

The role of the CMVM may be seen as providing flexibility and proportionality to the takeover bids' regime. However, when deciding on the application of the relevant legal provisions, CMVM is legally bound to grant a derogation or to recognize the absence of control only when the defined legal requirements are met.

As such, CMVM is not legally granted a discretionary power to decide on a case by case basis, thus providing market participants with greater predictability, transparency and legal certainty. The specific circumstances of the case are only relevant within the remit of the rules which apply to the referred mechanisms. CMVM's is bound to apply the law according to an adequate balance between minority shareholders' protection and the interests of investors acquiring major shareholdings in a listed company.

When enforcing the MBR, CMVM also plays a key role in the assessment of the consideration to be paid in the mandatory bid. CMVM must assess whether the proposed consideration meets the legal requirements, namely if it is *duly justified and equitable*. CMVM has the legal duty to verify if the consideration presented by the offeror is not lower than (i) the highest price paid by the offeror in the last six months for the acquisition of shares of the same category as those object of the offer; and (ii) the average price of these securities in a regulated market in the same period.

If it is not possible to determine the minimum consideration based on those criteria or if the CMVM considers that the proposed consideration is not duly justified or equitable, consideration must be determined by an independent auditor appointed by the CMVM.

The Securities Code foresees three cases where the consideration is presumed non-equitable, forcing the appointment of an independent auditor:

- the highest price was set by means of an agreement between the purchaser and the seller, in the context of a private negotiation;
- the targeted securities have low level of liquidity with reference to the regulated market in which they are admitted to trading;
- the consideration has been determined on the basis of the securities market price and either said price or the market in which the securities are trading was affected by extraordinary events (e.g., a long suspension of trading).

In short, the role played by the CMVM promotes flexibility and proportionality, which is especially evident when:

- assessing the emergence of a controlling position, in order to enforce the MBR;
- evaluating the evidence that the holder of more than 1/3 and less than 1/2 of voting rights does not control the company;
- verifying the applicability of a legal derogation to the MBR; and
- ensuring that the consideration to be paid is duly justified and equitable.

Flexibility and proportionality within the regulatory framework

The ability to prove the absence of control in a two tier relevant thresholds' model

As mentioned before, for the purposes of the Portuguese MBR, exceeding the relevant thresholds of voting rights is only relevant when someone actually acquires control the company. For that reason, and in order to ensure compatibility with the Takeover Directives' principles, Portuguese law allows that a person who has crossed the 1/3 threshold to prove before the CMVM that, nevertheless, he does not control the company.

One third of voting rights *usually* confers the possibility to control company, considering relatively large free floats and low levels of attendance at general meetings. However, shareholders may prove that, under specific circumstances, such voting rights do not provide them with the power to control the company.

The shareholder may, e.g., demonstrate that another shareholder controls the company, based on a higher voting power: shareholder A has acquired shares representing 35% of voting rights, while shareholder B already held a 51% stake; shareholder A proves the absence of control by arguing that shareholder B holds control over the company. If shareholder A proves the absence of control he is not forced to bid.

Another possible way to prove the absence of control is by arguing that the 1/3 voting rights do not carry a relevant voting power due to voting caps set forth by the articles of association: the owner of a 15% stake in a public company – which articles of association state that votes cast are necessarily limited to 20% of the share capital – that increases his stake to 40% must inform the market for transparency purposes, but will still have its voting power limited to 20%, considering the voting cap. Therefore, it will not be forced to bid.

The number of votes above the voting cap tends to be irrelevant in terms of voting, as they may not be exercised at general shareholders' meetings. For as long as the voting caps are in place, the shareholder's voting power will not exceed the voting cap, preventing him to control the company.

However, the proof of absence of control is only valid for as long as the person that had proved such absence of control does not reinforce his stake up to a controlling position. If that becomes the case, the MBR will apply, regardless of the thresholds that might have – or not have – been crossed. This will be the case when, by reference to the examples provided above, shareholder B sells its 51% stake to various unrelated shareholders (thus shareholder A becoming the one with the higher voting power), or when voting caps are removed.

From the combination of these elements, we conclude that the MBR will only be enforceable when the crossing of voting rights entails acquisition of a controlling position. Otherwise, the MBR would be imposed on those who do not effectively control the public company. As such, the proof of absence of control really comes out as an important mechanism of flexibility and proportionality in the Portuguese legal framework, with regards to the enforcement of the MBR.

Derogations to the MBR

The derogations to the MBR are another important legal mechanism introducing flexibility and proportionality. Its intention is to prevent iniquities deriving from the imposition of the MBR in cases where minority shareholders do not require the protection of such mechanism, because they have been protected by other means. That is the case when control arises:

- as a consequence of a previously launched voluntary bid;
- in the context of a merger, approved by the shareholders of the companies involved;
- in the context of the recovery of a financially distressed company.

Acquisition of control following a voluntary bid: The MBR shall not apply when the acquisition of control results from a prior voluntary takeover launched over all shares of the target company, complying with the equitable price rules of the mandatory bid, mentioned above.

The rationale for this derogation is that minority shareholders had the chance to exit by accepting the previous offer. A further mechanism to protect them would impose a disproportional burden to the offeror.

In addition, if the offeror, in the context of the voluntary takeover, reaches 90% of the voting rights of the target company and acquires 90% of the shares subject to the voluntary takeover, the minority shareholders have the right, during a 3-month period, to request that the (new) dominant shareholder acquires their shares. This mechanism is deemed as an additional option to exit the target company.

Acquisition of control in the context of a merger: In addition, the MBR shall also not apply whenever the control holding results from a merger, which is necessarily approved by the shareholders of the companies involved, including the company that would be the “target company” if this derogation would not apply.

The information disclosed prior to the general meeting of shareholders must clearly disclose that the MBR would apply if this derogation was not provided for, as well as the criteria for attribution of shares and/or the new shareholders structure, including a new control.

The merger must be registered with the Companies Registrar, which may refuse to register it in specific circumstances where it causes losses to certain shareholders. In this

case, registration is only permitted if such shareholders give their consent, in addition to the shareholders resolution taken at the general meeting. In this context, additional mechanisms to protect minority shareholders – such as the MBR – are deemed unnecessary.

Acquisition of control of a company in a financially distressed situation: The MBR is also derogated when control is acquired within a (administrative or judicial) process of recovery of the company in a financially distressed situation. This includes any recovery process established under Portuguese law, including, for instance, any resolution measures or write-down and/or conversion of own funds of financial institutions.

This derogation is meant to avoid delays or difficulties in implementing such recoveries processes, thus accepting a reduced protection of the shareholders in order to enhance any chances of survival of the company and taking into consideration the company's obligations towards its creditors and stakeholders in general.

The commitment to cease the triggering event and the suspension of the MBR

The MBR may be suspended upon inadvertent or undesirable acquisitions of control. The law provides for this flexible solution whenever the shareholder undertakes before the CMVM to put an end to the control situation and not to exercise control. From the moment the shareholder publicly announces its intention, he's given a 120 days period to, for instance, sell at least the sufficient number of shares in order to ensure that his controlling position comes below the relevant thresholds, to persons not acting in concert with him. During this period, the exercise of voting rights is inhibited, as a preventive measure.

Although the selling of shares is usually the most adequate and obvious way to put an end to a controlling position, that is not the only way to achieve this goal. Where the controlling position does not lie on the ownership of shares but on other mechanisms (shareholders' agreements), that sale might not even allow that result.

In all circumstances, it is imperative to reduce the voting power to the extent that the shareholder can no longer assert any dominant influence over the company. It is somehow irrelevant how the controlling position ceases, since what matters is that the controlling shareholder ceases to control, either because of a capital increase diluting his position, or because of an amendment to the company's articles of association introducing a voting cap (see below).

The commitment to cease the triggering event and the assumption that the control was not yet, and will not be, exercised by the new controlling shareholder, are key features of a proportional approach to the conciliation of conflicting interests. Minority shareholders are protected because the controlling ability is suspended – as no voting power can be exercised at general meetings – and the controlling shareholder is given a 120 days period to cease the triggering event. The controlling shareholder not intending to exercise control over the company is given the chance to revert this situation, without ever benefitting from it.

