



# **The 2007 Asian Roundtable on Corporate Governance**

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## **SESSION II Moving away from box-ticking – the OECD Methodology for Assessing Implementation of the OECD Principles on Corporate Governance**

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*The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD Member countries or the World Bank*

# **THE OECD METHODOLOGY FOR ASSESSING IMPLEMENTATION OF THE OECD PRINCIPLES**

## **SUMMARY OF THE METHODOLOGY'S ASSESSMENT SCHEME**

An OECD Principle is **Fully Implemented** in all material respects with respect to all of the applicable Essential Criteria. Where the Essential Criteria refer to standards (*i.e.* practices that should be required, encouraged or, conversely, prohibited or discouraged), all material aspects of the standards are present. Where the Essential Criteria refer to corporate governance practices, the relevant practices are widespread. Where the Essential Criteria refer to enforcement mechanisms, there are adequate, effective enforcement mechanisms. Where the Essential Criteria refer to remedies, there are adequate, effective and accessible remedies.

A **Broadly Implemented** assessment is likely appropriate where one or more of the applicable Essential Criteria are less than fully implemented in all material respects, but, at a minimum:

- all of the applicable Essential Criteria are implemented to some extent;
- the core elements of the standards are present (*e.g.* general standards may be in place although some of the specific details may be missing); and
- incentives and/or disciplinary forces are operating with some effect to encourage at least a majority of market participants, including significant enterprises, to adopt the recommended practices.

A **Partly Implemented** assessment is likely appropriate in the following situations:

- One or more core elements of the standards described in a minority of the applicable Essential Criteria are missing, but the other applicable Essential Criteria are fully or broadly implemented in all material respects (including those aspects of the Essential Criteria relating to corporate governance practices, enforcement mechanisms and remedies);
- The core elements of the standards described in all of the applicable Essential Criteria are present, but incentives and/or disciplinary forces are not operating effectively to encourage at least a significant minority of market participants to adopt the recommended practices; or
- The core elements of the standards described in all of the applicable Essential Criteria are present, but implementation levels are low because some or all of the standards are new, it is too early to expect high levels of implementation and it appears that the reason for low implementation levels is the newness of the standards (rather than other factors, such as low incentives to adopt the standards).

A **Not Implemented** assessment likely is appropriate where there are major shortcomings, *e.g.* where:

- The core elements of the standards described in a majority of the applicable Essential Criteria are not present; and/or
- Incentives and/or disciplinary forces are not operating effectively to encourage at least a significant minority of market participants to adopt the recommended practices.

A **Not Applicable** assessment is appropriate where an OECD Principle (or one of the Essential Criteria) does not apply due to structural, legal or institutional features (e.g. institutional investors acting in a fiduciary capacity may not exist).

### Example of Applying the Methodology's assessment scheme and Essential Criteria

The following example illustrates how the assessment scheme might be applied to a particular Principle (for this example, Principle VI.E.2) in a country.

#### Principle VI.E.2 and the Methodology's Essential Criteria

Principle VI.E.2 states that "When committees of the board are established, their mandate, composition and working procedures should be well disclosed by the board." The Methodology specifies the following Essential Criterion for Principle VI.E.2:

"The corporate governance framework encourages or requires full disclosure of the mandate, composition and working procedures of the most important standing and *ad hoc* board committees. Such disclosure should form an essential part of the company's report on its corporate governance practices. There are effective enforcement mechanisms, including shareholder rights to request the information. Whether required or encouraged, there is widespread implementation of the standard."

#### Fact Situation

Three years ago, Country A introduced a Code of Corporate Governance that applies to publicly held companies. Companies are not required to implement the practices recommended in the Code, but there is legislation requiring them to publish a statement every year in which they identify which of the Code's recommendations they have implemented (and, if so, how they have implemented the recommendation) and which recommendations they have not implemented (and, if not, why they have decided not to implement the recommendation). The Code recommends that that company boards should establish audit committees, nomination committees and corporate governance committees and that these committees should be chaired by an independent board member and have a majority of independent members. The Code also recommends that companies disclose the mandate, composition (including the presence or absence of independent status of each member) and working procedures of these and any other important standing or *ad hoc* committees established by the board in the company's annual report to shareholders.

For the past three years, a management consulting firm in Country A has conducted a comprehensive review of companies' statements relating to their implementation of the Code. The studies show a moderate upward trend with respect to implementation of this Principle, although implementation levels of some aspects of the Principle are still low. This year, the study indicated that:

- more than 75% of Country A's listed companies indicate that they have established audit, nomination and corporate governance committees;
- 60% of the companies disclose the names of the committee members;
- 35% of the companies indicate which committee members are considered to be independent (and, among such companies, the committees appear to have a sufficient percentage of independent members and are chaired by independent board members); but
- fewer than 20% disclose details regarding the committees' mandates or working procedures.

