CHAPTER 1

INTRODUCTION TO CORPORATE GOVERNANCE AND OTHER ESG CONSIDERATIONS

Assem Safieddine, PhD, Young Lee, CFA, Donna F. Anderson, CFA, Deborah S. Kidd, CFA, and Hardik Sanjay Shah, CFA

LEARNING OUTCOMES

The candidate should be able to:

- describe corporate governance;
- describe a company's stakeholder groups, and compare interests of stakeholder groups;
- describe principal–agent and other relationships in corporate governance and the conflicts that may arise in these relationships;
- describe stakeholder management;
- describe mechanisms to manage stakeholder relationships and mitigate associated risks;
- describe functions and responsibilities of a company's board of directors and its committees;
- describe market and non-market factors that can affect stakeholder relationships and corporate governance;
- identify potential risks of poor corporate governance and stakeholder management, and identify benefits from effective corporate governance and stakeholder management;
- describe factors relevant to the analysis of corporate governance and stakeholder management;
- describe environmental and social considerations in investment analysis;
- describe how environmental, social, and governance factors may be used in investment analysis.

1. INTRODUCTION AND OVERVIEW OF CORPORATE GOVERNANCE

Weak corporate governance is a common thread found in many company failures. Lack of proper oversight by the board of directors, inadequate protection for minority shareholders, and incentives at companies that promote excessive risk taking are just a few of the examples that can be problematic for a company. Poor corporate governance practices resulted in several high-profile accounting scandals and corporate bankruptcies over the past several decades and have been cited as significantly contributing to the 2008–2009 global financial crisis.

In response to these failures, regulations have been introduced to promote stronger governance practices to protect financial markets and investors. Academics, policy makers, and other groups have published numerous works discussing the benefits of good corporate governance and identifying core corporate governance principles believed to be essential to ensuring continuous, well-functioning capital markets and the stability of the financial system.

The investment community has also demonstrated a greater appreciation for the importance of good corporate governance. The assessment of a company's corporate governance structure and controls, including consideration of conflicts of interest and transparency of operations, has been an essential factor in investment analysis. More data availability and demands for better governance have increased the weight of corporate governance in the investment decision-making process. In addition, investors have become more attentive to environmental and social issues related to a company's operations. Collectively, these concepts often are referred to as environmental, social, and governance (**ESG**).

Section 1 of this chapter provides an overview of corporate governance, including its underlying principles and theories. Section 2 discusses the various stakeholders of a company and conflicts of interest that exist among stakeholder groups. Section 3 describes the principal–agent and other relationships in corporate governance and the conflicts that may arise in these relationships. Section 4 describes stakeholder management, reflecting how companies manage their relationships with stakeholders. Section 5 focuses on mechanisms to manage stakeholder relationships and mitigate associated risks. Section 6 focuses on the role of the board of directors and its committees as overseers of the company. Section 7 explores certain key factors that affect stakeholder relationships and corporate governance. Section 8 highlights the risks and benefits that underlie a corporate governance structure. Section 9 synthesizes corporate governance concepts that should be considered by investment professionals. Finally, Section 10 discusses the growing use of environmental, social, and governance factors in investment analysis and portfolio construction processes.

1.1. Corporate Governance Overview

Corporate governance can be defined as "the system of internal controls and procedures by which individual companies are managed. It provides a framework that defines the rights, roles, and responsibilities of various groups within an organization. At its core, corporate governance is the arrangement of checks, balances, and incentives a company needs in order to minimize and manage the conflicting interests between insiders and external shareowners."[1]

[1] CFA Institute Centre for Financial Market Integrity, *The Corporate Governance of Listed Companies: A Manual for Investors*, 2nd ed. (Charlottesville, VA: CFA Institute, 2009).

Corporate governance practices differ among countries and jurisdictions, and even within countries different corporate governance systems may co-exist. The corporate governance systems adopted in most of the world typically reflect the influences of either *shareholder theory* or *stakeholder theory* to a varying extent, as well as historical, cultural, legal, political, and other influences specific to a region.

Shareholder theory takes the view that the most important responsibility of a company's managers is to maximize shareholder returns. Stakeholder theory broadens a company's focus beyond the interests of only its shareholders to its customers, suppliers, employees, and others who have an interest in the company. The approach to corporate governance in a given country typically places greater emphasis on one of the two theories but can also exhibit a combination of the two. Notwithstanding the system of corporate governance used, nearly all companies depend on contributions from a number of stakeholders for their long-term success. The company's strategy is set by the board of directors, which also oversees management. In turn, the company's strategy is executed by its managers; financial capital to fund the company's activities and operations is supplied by shareholders, creditors, and suppliers; human capital is provided by employees; and demand for goods and services comes from customers. Other stakeholders include governments and regulators, which seek to protect the interests and well-being of their citizens. Certain external forces, such as the legal environment and competition, affect the way a company operates and the relationships among its stakeholders.