The imposition of the MBR under these circumstances would not be in accordance with the Takeover Directive's scope of protection and would come out as a very disproportionate consequence, considering that minority shareholders do not require protection from a controlling position which is immediately suspended, following the acquisition of control.

Case studies on proportional and flexible mechanisms within the Portuguese securities market

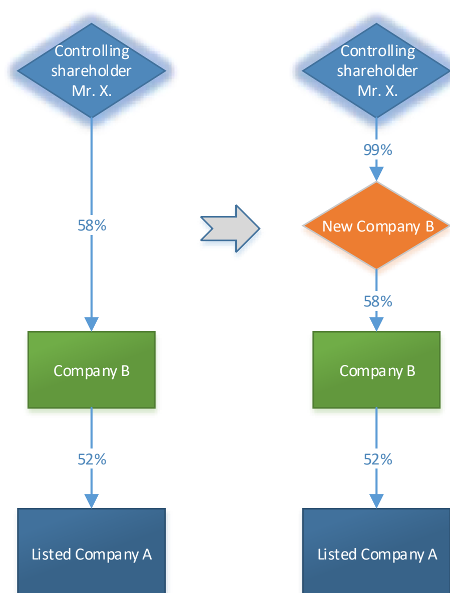
In the context of corporate restructuring

Several cases of corporate restructuring were submitted to the CMVM for analysis under the MBR. Such cases involved changes in the chain of control (*e.g.*, by including a new company or by changing the relevant holdings by companies within the group).

CASE 1: Company A is listed in the Portuguese regulated market and its major shareholder (Mr. X, a natural person holding more than 50% of its share capital) sets up Company B (with a 99.99% stake) to which it transfers its controlling stake in Company A. The question was if Company B was subject to the MBR, as the new major shareholder of Listed Company A.

CMVM understood that the control stake of Company B was not different from the prior position of control of Mr. X. Such control was neither changed nor replaced by a new position, as the ultimate beneficial owner remains the same. Therefore, Company B is a mere vehicle for Mr. X, who remains in control of Listed Company A.

Figure 9.10. The Portuguese securities market: Case 1



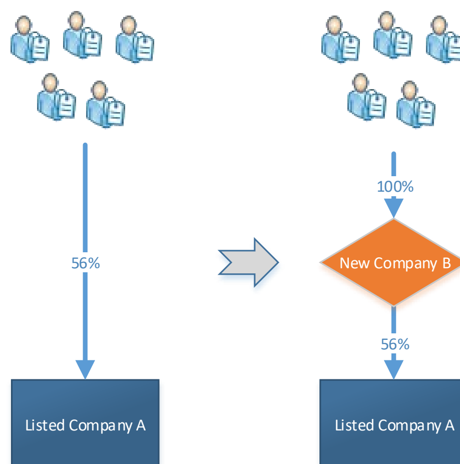
Source: CMVM

CASE 2: CMVM was called upon to decide, in advance, whether a corporate restructuring (essentially for tax purposes) should give rise to a mandatory takeover. In the context of this corporate restructuring, Company C, incorporated in another Member State, would acquire the controlling stake in a Portuguese listed company (Company A) from Company B, a Portuguese company. The chain of control of Company C was specifically set up to reproduce the existing chain of control of Company B.

Having analysed the chain of control and the corporate bodies planned for Company C, CMVM concluded that the transfer of this controlling stake was not a change of control, but merely a formal transfer to another company, controlled by the same shareholders, in

the same manner. The position of control remained unchanged. Therefore, Company C was not subject to the MBR.

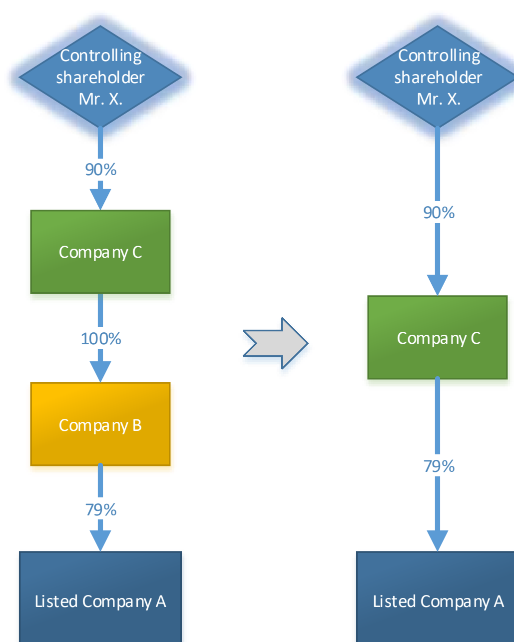
Figure 9.11. The Portuguese securities market: Case 2



Source: CMVM

CASE 3: Similar to Case 1 above. Mr. X, a natural person that was indirectly (*via* Company C) the major shareholder of Company A (a Portuguese listed company), through Company B (incorporated in Portugal), intended to transfer said major holding to Company C (incorporated in another Member State). As in Case 1, CMVM decided that the transfer to Company C would not give rise to a mandatory takeover, provided that the ultimate beneficial owner remained the same.

Figure 9.12. The Portuguese securities market: Case 3

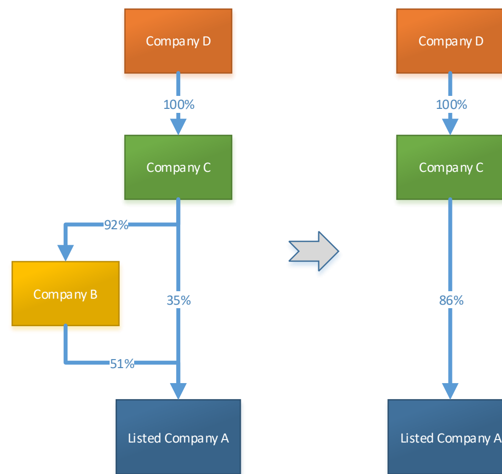


Source: CMVM

CASE 4: Company B held a controlling stake of more than 50% in Company A — a Portuguese non-listed public company (sociedade aberta) — and was, in turn, controlled by Company C, which was fully owned by Company D, the ultimate beneficial owner of control over Listed Company A. Company C intended to acquire from Company B its stake in Company A, as part of an intragroup corporate restructuring.

The CMVM concluded that the restructuring would not involve a change of control (although Company C has directly crossed the 50% threshold in Listed Company A), as the ultimate beneficial owner of Company A remained unchanged (Company D).

Figure 9.13. The Portuguese securities market: Case 4

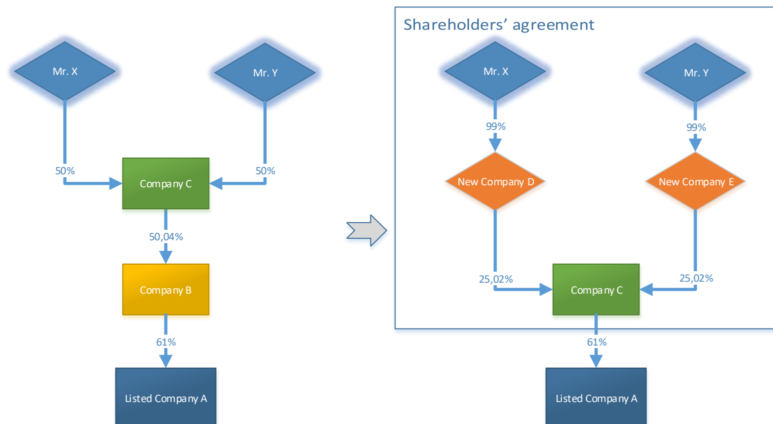


Source: CMVM

CASE 5: Mr. X and Mr. Y, natural persons, jointly controlled Company A which, in turn, held a major stake in Company B (a Portuguese listed company). Mr. X and Mr. Y intended to enter into a shareholders' agreement and add, in relation to each natural person, a new company in the chain of control.

The CMVM resolved that, although the mechanism of joint control was different, the transaction did not involve a change of control.