Most companies include only a one sentence or two sentence description of the committee's role. Companies that provide little or no disclosure about committee mandates and working procedures have not specified in their annual Statements that they are not in compliance with the Code's recommendations in this regard. Likewise, more than half the companies that have not implemented some other aspect of the Code recommendation relating to board committees (e.g. regarding disclosure of whether or not committee members are considered to be independent) have

not explained why they have not implemented the recommendation.

The securities regulatory authority in Country A is responsible for enforcing the legislative requirement that companies explain how they have implemented the Code and why they have not implemented certain provisions. To date, it has not taken any formal enforcement action with respect to any company's statements regarding their implementation of the Code. Its staff, however, have held training sessions for companies on how to prepare their Statements and they recently published a Guidance Note specifically advising companies on the level of detail needed to meet the standard of "full disclosure" regarding independence of committee members, committee mandates and working procedures. Furthermore, the board of the securities regulatory authority issued a Notice stating that a failure by a company either to explain in sufficient how it had implemented one or more elements of the Code or why it had chosen not to implement one or more elements of the Code constituted a breach of the legislation and could result in enforcement penalties (including a fine or an order directing the company to comply with the legislation).

The management consultant's report, together with the securities regulatory authority's Guidance Note and Notice attracted media attention early this year. Several articles criticising high profile companies' disclosure practices were published in newspapers in the weeks leading up to the period when most companies hold their annual meetings. There is some anecdotal evidence (e.g. media reports) that at 10-12 company annual meetings, shareholders asked for more information about the independence of board committee members where the company failed to disclose this information in its annual report.

The securities legislation in Country A provides that a shareholder who believes that any document filed with the securities regulatory authority does not contain information that it is required by legislation or regulations to contain may apply to the securities regulatory authority for an order requiring the company to make the required disclosure. It costs approximately EUR 100 to file such an application for an order, but the shareholder can be exempted from the requirement to pay the application fee upon proof of financial hardship. No applications were filed in the first two years after the Code was adopted. This year, however, three applications have been filed and are pending before the securities regulatory authority.

## Assessment

Country A has adopted a standard, in the form of a non-binding Code, that contains all material elements of the standard recommended in Principle VI.E.2. Furthermore, there appears to be an enforcement mechanism where there is non-compliance with the mandatory requirement to explain how the standard has been implemented or, alternatively, why the company has chosen not to implement the standard. In addition, shareholders have been provided with what appears to be a relatively inexpensive way of holding the company accountable if it fails to disclose either how it has implemented the standard or why it has not implemented the standard. Although these enforcement mechanisms apply indirectly (i.e. they apply if there has been a failure to explain how the standard has been implemented or why it has not been implemented, rather than to a failure to disclose the mandates and working procedures of the board committees), they have the potential to operate in a way that puts pressure on companies to disclose the mandates and working procedures of their committees and whether or not committee members are independent, as called for in the Code.

Nevertheless, a **Fully Implemented** assessment is inappropriate. The reviewer must look beyond the "law on the books" (or in this case, a non-binding Code) and consider company practices and enforcement of the standard. Only two aspects of the recommended standard appears to have been widely adopted by companies: most companies disclose that they have established the recommended committees and more than half the companies disclose the names of committee members. The practices recommended in Principle VI.E.2 are not, therefore, widespread.

A **Broadly Implemented** assessment would be appropriate only if: (A) all of the Essential Criteria (for Principle VI.E.2, there is only one) are implemented *to some extent*; (B) the *core elements* of the standard recommended in Principle VI.E.2 are present; and (C) incentives and/or disciplinary forces are operating with some effect to encourage *at least a majority of market participants*, including significant enterprises, to adopt the recommended practices. A and B are true, but C is not (although there is some evidence that market disciplinary forces are starting to play a role).

In deciding whether or not a **Partly Implemented** or a **Not Implemented** assessment is appropriate in this case, the key questions for the reviewer are as follows:

- Are implementation levels low because some or all of the standards are new, it is too early to expect high levels of implementation and it appears that the reason for low implementation levels is the newness of the standards (rather than other factors, such as low incentives to adopt the standards)? If the answer is yes, then a **Partly Implemented** assessment is appropriate in this case.
- Are incentives and/or disciplinary forces ineffective to encourage at least a significant minority of market participants to adopt the recommended practices? If the answer is yes, then a **Not Implemented**

assessment is appropriate.

(The assessment schemes for **Partly Implemented** and **Not Implemented** include other elements (e.g. a consideration of the extent to which the recommended standards are in place), but the decision as to whether or not a Partly or Not Implemented assessment should be assigned in this example does not turn on these other elements.)

Some facts suggest that a Partly Implemented assessment may be appropriate. This is because: (a) several aspects of the recommended standard (establishment of committees, disclosure of committee composition and disclosure as to whether or not committee members and the chair are independent) have been implemented by a significant minority of companies; (b) the standard is relatively new (3 years old); and (c) there is evidence of some market pressure (through the media, the published results of the consultants' study, questions at a few annual meetings this year and the recent applications by shareholders for orders) being brought to bear on companies. The facts presented in this example, however, do not provide a definitive answer to the question and so it is likely that the reviewer would need to examine further the reasons why implementation levels are uneven.