Thought Starter

Proportionality and Flexibility in Corporate Governance

Business at OECD (BIAC) believes the issue of “proportionality and flexibility” in corporate governance is not a simple one. While one should not necessarily assume that “one size fits all”, the call for different standards/principles applying to companies of differing size, form, purpose, ownership or stage of maturity or geography should not be the automatic answer.

The difficulty, if this kind of approach were taken too far, is that basic standards and key principles of good governance would be undermined. We caution that “proportionality” and “flexibility” not be synonyms for limitation of the application of principles; rather the terms should be seen through a lens of scalable application/operationalization. Within a principles-based framework, the principle of proportionality in corporate governance relates to the manner in which the principles are applied or implemented.

Introducing proportionality as a concept in applying corporate governance principles requires close collaboration and consultation between regulators and supervisors recommending their use, to ensure that the overall validity of the principles are maintained, and that the principles are implemented in a practical manner.

Introducing proportionality with respect to company size as a binary (go/no-go or do/don’t) principle of policy-making would create new problems. In particular, it could create a disincentive for growing companies who may have concerns or even seek to avoid passing a threshold that would oblige them to adapt to a more extensive or onerous corporate governance framework. Such an approach would also send an unhelpful message that ‘good’ governance is reserved only for larger companies. Governance should not be seen as a cost, but rather as empirically proven to outcome of economic benefits. Good corporate governance is relevant to all companies of all stages of growth, structure, ownership and sizes.

Furthermore, it is not just about size but also about listing and the stage of development a company has achieved at the IPO stage. There are responsibilities a company assumes when listing and accessing money from the public. Unlike size, corporate complexity and in particular the intensity of the business risks may relate to a proportionate approach. Financial institutions (including banks), for example, do not only accumulate risk through their operations, but trade in risk. This would call for different governance structures for such institutions (including risk committees) as well as increased disclosure about risk governance by the board.
“Flexibility” speaks to an outcomes-based application of principles rather than applying bright-line requirements (e.g. independence of all directors may be less purposeful in some owner/purpose scenarios).

Scalable, proportional and flexible application of corporate governance principles beyond traditional for-profit corporate structures is also highly relevant; i.e. consideration of the Principles’ applicability to Public Interest Entities which includes some private entities.¹

At the same time, practical and fundamental differences in companies and other types of organization should not be ignored. It is important to proactively consider issues that might arise in different types of companies and organizations to see where gaps exist and explore solutions.

In general, a principles-based framework, together with a “comply or explain” provision now existing for most governance codes, provides sufficient flexibility, proportionality and scalability for smaller entities and for most entities warranting owner/stakeholder oversight of management, outside of financial institutions.

This approach, inter alia:

- Allows enterprises of all kinds to develop best practices within a structure of effective governance mechanisms.
- Provides sufficient flexibility to develop best practices, irrespective of jurisdiction or industry sector.
- Permits timely updating of governance practices as markets evolve; and responsiveness to emerging risks (for example cybersecurity issues and climate change challenges).
- Empowers investors with different investment philosophies and strategies to readily compare enterprises’ governance practices in their portfolios.
- Speeds the development of new corporate forms, such as, for example, U.S. ‘Public Benefit Corporations’ by identifying and streamlining the adoption of lofty and transparent governance standards and practices.

¹ As being considered by UK authorities in response to the collapse of BHS; US recognition of an investment stewardship and governance role by insurance, private pension fund and asset managers; and as in South Africa beyond traditional for-profit, or even traditional not-for-profit, structures.
Additional considerations for the peer review:

We support this review topic as it may, among others, provide further insights on particular corporate governance issues with controlling shareholders, family companies, large private companies as well as SMEs.

The issue however should be looked at holistically and encompass the role poor governance plays in the high SME and family business failure rate and the barriers to corporate governance action in SMEs. The thematic review should encompass a review of the trigger points when SMEs turn to better governance practices to solve company issues e.g. when SMEs or family businesses face a new generation in the company.

Good corporate governance is relevant to all companies of all stages of growth, structure, ownership and sizes. At the same time, consideration should be given to distinguishing SMEs that are listed from similar sized unlisted SME companies. Listed SMEs should be able to adjust corporate governance practices to fit their particular business as the G20/OECD Principles adhere to the principles approach. This leaves certain flexibility for application.

The benefits to SMEs of good governance equally should be further highlighted (para 36 and 37). Consideration should be given to the role poor governance plays in the SME failure rate. More research would be helpful of the effects in countries (US, Italy, France, Israel, Singapore) of corporate governance measures for listed SMEs to inform the Committee of the impact of these measures. It would be interesting to include non-member countries, such as India in view of the great number of SMEs.

Questions to be addressed could include for example how SMEs make the transition to full CG practices, whether there have been more SME listings as a consequence, and if so, whether these companies were successful. Some research on the effects of corporate governance codes for SMEs would be helpful. It should be considered that often SMEs require more guidance in support of application of the standards and training and awareness of the true value of CG.

With regard to the second stage – the in-depth analysis – it would be useful to seek information about how governments and regulators go about the process of applying the principles flexibly and proportionately, that is, do they subscribe to any principles of “good regulation” – e.g., consulting with those affected, researching potential consequences, undertaking a post-implementation analysis of impacts, and collaborating and cooperating internationally.

In the section on “Flexibility and proportionality in practice” (e.g. paragraph 6), it could be considered to make reference to “public interest entities” as a distinguishing feature – especially as it is used prominently in some jurisdictions (e.g., European audit legislation).