Figure 9.14. The Portuguese securities market: Case 5



Source: CMVM

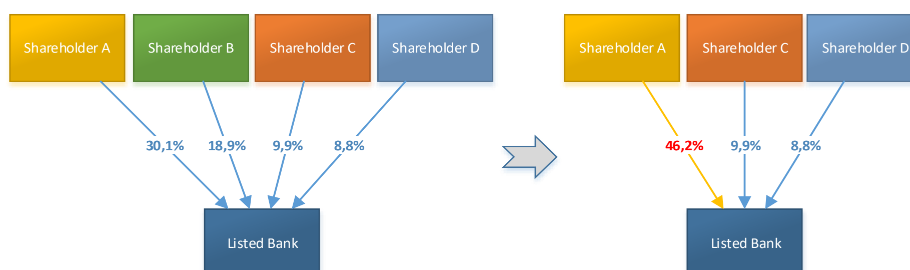
Voting caps as proof of lack of control and as a remedy for inadvertent acquisitions of control

Case study A: Voting caps as proof of lack of control. As described above, crossing 1/3 threshold of voting rights is deemed as acquiring control the company, given the theoretical high level of free float and the fact that not all shareholders attend general shareholders' meetings.

This is a (rebuttable) presumption that may be out of touch with the specific circumstances of a given listed company. As such, the shareholder crossing said threshold (but not the 1/2 threshold), may prove to the CMVM that, in fact, he is not in control of the company, because he does not hold the voting power required to determine the decisions of its corporate bodies (article 187/2 of the Securities Code).

In 2012 there was one such case, involving a Portuguese listed bank. One of its shareholder (which initially held approx. 30% of its share capital and voting rights), acquired a new block of shares and its stake in the bank raised to 48.97% of its share capital and voting rights.

Figure 9.15. The Portuguese securities market: Case study A



Source: CMVM

Having crossed the 1/3 threshold, the shareholder tried to prove to the CMVM that he did not control the company, and, as such, should not be forced to launch a takeover bid. He alleged that the exiting voting cap limited his voting power below the relevant threshold. He further stated that, considering two other relevant circumstances, he could not actually control the bank. These other two relevant circumstances were *(i)* the fact that there were two other unrelated shareholders with an approximately similar voting power (close to the voting cap), with the power to block any intention to exercise control, and *(ii)* the fact that he had not appointed and, therefore, was not "represented" in the board, by the majority of its members.

CMVM held that the concept of control, foreseen in the PSC – as understood in accordance with the Takeover Directive –, is mainly a qualitative concept, although based in quantitative thresholds (as mentioned above). The *qualitative* element of control is the possibility of exercising a dominant influence, reflected, for example, in the possibility of exercising the majority of the voting rights or of appointing (or removing) the majority of the board members. The *quantitative* thresholds (a fixed percentage of voting rights) are the means to determine whether someone actually holds control over a listed company. Such thresholds alone do not trigger the MBR.

Therefore, a shareholder crossing the 1/3 threshold is not forced to bid if he proves to the CMVM that, notwithstanding the number of voting rights he controls, he does not have the power to exercise control over the listed company. This is known as *the proof of lack*

of control. A typical example is the case in which another shareholder, not related to him, holds a higher stake in the company (*v.g.*, 51%).

In this specific case, nevertheless, there was no shareholder with a higher stake, but there were several factors that, combined altogether, forced CMVM to the conclusion that the relevant shareholder did not control the company. Perhaps the most relevant factor was the existence of a voting cap. This cap actually converted a 40% qualified stake in a limited voting power of 20%. With such limited voting power, the shareholder was not able to determine, on its own, the company's decisions, including the election of the members of the corporate bodies.

Besides, the relevant shareholder was not the only one with a relevant position, as it was followed closely by two other unrelated shareholders with a similar position in the company's share capital (shareholders with an historical frequent high level of attendance at the general meetings). Together, these two circumstances lead to another relevant one, which was the fact that this shareholder's position did not grant him the possibility to appoint and be "represented" by the majority of the board members.

In short, the relevant shareholder had only a *formal* controlling position – a stake higher than 1/3 of the company's voting rights – but did not have the substantial power to actually determine, on its own, the company's will. Thus, he was not materially in control of the company.

A few years later (2016), the previously described situation would undergo a relevant modification. As the financial situation of the listed company became significantly affected by the financial crisis, shareholders were forced to take measures to recapitalize and strengthen its financial situation. In this context, the voting cap was blocking further investments in the company, as shareholders had an incentive not to subscribe additional shares over the voting cap. That would have created a gap between the financial risk taken and their voting power.

Reverting the voting cap became an issue. As shareholders failed to reach an agreement, the Government enacted a new law, allowing voting caps at financial institutions to be revoked under a breakthrough rule. As long as revocation was proposed by the board, a simple shareholders resolution with no voting caps and no supermajorities would suffice.

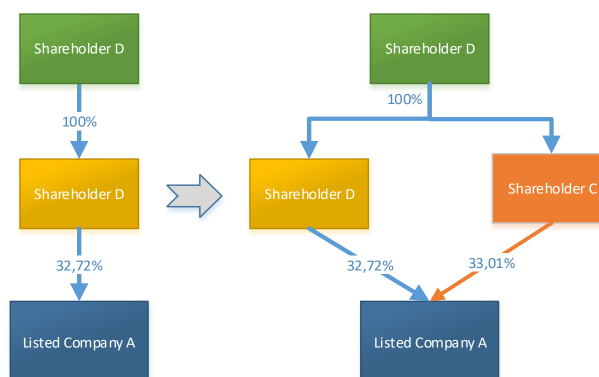
Based on this new law, voting caps were revoked in this bank, turning the *formal* control of the aforementioned relevant shareholder into a *material* one. Therefore, said shareholder could no longer prove a lack of control and was forced to bid. In this case, the duty to bid arose independently from the acquisition of any additional shares. The MBR relies not only on the acquisition of shares, but also on other relevant changes in the voting power of a specific shareholder, including entering into shareholders agreements or abolition of voting caps.

Case study B: voting caps as a remedy to inadvertent acquisitions of control. In 2011, Company A, facing a financially distressed situation, decided to convert some of its debt into capital. In order to achieve this goal, it issued non-voting preferred shares that were subscribed by its major creditors. With the proceeds of the issuance of those preferred shares, Company A reimbursed part of its debt.

The Portuguese legal regime on non-voting preferred shares entitles the holders of these shares to receive a priority dividend and, if such priority dividends are not paid two years in a row, they become entitled to voting rights.

At the annual general meeting of 2014, Company A confirmed non-compliance with the obligation to pay said priority dividend for two years in a row, therefore entitling the holders of the non-voting preferred shares with voting rights. At that time, shareholders B and C – both controlled by shareholder D – acquired an additional voting power, causing D to overcome the 1/3 threshold. Therefore, shareholder D was forced to announce a mandatory bid (art. 187/1 of the Securities Code). Under the transparency rules, the shareholders B and C informed the CMVM and the company that they became to hold voting rights representing 43.89% of the total share capital.

Figure 9.16. The Portuguese securities market: Case study B



Source: CMVM

Shareholder D could not prove lack of control because it was, in fact, able to exercise control. However, shareholder C, which held approximately 1/3 of the voting rights (by virtue of its preferred shares), argued that it did not intend to exercise control, as its shareholding was of a purely financial nature. Therefore, these shareholders intended to suspend their duty to announce a bid and put an end to their control over Company A, under article 190 of the Securities Code. This mechanism is intended to cover situations of inadvertent acquisitions of control.

They submitted to the CMVM a list of measures intended to put an end to the referred controlling position within the 120 days legal deadline (following the occurrence of the event constituting the obligation). However, shortly after, it became clear that, although D did not intend to exercise control over A (nor ever exercised it), it was not feasible for it to sell sufficient shares in the market (without causing a significant depreciation) as to lower its voting power below the relevant legal threshold.

The shareholders then suggested, as an alternative, to include a voting cap of 33.3% in Company A's articles of association. This solution would safeguard the interests of minority shareholders who would benefit from the stabilization of the shareholding structure of the company and from the fact that no one would have a controlling position over the company. This solution was approved at a shareholders meeting within the 120 days foreseen in article 190 of the Securities Code.

The CMVM then concluded that, considering the voting cap and the major stakes of each shareholder, shareholder D did not actually control Company A and, therefore, was not subject to the MBR.