Two reports issued during the 1990s, the Cadbury Report and the Principles of Corporate Governance, were particularly influential in shaping the global corporate governance landscape. In 1991, the Committee on the Financial Aspects of Corporate Governance was established in the United Kingdom by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession to examine corporate governance. In the following year, the report of the committee—commonly referred to as the Cadbury Report, after its chairperson—defined corporate governance simply as "the system by which companies are directed and controlled." The report focused on the responsibilities of a company's board of directors, shareholders, and auditors, with shareholders implicitly identified as the primary stakeholders. In 1999, the Organisation for Economic Co-Operation and Development (OECD) produced the *Principles of Corporate Governance*, which expanded the scope of corporate governance to consider the interests of other stakeholders—notably, employees, creditors, and suppliers. According to the OECD, "Corporate governance includes a set of relationships between a company's management, its board, its shareholders, and other stakeholders." The *Principles of Corporate Governance*, which has been revised numerous times since its initial publication, also discusses potential positive outcomes of good corporate governance practices (including financial market stability and economic growth) and includes standards and guidelines designed to evaluate and improve the corporate governance framework throughout the world.

There is evidence that some movement toward global convergence of corporate governance systems is underway. One trend is the increased acceptance and adoption of corporate governance regulations with similar principles from one jurisdiction to another. For example, several countries implemented regulations similar to those of the US Sarbanes–Oxley Act of 2002 (SOX) in response to corporate and accounting scandals of the early 2000s. Although these regulations are not identical, they share the same objective of improving internal controls and restoring investor confidence in financial disclosures. Another trend is initiatives by international agencies to build greater consensus on important corporate governance principles. The *Principles of Corporate Governance*, for example, has been ratified by more than 30 member countries, representing a broad range of corporate governance models. The *Principles of Corporate Governance* do not mandate, or even promote, the adoption of a single corporate governance regime; rather, the principles were designed to serve as a framework that can be adopted by any number of corporate governance systems.

EXAMPLE 1 Corporate Governance Overview

Which statement regarding corporate governance is *most* accurate?

A. Most countries have similar corporate governance regulations.
B. A single definition of corporate governance is widely accepted in practice.
C. Both shareholder theory and stakeholder theory consider the needs of a company's shareholders.

Solution: C is correct. Both shareholder and stakeholder theories consider the needs of shareholders, with the latter extending to a broader group of stakeholders. A is incorrect because corporate governance regulations differ across countries, although there is a trend toward convergence. B is incorrect because a universally accepted definition of corporate governance remains elusive.

2. STAKEHOLDER GROUPS

A corporate governance system is likely to be influenced by several stakeholder groups. These groups do not necessarily share similar goals or needs; in fact, the interests of any one group may conflict with the interests of another group. The varying influences of these groups are important considerations for investment professionals when analyzing a corporate governance system. This section provides an overview of a corporation's primary stakeholder groups, followed by a discussion of principal–agent considerations and the conflicts that may arise among the groups.

2.1. Stakeholder Groups

The primary stakeholder groups of a corporation consist of shareholders, creditors, managers (or executives), other employees, the board of directors, customers, suppliers, affected individuals and community groups, and governments/regulators. The interests of each of these groups are discussed in the following sections.

2.1.1. Shareholders

Shareholders own shares of stock in a corporation and are entitled to certain rights, such as the right to receive dividends and to vote on certain corporate issues.[2] In terms of capital structure, shareholders are the most junior class of capital providers; in case of a company bankruptcy,

[2]The Modern Corporation, "Statement on Company Law." https://themoderncorporation.wordpress.com/company-law-memo/.

shareholders receive proceeds only after all creditors' claims are paid. Shareholder interests are, therefore, typically focused on growth in corporate profitability that maximizes the value of a company's equity.

As a company grows in size and its operations and structure become more complex, most individual shareholders have limited or no involvement in the company's activities. Shareholders maintain control over the company through their power to elect the board of directors and vote for specified resolutions. The board of directors is expected to represent shareholders—protecting their interests, appointing senior management, providing strategic direction, and monitoring company and management performance. In publicly traded companies that have dispersed ownership, the voting power in general meetings is distributed among a large number of shareholders. But in some companies, a particular shareholder or block of shareholders may hold a percentage of shares that gives them sufficient voting power to control the election of the board of directors and to influence the approval or blockage of a company resolution; these shareholders are known as **controlling shareholders**. In contrast, non-controlling shareholders (**minority shareholders**) hold a much smaller proportion of a company's outstanding shares, resulting in a more limited ability to exercise control in voting activities.

2.1.2. Creditors

Creditors, most commonly bondholders and banks, are a company's lenders and the providers of debt financing. Creditors do not hold voting power (unlike common shareholders) and typically have limited influence over a company's operations. Creditors may protect themselves and exert some control over a company by using covenants, which restrict activities of the borrower. In return for capital provided, creditors expect to receive interest and principal payments. These payments are pre-determined from the terms of a debt contract and are typically not contingent on the company's performance. Creditors usually do not participate in a company's superior performance beyond receiving promised interest and principal payments. The company's ability to generate cash flows, mainly through its operations, is the primary source of payments for creditors. Consequently, creditors generally prefer stability in company operations and performance, which contrasts with the interests of shareholders, who generally are inclined to tolerate higher risks in return for higher return potential from strong company performance.