Conclusions of the case study

Portugal, as member of the European Union, is legally bound to European Directives and Regulations. This implies that the Portuguese regime governing takeovers must be in accordance with the Takeover Directive (Directive 2004/25/EC of the European Parliament and of the Council) transposed into national law in 2006.

The transposition of this Directive, however, did not lead to significant changes in the pre-existing regime, considering that it was already aligned with most of its rules. Takeover Directive is deemed as a minimum harmonization Directive, thus providing various options to the Member States. For that reason, this Directive encloses mechanisms of flexibility and proportionality, by virtue of allowing EU member states to opt-in/opt-out in respect of certain provisions.

Taking advantage of this flexibility, and bearing in mind the main goal of the Directive – protection of minority shareholders in the event of a change of control –, the Portuguese regime seeks to reconcile the confronting interests, determining that the protection to be granted to minority shareholders through the possibility of selling their shares at a fair and equitable price shall only be imposed on a third party whenever this third party has actually acquired the power to exercise a controlling influence over the company.

In cases where certain thresholds have been crossed without acquiring a controlling influence, the MBR shall not apply, because shareholders do not require to be protected against an inexistent controlling position.

In certain circumstances, it is up to the holder of a qualifying position to demonstrate to the competent authority that, despite the attribution of voting rights, no power to exercise control over the company exists, in order to discharge the MBR.

Along with these, other situations exist where a controlling position effectively put in place does not lead to the enforceability of the MBR: this is the case when the control was acquired following a takeover bid, in the context of a merger or in the context of the recovery or insolvency plan. In these cases, not only minority shareholders protection is ensured by means different from the possibility of selling their shares in the context of a mandatory takeover bid, but also other interests are deemed relevant.

Lastly, another mechanism of flexibility and proportionality is the possibility of suspension of the MBR, allowing the possibility of the holder of control to undertake before the CMVM to put an end to the control situation, without ever exercising its controlling position.

The combination of the applicable rules and principles allow the identification of a mandatory bid rule regime with flexibility and proportionality mechanisms, foreseen in order to promote the adequate composition of the interests involved, ultimately aimed at safeguarding the protection of minority shareholders faced with an effective change of control.

Conclusions

The survey results shows that three quarters of the jurisdictions covered by the report have provided for flexible or proportional means to implement takeover regulations in their corporate governance frameworks. This is regardless of the different approaches to takeover regulation adopts across jurisdictions, which the OECD Corporate Governance

Factbook describes as including include mandatory as well as voluntary regimes, some operating ex-ante and others ex-post.

As argued in the chapter, in dealing with an area of regulation that may impose important burdens on their targets (i.e. preventing the board of the target company from deploying anti-takeover measures or force a buyer to give all other shareholders a chance to tender their own shares) at critical times in a firms' life, a flexible and proportional approach offers a way to ensure that the policy objectives are met without causing large unintended consequences.

This is part of the EU Takeover Directive approach as well, which includes mechanisms of flexibility and proportionality by allowing EU member states to opt-in or out with respect to certain provisions. The Portuguese case study offers a window into the thinking behind the choices the Portuguese authorities have adopted in implementing the Directive. For them, a combination rules and principles allows for the identification of a mandatory bid rule regime with flexibility and proportionality mechanisms, thought to promote the adequate equilibrium that can effectively protect minority shareholders' interest.

Notes

[1] The roundtable discussed the importance of a well-functioning and transparent market for corporate control for industrial restructuring and effective allocation of productive resources.

[2] In two jurisdictions with ex-ante frameworks (Japan and Korea), acquisition of 5% of voting rights from more than 10 shareholders within a certain period is also prescribed as a trigger for mandatory takeover bids. In Italy, the triggering threshold is differentiated with reference to the size of companies. While SMEs may establish in the bylaws a threshold in the range between 25% and 40% of voting rights, the threshold for other companies is 25% of voting rights.

[3] There are other mechanisms, used less often and particularly in situations involving illiquid stocks, such as the price being fixed by an appraiser firm or calculated based on net assets divided by number of shares.

[4] See DAF/CA/CG/RD(2016)8.

[5] See http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32004L0025&from=en.

[6] Under Delaware corporate law, flexibility and proportionality is also present in the permissibility of corporations to adopt a dual class capital structure; adopt a 'poison pill' shareholder rights plan; structure the terms of directors so that re-election is staggered; not enable shareholders to act by written consent; and not provide a mechanism by which shareholders can call a special meeting. All of these defensive provisions, collectively and individually, may affect the company's ownership and control structure and, in turn, its attractiveness to not only receive takeover offers in the market for corporate control, but also offers reflective of fair market value even if made.

[7] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142/12 of 30.03.2004, p.38. Available at http://ec.europa.eu/internal_market/company/official/index_en.htm.

[8] Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions, on the application of directive 2004/25/EC on takeover bids, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012 DC0347&from=PT.

References

Hermalin, B. (2005), "Trends in Corporate Governance", The Journal of Finance, Vol. 60/5, pp. 2351-2384, http://dx.doi.org/10.1111/j.1540-6261.2005.00801.x.

OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, https://doi.org/10.1787/9789264236882-en.

OECD (2017), "OECD Corporate Governance Factbook 2017", http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.

Pepper, A., J. Gore and A. Pepper Dba (2013), "The economic psychology of incentives: an international study of top managers The Economic Psychology of Incentives: An International Study of Top Managers The Economic Psychology of Incentives: An International Study of Top Managers", http://dx.doi.org/10.1016/j.jwb.2013.07.002.

Slaughter and May Law Firm (2006), The European Takeovers Directive -an overview, http://www.slaughterandmay.com/media/39335/the_european_takeovers_directive_-_an%20overview.pdf.

Annex A. Survey instrument

OECD Corporate Governance Committee: Questionnaire Thematic Peer Review on Flexibility and Proportionality in Corporate Governance Frameworks (2017)

The OECD Corporate Governance Committee has decided to conduct a thematic peer review[1] on the use of flexibility and proportionality in corporate governance frameworks. This questionnaire seeks to take stock of criteria and mechanisms that may motivate and allow flexibility and proportionality in the application of rules and regulations relating to selected areas of regulation within corporate governance frameworks.

BACKGROUND

Chapter I of the G20/OECD Principles of Corporate Governance states that the corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources, and that it should be consistent with the rule of law and support effective supervision and enforcement. It further says that the corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and well-functioning markets.

Chapter I also states that the corporate form of organisation of economic activity is a powerful force for growth, and that the regulatory and legal environment within which corporations operate therefore is of key importance to overall economic outcomes. The G20/OECD Principles of Corporate Governance further highlight that policy makers have a responsibility to put in place a framework that is flexible enough to meet the needs of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources.

The annotations add that, where appropriate, corporate governance frameworks should allow for flexibility and proportionality, in particular with respect to the size of listed companies, but also with respect to other factors such as the company's ownership and control structure, geographical presence, sectors of activity, and the company's stage of development. The annotations further state that policy makers in the design of the regulatory framework should remain focussed on ultimate economic outcomes and when considering policy options, they will need to undertake an analysis of the impact on key variables that affect the functioning of markets, for example in terms of incentive structures, the efficiency of self-regulatory systems and dealing with systemic conflicts of interest.

SELECTED AREAS OF REGULATION

This questionnaire seeks to take stock of criteria and mechanisms that may motivate and allow flexibility and proportionality in the application of rules and regulations in

corporate governance frameworks. In order to limit the scope of a potentially extremely wide data collection exercise, 7 areas of regulation will be covered by this thematic peer review:

- Pre-emptive rights
- Board composition, board committees and board member qualifications
- Say on pay and the detail of disclosure on remuneration
- Related party transactions
- Periodic financial information and ad-hoc information
- Major shareholding disclosure
- Takeovers

FLEXIBILITY AND PROPORTIONALITY CRITERIA

The questionnaire will cover the flexibility and proportionality criteria listed below that may motivate and allow flexibility and proportionality with respect to the application of rules in the areas listed above. As noted, some of these criteria can be defined in more than one way (for example company size can be defined as sales, employees, market capitalization, etc.). For the sake of this questionnaire, we will call these "dimensions" within each criterion.

- Size, in terms of:
  - equity;
  - sales;
  - revenues;
  - assets;
  - debt;
  - work force;
  - market capitalization.
- Ownership/control structure:
  - controlling shareholder;
  - blockholders;
  - free float;
  - subsidiaries of listed companies;[2]
  - private placements;
  - large privately owned firms.[3]
- Listing/Publicly traded:
  - listing level;
  - listing venue;
  - debt only listing;
  - cross-listing;
  - trading in alternative trading platforms or other alternative trading venues.
- Maturity of the firm (number of years that the company has been listed)
- Accounting standards used
- Legal form

GUIDE FOR COMPLETING THE QUESTIONNAIRE

Scope

Corporate Governance Framework: In order to determine the scope of your answers, please consider that for this questionnaire we will focus mainly on the **mandatory** elements of the corporate governance framework, typically comprising company law, securities law and listing requirements. **Codes** of corporate governance, important in many frameworks, are applied under different regimes, often under voluntary comply-or-explain mechanisms (that are in itself a flexibility and proportionality tool). If your Code is of voluntary application (including comply-or-explain) we will ask you to consider it in your responses but with the following **limitation**: focusing your answers only on any flexibility and proportionality features included explicitly in the text of the Code recommendations themselves.[4] Please do not consider any other voluntary source beyond your national Code, including any self-regulatory arrangements, voluntary commitments, and business practices.

Special sectors of activity and firms: Again for reasons of managing the scope of the review, this questionnaire is also not looking to collect information about the use of flexibility and proportionality as applied to special sectors of activity (typically the financial sector, but also true in respect to others). The same is true for state-owned enterprises (SOEs) and for foreign companies listed in your jurisdiction. We have opted to **exclude** them to avoid making this exercise too broad to handle. In your responses to the questions related to the 7 areas of regulation, please focus on the corporate governance framework as applied to non-financial companies and please ignore special sectors of activities, SOEs and foreign listed companies. However, please note that in order to have a general idea of their influence, you will find that we have addressed these separate issues with a couple of questions included at the end of the questionnaire.

Structure

In terms of the organisation of the questionnaire, it is composed of 8 sections. The first 7 sections cover the 7 areas of regulation and will present questions about the criteria used in the relevant area. The last section contains general questions aimed at, first, identifying who is responding and, second, to cover the sectorial criteria mentioned in the preceding paragraph. For the main part, the questionnaire is structured as follows:

1) First, you will be asked to **identify the criteria** (and in some cases also the dimensions within each criterion) that are used in your corporate governance framework to motivate flexibility and proportionality with respect to the application of regulation in the different areas of regulation. If more than one criterion is used for motivating flexibility and proportionality, you should indicate all the criteria used. If a criterion used is not listed in the questionnaire, you can add it by choosing *Other* and typing the necessary text. If there are no criteria allowing for flexibility and proportionality in the relevant area of regulation, you can simply choose *None* and move to the next page.

2) Second, you will be asked about the use of **"opt-in" and "opt-out" mechanisms** in your corporate governance framework. Here we are trying to identify flexibility mechanisms within the laws and regulations that may be enabling companies to "opt-in" or "opt-out" of some practice, right or obligation that in the absence of that option would not be mandatory for them (in the case of the opt-in) or would be the default mandatory

rule (in the case of the opt-out). You will be asked to **identify** the use of such mechanisms used in the 7 areas of regulation and to offer a brief **description** of its scope and the mechanisms that companies can use to (i.e. how they can choose or alter the default rule or choose among options that are provided in the law or regulation).

3) Third, provided that you have indicated one or more criteria (and in some cases also dimensions of those criteria) or mechanisms, you will be asked to explain in your own words **how** these criteria and mechanisms allow for flexibility and proportionality in the application of the rules in the particular area.

For example, you may have indicated that Size (of market capitalization) and Ownership/control structure (free float) are criteria that are relevant for how rules relating to board composition and qualifications are applied. Your explanation with respect to how may be that in your country independent directors are only mandated in the composition of the board if the company has a market capitalization equivalent to or greater than USD 85 million and at least 12.5% of its issued voting shares are held by investors that individually control or hold less than 10% of such shares. Or, you may have chosen Size (of workforce) and explain that worker representation on the board is mandatory in almost all companies with more than 25 employees, and further increased from 2 to 3 representatives for companies with more than 1 000 employees which operate in several industries.

4) Finally, you will be asked to provide **a reference** to the law, regulation or rules that contain the provisions that allow for proportionality and flexibility as described in your previous answers and the **date** of their adoption. You will also have the possibility to **upload** the file with the relevant text.

For example, using the same cases described in the previous examples, you will be able to indicate that it is article 50 Bis of the Chilean Stock Company Law (introduced in October 2009) the one that mandates listed companies to appoint at least one independent director when they have the size of market capitalization and free float criteria selected. Likewise, you may say that it is the Swedish 1987 Act on Board Representation for Employees in Private Employment, the one that established the right of employees have to elect board members under different sizes of workforce.

SUBMITTING YOUR RESPONSES

Once you have prepared your answers for the questionnaire, including any relevant inter-agency consultations, we will ask you to please submit them using an online survey tool **no later than 7 July 2017**. By following the link below, you will be able to copy-paste the answers that you have prepared for this document in the online questionnaire that has the exact same structure and content of this document**. Link to online questionnaire:**

http://survey.oecd.org/Survey.aspx?s=0c0e187203cb4256be555fe916240fc6
(please note that the link opens a new browser window, so please ensure
that any pop-up blocking software is temporarily disabled).

When you complete the online questionnaire you will be offered a chance to review and print your answers to verify them. Using this method of submitting your information will make it possible to process the responses in a more secure way and ensure better comparability of the answers.

If you encounter any problems with the online questionnaire, please do not hesitate contacting the OECD Secretariat:

PRE-EMPTIVE RIGHTS

This section seeks to identify the criteria that motivate and allow flexibility and proportionality with respect to the use of pre-emptive rights giving existing shareholders a right to subscribe to new issues of shares in proportion to shares already held, as discussed in Principle II.G of the G20/OECD Principles of Corporate Governance.

Question 1.1*: Which criteria can motivate and allow for flexibility and proportionality when applying rules that relate to pre-emptive rights in your corporate governance framework?

Select all relevant criteria for the topic of this section (*response required).

- □ Size
- □ Ownership/control structure
- □ Listing/publicly traded
- □ Maturity of firm
- □ Accounting standards used
- □ Legal form
- □ Other: _______________
- □ None

Question 1.2c: [Conditional on the fact that *Size* was selected among the answers to question 1.1] You responded that <u>size</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to pre-emptive rights in your corporate governance framework. Please indicate which dimensions of this criterion are used.

Select all dimensions relevant for the topic of this section.

- □ Size of equity
- □ Size of sales
- □ Size of revenues
- □ Size of assets
- □ Size of debt
- □ Size of workforce
- □ Size of market capitalization
- □ Other: _______________

Question 1.3c: [Conditional on the fact that *Ownership/control structure* was selected among the answers to question 1.1] You responded that ownership/control structure is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to pre-emptive rights in your corporate governance framework. Please indicate which dimensions of this criterion are used.

Select all dimensions relevant for the topic of this section.

- □ Controlling shareholder
- □ Blockholders
- □ Free float
- □ Subsidiaries of listed companies
- □ Private placements
- □ Privately owned
- □ Other: _______________

Question 1.4c: [Conditional on the fact that *Listing/publicly traded* was selected among the answers to question 1.1] You responded that listing/publicly traded is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to pre-emptive rights in your corporate governance framework. Please indicate which dimensions of this criterion are used.

Select all dimensions relevant for the topic of this section.

- □ Listing level
- □ Listing venue
- □ Debt only listing
- □ Cross-listing
- □ Trading in alternative trading platforms or other alternative trading venues
- □ Other: ________________

Question 1.5*: Does your corporate governance framework contain "opt-in" or "opt-out" mechanisms that can allow for flexibility when applying rules that relate to pre-emptive rights?

Please select the correct answers (*response required).

- □ Opt-in
- □ Opt-out
- □ None

Question 1.6c: [Conditional on the fact that *None* was not the answer to question 1.1 and 1.5] Please explain how the criteria and/or mechanisms you have selected in the previous questions are used in your corporate governance framework to motivate and allow for flexibility and proportionality when applying rules that relate to pre-emptive rights.

Please use your own words by inserting or typing the text in the box below.

Question 1.7c: [Conditional on the fact that *None* was not the answer to question 1.1 and 1.5] Please provide the references to the legal, regulatory or other source of the relevant provisions where the use of the flexibility and proportionality you have described in relation to pre-emptive rights can be found in your corporate governance framework. Please also indicate the date when these provisions were introduced.

The more specific the reference, the better.

Question 1.8c: [Conditional on the fact that *None* was not the answer to question 1.1 and 1.5] **If you want, you can upload a file with the official text of the reference provided.**

By clicking below you will be able to select the file from your own folders.

Select file to upload...

Allowed file type(s): .doc, .docx, .pdf

BOARD COMPOSITION, BOARD COMMITTEES AND BOARD MEMBER QUALIFICATIONS

This section seeks to identify the criteria that motivate and allow flexibility and proportionality with respect to the board composition, the use of board committees and the qualifications of board members as discussed in Principle VI.E of the G20/OECD Principles of Corporate Governance.

Question 2.1*: Which criteria can motivate and allow for flexibility and proportionality when applying rules that relate to the board composition, the use of board committees and the qualifications of board members in your corporate governance framework?

Select all relevant criteria for the topic of this section (*response required).

- ☐ Size
- ☐ Ownership/control structure
- ☐ Listing/publicly traded
- ☐ Maturity of firm
- ☐ Accounting standards used
- ☐ Legal form
- ☐ Other: _______________
- ☐ None

Question 2.2c: [Conditional on the fact that *Size* was selected among the answers to question 2.1] **You responded that size is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the board composition, the use of board committees and the qualifications of board members in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Size of equity
- □ Size of sales
- □ Size of revenues
- □ Size of assets
- □ Size of debt
- □ Size of workforce
- □ Size of market capitalization
- □ Other: ______________

Question 2.3c: [Conditional on the fact that *Ownership/control structure* was selected among the answers to question 2.1] **You responded that ownership/control structure is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the board composition, the use of board committees and the qualifications of board members in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Controlling shareholder
- □ Blockholders
- □ Free float
- □ Subsidiaries of listed companies
- □ Private placements
- □ Privately owned
- □ Other: ______________

Question 2.4c: [Conditional on the fact that *Listing/publicly traded* was selected among the answers to question 2.1] **You responded that listing/publicly traded is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the board composition, the use of board committees and the qualifications of board members in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Listing level
- □ Listing venue
- □ Debt only listing

□ Cross-listing

□ Trading in alternative trading platforms or other alternative trading venues

□ Other: _______________

Question 2.5*: Does your corporate governance framework contain "opt-in" or "opt-out" mechanisms that can allow for flexibility when applying rules that relate to board composition, the use of board committees and the qualifications of board members?

Please select the correct answers (*response required).

□ Opt-in

□ Opt-out

□ None

Question 2.6c: [Conditional on the fact that *None* was not the answer to question 2.1 and 2.5] **Please explain how the criteria and/or mechanisms you have selected in the previous questions are used in your corporate governance framework to motivate and allow for flexibility and proportionality when applying rules that relate to board composition, the use of board committees and the qualifications of board members.**

Please use your own words by inserting or typing the text in the box below.

Question 2.7c: [Conditional on the fact that *None* was not the answer to question 2.1 and 2.5] **Please provide the references to the legal, regulatory or other source of the relevant provisions where the use of the flexibility and proportionality you have described in relation to board composition, the use of board committees and the qualifications of board members can be found in your corporate governance framework. Please also indicate the date when these provisions were introduced.**

The more specific the reference, the better.

Question 2.8c: [Conditional on the fact that *None* was not the answer to question 2.1 and 2.5] **If you want, you can upload a file with the official text of the reference provided.**

By clicking below you will be able to select the file from your own folders.

Select file to upload...

Allowed file type(s): .doc, .docx, .pdf

SAY ON PAY AND THE DETAIL OF DISCLOSURE ON REMUNERATION

This section seeks to identify the criteria that motivate and allow flexibility and proportionality with respect to the detail of disclosure of remuneration and measures giving shareholders a say on the remuneration of the company, as discussed in Principle II.C4 and V.A4 of the G20/OECD Principles of Corporate Governance.

Question 3.1*: Which criteria can motivate and allow for flexibility and proportionality when applying rules that relate to say on pay and the detail of disclosure on remuneration in your corporate governance framework?

Select all relevant criteria for the topic of this section (*response required).

- □ Size
- □ Ownership/control structure
- □ Listing/publicly traded
- □ Maturity of firm
- □ Accounting standards used
- □ Legal form
- □ Other: _______________
- □ None

Question 3.2c: [Conditional on the fact that *Size* was selected among the answers to question 3.1] **You responded that <u>size</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to say on pay and the detail of disclosure on remuneration in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Size of equity
- □ Size of sales
- □ Size of revenues
- □ Size of assets
- □ Size of debt
- □ Size of workforce
- □ Size of market capitalization
- □ Other: ______________

Question 3.3c: [Conditional on the fact that *Ownership/control structure* was selected among the answers to question 3.1] **You responded that <u>ownership/control structure</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to say on pay and the detail of disclosure on remuneration in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Controlling shareholder
- □ Blockholders
- □ Free float
- □ Subsidiaries of listed companies
- □ Private placements
- □ Privately owned
- □ Other: _______________

Question 3.4c: [Conditional on the fact that *Listing/publicly traded* was selected among the answers to question 3.1] **You responded that <u>listing/publicly traded</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to say on pay and the detail of disclosure on remuneration in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Listing level
- □ Listing venue
- □ Debt only listing
- □ Cross-listing
- □ Trading in alternative trading platforms or other alternative trading venues
- □ Other: _______________

Question 3.5*: **Does your corporate governance framework contain "opt-in" or "opt-out" mechanisms that can allow for flexibility when applying rules that relate to say on pay and the detail of disclosure on remuneration?**

Please select the correct answers (*response required).

- □ Opt-in
- □ Opt-out
- □ None

Question 3.6c: [Conditional on the fact that *None* was not the answer to question 3.1 and 3.5] **Please <u>explain how</u> the criteria and/or mechanisms you have selected in the previous questions are used in your corporate governance framework to motivate and allow for flexibility and proportionality when applying rules that relate to say on pay and the detail of disclosure on remuneration.**

Please use your own words by inserting or typing the text in the box below.

Question 3.7c: [Conditional on the fact that *None* was not the answer to question 3.1 and 3.5.] **Please provide the references to the legal, regulatory or other source of the relevant provisions where the use of the flexibility and proportionality you have described in relation to say on pay and the detail of disclosure on remuneration can be found in your corporate governance framework. Please also indicate the date when these provisions were introduced.**

The more specific the reference, the better.

Question 3.8c: [Conditional on the fact that *None* was not the answer to question 3.1 and 3.5.**] If you want, you can upload a file with the official text of the reference provided.**

By clicking below you will be able to select the file from your own folders.

Select file to upload...

Allowed file type(s): .doc, .docx, .pdf

RELATED PARTY TRANSACTIONS

This section seeks to identify the criteria that motivate and allow flexibility and proportionality with respect to related party transactions, as discussed in Principle II.F of the G20/OECD Principles of Corporate Governance.

Question 4.1*: **Which criteria can motivate and allow for flexibility and proportionality when applying rules that relate to related party transactions in your corporate governance framework?**

Select all relevant criteria for the topic of this section (*response required).

- ☐ Size
- ☐ Ownership/control structure
- ☐ Listing/publicly traded
- ☐ Maturity of firm
- ☐ Accounting standards used
- ☐ Legal form
- ☐ Other: _______________
- ☐ None

Question 4.2c: [Conditional on the fact that *Size* was selected among the answers to question 4.1] **You responded that size is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to related party transactions in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- ☐ Size of equity
- ☐ Size of sales
- ☐ Size of revenues
- ☐ Size of assets
- ☐ Size of debt
- ☐ Size of workforce
- ☐ Size of market capitalization
- ☐ Other: ______________

Question 4.3c: [Conditional on the fact that *Ownership/control structure* was selected among the answers to question 4.1] **You responded that ownership/control structure is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to related party transactions in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- ☐ Controlling shareholder
- ☐ Blockholders
- ☐ Free float
- ☐ Subsidiaries of listed companies
- ☐ Private placements
- ☐ Privately owned
- ☐ Other: ______________

Question 4.4c: [Conditional on the fact that *Listing/publicly traded* was selected among the answers to question 4.1] **You responded that listing/publicly traded is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to related party transactions in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- ☐ Listing level
- ☐ Listing venue
- ☐ Debt only listing
- ☐ Cross-listing
- ☐ Trading in alternative trading platforms or other alternative trading venues
- ☐ Other: _______________

Question 4.5***: Does your corporate governance framework contain "opt-in" or "opt-out" mechanisms that can allow for flexibility when applying rules that relate to related party transactions?**

Please select the correct answers (*response required).

□ Opt-in

□ Opt-out

□ None

Question 4.6c: [Conditional on the fact that *None* was not the answer to question 4.1 and 4.5] **Please explain how the criteria and/or mechanisms you have selected in the previous questions are used in your corporate governance framework to motivate and allow for flexibility and proportionality when applying rules that relate to related party transactions.**

Please use your own words by inserting or typing the text in the box below.

Question 4.7c: [Conditional on the fact that *None* was not the answer to question 4.1 and 4.5] **Please provide the references to the legal, regulatory or other source of the relevant provisions where the use of the flexibility and proportionality you have described in relation to related party transactions can be found in your corporate governance framework. Please also indicate the date when these provisions were introduced.**

The more specific the reference, the better.

Question 4.8c: [Conditional on the fact that *None* was not the answer to question 4.1 and 4.5] **If you want, you can upload a file with the official text of the reference provided.**

By clicking below you will be able to select the file from your own folders.

Select file to upload...

Allowed file type(s): .doc, .docx, .pdf

PERIODIC FINANCIAL INFORMATION AND AD-HOC INFORMATION

This section seeks to identify the criteria that motivate and allow flexibility and proportionality with respect to the disclosure of periodic financial information and ad-hoc information, as discussed in Principle V.E of the G20/OECD Principles of Corporate Governance.

Question 5.1*: Which criteria can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of periodic financial information and ad-hoc information in your corporate governance framework?

Select all relevant criteria for the topic of this section (*response required).

- □ Size
- □ Ownership/control structure
- □ Listing/publicly traded
- □ Maturity of firm
- □ Accounting standards used
- □ Legal form
- □ Other: _______________
- □ None

Question 5.2c: [Conditional on the fact that *Size* was selected among the answers to question 5.1] **You responded that <u>size</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of periodic financial information and ad-hoc information in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Size of equity
- □ Size of sales
- □ Size of revenues
- □ Size of assets
- □ Size of debt
- □ Size of workforce
- □ Size of market capitalization
- □ Other: ______________

Question 5.3c: [Conditional on the fact that *Ownership/control structure* was selected among the answers to question 5.1] **You responded that <u>ownership/control structure</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of periodic financial information and ad-hoc information in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Controlling shareholder
- □ Blockholders
- □ Free float
- □ Subsidiaries of listed companies
- □ Private placements
- □ Privately owned
- □ Other: ______________

Question 5.4c: [Conditional on the fact that *Listing/publicly traded* was selected among the answers to question 5.1] **You responded that listing/publicly traded is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of periodic financial information and ad-hoc information in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Listing level
- □ Listing venue
- □ Debt only listing
- □ Cross-listing
- □ Trading in alternative trading platforms or other alternative trading venues
- □ Other: _______________

Question 5.5*: **Does your corporate governance framework contain "opt-in" or "opt-out" mechanisms that can allow for flexibility when applying rules that relate to disclosure of periodic financial information and ad-hoc information?**

Please select the correct answers (*response required).

- □ Opt-in
- □ Opt-out
- □ None

Question 5.6c: [Conditional on the fact that *None* was not the answer to question 5.1 and 5.5] **Please explain how the criteria and/or mechanisms you have selected in the previous questions are used in your corporate governance framework to motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of periodic financial information and ad-hoc information.**

Please use your own words by inserting or typing the text in the box below.

Question 5.7c: [Conditional on the fact that *None* was not the answer to question 5.1 and 5.5.] **Please provide the references to the legal, regulatory or other source of the relevant provisions where the use of the flexibility and proportionality you have described in relation to the disclosure of periodic financial information and ad-hoc information can be found in your corporate governance framework. Please also indicate the date when these provisions were introduced.**

The more specific the reference, the better.

Question 5.8c: [Conditional on the fact that *None* was not the answer to question 5.1and 5.5] **If you want, you can upload a file with the official text of the reference provided.**

By clicking below you will be able to select the file from your own folders.

Select file to upload...

Allowed file type(s): .doc, .docx, .pdf

MAJOR SHAREHOLDING DISCLOSURE

This section seeks to identify the criteria that motivate and allow flexibility and proportionality with respect to the disclosure of major shareholding information, as discussed in Principle V.A.3 of the G20/OECD Principles of Corporate Governance.

Question 6.1*: **Which criteria can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of major shareholding information in your corporate governance framework?**

Select all relevant criteria for the topic of this section (*response required).

- □ Size
- □ Ownership/control structure
- □ Listing/publicly traded
- □ Maturity of firm
- □ Accounting standards used
- □ Legal form
- □ Other: _______________
- □ None

Question 6.2c: [Conditional on the fact that *Size* was selected among the answers to question 6.1] **You responded that <u>size</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of major shareholding information in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Size of equity
- □ Size of sales
- □ Size of revenues
- □ Size of assets
- □ Size of debt
- □ Size of workforce
- □ Size of market capitalization
- □ Other: ______________

Question 6.3c: [Conditional on the fact that *Ownership/control structure* was selected among the answers to question 6.1] **You responded that <u>ownership/control structure</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of major shareholding information in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Controlling shareholder
- □ Blockholders
- □ Free float
- □ Subsidiaries of listed companies
- □ Private placements
- □ Privately owned
- □ Other: ______________

Question 6.4c: [Conditional on the fact that *Listing/publicly traded* was selected among the answers to question 6.1] **You responded that listing/publicly traded is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of major shareholding information in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Listing level
- □ Listing venue
- □ Debt only listing
- □ Cross-listing
- □ Trading in alternative trading platforms or other alternative trading venues
- □ Other: _______________

Question 6.5*: **Does your corporate governance framework contain "opt-in" or "opt-out" mechanisms that can allow for flexibility when applying rules that relate to the disclosure of major shareholding information?**

Please select the correct answers (*response required).

- □ Opt-in
- □ Opt-out
- □ None

Question 6.6c: [Conditional on the fact that *None* was not the answer to question 6.1 and 6.5] **Please explain how the criteria and/or mechanisms you have selected in the previous questions are used in your corporate governance framework to motivate and allow for flexibility and proportionality when applying rules that relate to the disclosure of major shareholding information.**

Please use your own words by inserting or typing the text in the box below.

Question 6.7c: [Conditional on the fact that *None* was not the answer to question 6.1 and 6.5] **Please provide the references to the legal, regulatory or other source of the relevant provisions where use of the flexibility and proportionality you have described in relation to the disclosure of major shareholding information can be found in your corporate governance framework. Please also indicate the date when these provisions were introduced.**

The more specific the reference, the better.

Question 6.8c: [Conditional on the fact that *None* was not the answer to question 6.1 and 6.5] **If you want, you can upload a file with the official text of the reference provided.**

By clicking below you will be able to select the file from your own folders.

Select file to upload...

Allowed file type(s): .doc, .docx, .pdf

TAKEOVERS

This section seeks to identify the criteria that motivate and allow flexibility and proportionality with respect to takeovers and the market for corporate control, as discussed in Principle II.H of the G20/OECD Principles of Corporate Governance.

Question 7.1*: **Which criteria can motivate and allow for flexibility and proportionality when applying rules that relate to takeovers in your corporate governance framework?**

Select all relevant criteria for the topic of this section (*response required).

- □ Size
- □ Ownership/control structure
- □ Listing/publicly traded
- □ Maturity of firm
- □ Accounting standards used
- □ Legal form
- □ Other: _______________
- □ None

Question 7.2c: [Conditional on the fact that *Size* was selected among the answers to question 7.1] **You responded that <u>size</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to takeovers in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Size of equity
- □ Size of sales
- □ Size of revenues
- □ Size of assets
- □ Size of debt
- □ Size of workforce
- □ Size of market capitalization
- □ Other: ______________

Question 7.3c: [Conditional on the fact that *Ownership/control structure* was selected among the answers to question 7.1] **You responded that <u>ownership/control structure</u> is a criterion that can motivate and allow for flexibility and proportionality when applying rules that relate to takeovers in your corporate governance framework. Please indicate which dimensions of this criterion are used.**

Select all dimensions relevant for the topic of this section.

- □ Controlling shareholder
- □ Blockholders
- □ Free float
- □ Subsidiaries of listed companies
- □ Private placements
- □ Privately owned
- □ Other: ______________

Question 7.4c: [Conditional on the fact that *Listing/publicly traded* was selected among the answers to question 7.1] **You responded that <u>listing/publicly traded</u> is a criterion**

that can motivate and allow for flexibility and proportionality when applying rules that relate to takeovers in your corporate governance framework. Please indicate which dimensions of this criterion are used.

Select all dimensions relevant for the topic of this section.

- □ Listing level
- □ Listing venue
- □ Debt only listing
- □ Cross-listing
- □ Trading in alternative trading platforms or other alternative trading venues
- □ Other: _______________

Question 7.5*: **Does your corporate governance framework contain "opt-in" or "opt-out" mechanisms that can allow for flexibility when applying rules that relate to takeovers?**

Please select the correct answers (*response required).

- □ Opt-in
- □ Opt-out
- □ None

Question 7.6c: [Conditional on the fact that *None* was not the answer to question 7.1 and 7.5] **Please explain how the criteria and/or mechanisms you have selected in the previous questions are used in your corporate governance framework to motivate and allow for flexibility and proportionality when applying rules that relate to takeovers.**

Please use your own words by inserting or typing the text in the box below.

Question 7.7c: [Conditional on the fact that *None* was not the answer to question 7.1 and 7.5] **Please provide the references to the legal, regulatory or other source of the relevant provisions where use of the flexibility and proportionality you have described in relation to takeovers can be found in your corporate governance framework. Please also indicate the date when these provisions were introduced.**

The more specific the reference, the better.

Question 7.8c: [Conditional on the fact that *None* was not the answer to question 7.1 and 7.5] **If you want, you can upload a file with the official text of the reference provided.**

By clicking below you will be able to select the file from your own folders.

Select file to upload...

Allowed file type(s): .doc, .docx, .pdf

GENERAL QUESTIONS

Question A*: Please identify your jurisdiction

Please select from the list below (*response required).

Select your jurisdiction...

Question B*: Please identify one contact person responsible for the responses to the questionnaire for your jurisdiction and her/his contact details, for the event that the OECD Secretariat has to get in touch with you for possible clarifications or follow up regarding your answers.

Please provide the name of the person, position, institution, email and phone number (*response required).

Question C: Please indicate whether the corporate governance framework in your country includes any specific regulations/rules about the 7 areas of regulation covered in the questionnaire for the following categories of companies.

Please select all those that are relevant.

- □ Financial sector (Banking, Investment funds, Insurance, Asset Management)
- □ Energy sector
- □ Media sector
- □ Technology sector
- □ SOEs
- □ Foreign listed firms

Question Dc: [Conditional on the fact that banking sector was selected among the answers] **You responded that there are specific regulations/rules for the financial sector in your framework, please indicate in which of the six areas of regulation they are used.**

Select all the topics where they are used.

- □ Pre-emptive rights
- □ Board composition, board committees and board member qualifications
- □ Say on pay and the detail of disclosure on remuneration
- □ Related party transactions
- □ Periodic financial information and ad-hoc information
- □ Major shareholding disclosure
- □ Takeovers

Question Ec: [Conditional on the fact that energy sector was selected among the answers] **You responded that there are specific regulations/rules for the energy sector in your framework, please indicate in which of the six areas of regulation they are used.**

Select all the topics where they are used.

- □ Pre-emptive rights
- □ Board composition, board committees and board member qualifications
- □ Say on pay and the detail of disclosure on remuneration
- □ Related party transactions
- □ Periodic financial information and ad-hoc information

- ☐ Major shareholding disclosure
- ☐ Takeovers

Question Fc: [Conditional on the fact that media sector was selected among the answers] **You responded that there are specific regulations/rules for the <u>media sector</u> in your framework, please indicate in which of the six areas of regulation they are used.**

Select all the topics where they are used.

- ☐ Pre-emptive rights
- ☐ Board composition, board committees and board member qualifications
- ☐ Say on pay and the detail of disclosure on remuneration
- ☐ Related party transactions
- ☐ Periodic financial information and ad-hoc information
- ☐ Major shareholding disclosure
- ☐ Takeovers

Question Gc: [Conditional on the fact that technology sector was selected among the answers] **You responded that there are specific regulations/rules for the <u>technology sector</u> in your framework, please indicate in which of the six areas of regulation they are used.**

Select all the topics where they are used.

- ☐ Pre-emptive rights
- ☐ Board composition, board committees and board member qualifications
- ☐ Say on pay and the detail of disclosure on remuneration
- ☐ Related party transactions
- ☐ Periodic financial information and ad-hoc information
- ☐ Major shareholding disclosure
- ☐ Takeovers

Question Hc: [Conditional on the fact that State-owned enterprise sector was selected among the answers] **You responded that there are specific regulations/rules for the <u>State-owned enterprise sector</u> in your framework, please indicate in which of the six areas of regulation they are used.**

Select all the topics where they are used.

- ☐ Pre-emptive rights
- ☐ Board composition, board committees and board member qualifications
- ☐ Say on pay and the detail of disclosure on remuneration
- ☐ Related party transactions
- ☐ Periodic financial information and ad-hoc information
- ☐ Major shareholding disclosure
- ☐ Takeovers

Question Ic: [Conditional on the fact that State-owned enterprise sector was selected among the answers] **You responded that there are specific regulations/rules for <u>Foreign listed companies</u> in your framework, please indicate in which of the six areas of regulation they are used.**

Select all the topics where they are used.

- ☐ Pre-emptive rights
- ☐ Board composition, board committees and board member qualifications
- ☐ Say on pay and the detail of disclosure on remuneration
- ☐ Related party transactions

- □ Periodic financial information and ad-hoc information
- □ Major shareholding disclosure
- □ Takeovers

Survey notes

[1.] In response to the corporate governance challenges that came into focus in the wake of the financial crisis, the Corporate Governance Committee launched its thematic review process designed to facilitate the effective implementation of the G20/OECD Principles and to assist market participants and policy makers to respond to emerging corporate governance risks. These are the thematic peer reviews produced so far: Risk Management and Corporate Governance (2014); Supervision and Enforcement in Corporate Governance (2013); Board Member Nomination and Election (2013); Related Party Transactions and Minority Shareholder Rights (2012); The Role of Institutional Investors in Promoting Good Corporate Governance (2011), and Board Practices: Incentives and Governing Risks (2011).

[2.] For example, when the application of rules for listed companies is extended to their subsidiaries, even if they are not listed.

[3.] For example, when the rules applicable to listed companies are extended to also cover large (perhaps even systemically important) non-listed companies.

[4.] This means we would not ask for responses related to the myriad of existing or hypothetical "explanations" that companies under unique circumstances may provide for deviations from the code by applying higher or alternative practices. For example, if the Code says that companies with boards comprised of more than five directors should have a remuneration committee, then we would expect respondents to the questionnaire to select only the criteria "Size", and then to add the dimension "Size of the board". Of course, there may be an unlimited number of explanations why a specific company at a specific point in time chooses to "explain" a deviation from the Code. But this follows logically from the nature of the "comply or explain" Code as a "flexibility" instrument in its own right. So we would not expect you to provide information of such "explanations" that may also evolve over time.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(26 2018 02 1 P) ISBN 978-92-64-30748-3 – 2018

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***.

This work is published on the OECD iLibrary, which gathers all OECD books, periodicals and statistical databases. Visit ***www.oecd-ilibrary.org*** for more information.

OECD*publishing*
www.oecd.org/publishing

ISBN 978-92-64-30748-3
26 2018 02 1 P