2.1.3. Managers and Employees

Senior executives and other high-level managers are normally compensated through salary, bonuses, equity-based remuneration (or compensation),[3] and certain perquisites. As a result, managers may be motivated to maximize the value of their total remuneration while also protecting their employment positions. Lower-level employees typically seek fair remuneration, good working conditions, access to promotions, career development opportunities, training and development, job security, and a safe and healthy work environment. Overall, remuneration packages that are designed to prevent employees from chasing short-term profits are likely to be most effective and aligned with long-term shareholder interests.

As with shareholders and creditors, managers and employees have a significant interest in the company's viability. Managers and employees tend to benefit if the company performs well

[3]The terms "remuneration" and "compensation" are typically interchangeable, with compensation generally used in North America and remuneration generally used outside North America. In this chapter, unless specifically identified with North America, we primarily use "remuneration."

and are among the most adversely affected stakeholders if a company's financial position weakens. Despite some similarities, the interests of managers and employees and other stakeholders can conflict. For example, a company may be presented with a takeover offer that is attractive to shareholders but would jeopardize the interests of managers in preserving their employment at the company.

2.1.4. Board of Directors

A company's board of directors is elected by shareholders to protect shareholders' interests, provide strategic direction, and monitor company and management performance. A board is typically structured as either *one-tier* or *two-tier*.

A one-tier structure consists of a single board of directors, composed of executive and non-executive directors. Executive (sometimes called "internal") directors are employees, typically senior managers, of the company. Non-executive (sometimes called "external") directors are not employees of the company. Countries in which one-tier boards are common include the United States, the United Kingdom, and India. A two-tier structure consists of two separate boards: (1) a *supervisory board*, which is primarily composed of non-executive directors, and (2) a *management (executive) board*, which is composed of executive directors. The supervisory board oversees the management board. Two-tier boards are common in such countries as Germany, the Netherlands, Finland, and China.

In this chapter, unless specified otherwise, the term "board" refers to the single board of directors in a one-tier structure and the supervisory board in a two-tier structure. Directors, both internal and external, are typically experienced individuals who are focused on fulfilling their responsibilities toward shareholders and the company while maintaining a good reputation in the business community. Directors are also typically concerned with their exposure to liability for breach of duty. Directors can mitigate this exposure, *inter alia*, by exercising appropriate levels of control over the company's operations and its management or by obtaining independent access to company documentation. A company's board of directors is discussed in more detail in Section 6 of this chapter.

2.1.5. Customers

Customers expect a company's products or services to satisfy their needs and provide appropriate benefits given the price paid, as well as to meet applicable standards of safety. Depending on the type of product or service and the duration of their relationship with the company, customers may desire ongoing support, product guarantees, and after-sale service. Companies are concerned with customer satisfaction given its potential correlation with sales revenue and profit. They are also increasingly concerned about brand boycotts due to adverse environmental and social impacts and controversies caused by their products and services. Compared with other stakeholder groups, customers tend to be less concerned with, and affected by, a company's financial performance. However, customers, particularly those who are dependent on the goods or services provided by the company, typically have an interest in a company's stability.

2.1.6. Suppliers

A company's suppliers have a primary interest in being paid as contracted or agreed on, and in a timely manner, for products or services delivered to the company. Suppliers often seek to build long-term relationships with companies for the benefit of both parties and aim for these relationships to be fair and transparent. Suppliers, like creditors, are concerned with a company's ability to generate sufficient cash flows to meet its financial obligations.

2.1.7. Governments/Regulators

Governments and regulators seek to protect the interests of the general public and ensure the well-being of their nations' economies. Because corporations have a significant effect on a nation's economic output, capital flows, employment, and social welfare, among other factors, regulators have an interest in ensuring that corporations behave in a manner that is consistent with applicable laws. Moreover, as the collector of tax revenues from companies and their employees, a government can also be considered one of the company's major stakeholders.

Stakeholders in Non-profit Organizations

The stakeholders of a non-profit organization tend to differ from those of for-profit companies. Non-profit organizations do not have shareholders. Their stakeholders most commonly include board directors or trustees, employees, regulators, society, patrons of the organization, donors, and volunteers. The stakeholders of non-profit organizations are generally focused on ensuring that the organization is serving the intended cause and that donated funds are used as promised.

EXAMPLE 2 Stakeholder Groups

Which stakeholders would *most likely* realize the greatest benefit from a significant increase in the market value of the company?

A. Creditors
B. Customers
C. Shareholders

Solution: C is correct. Shareholders own shares of stock in the company, and their wealth is directly related to the market value of the company. A is incorrect because creditors are usually not entitled to any additional cash flows (beyond interest and debt repayment) if the company's value increases. B is incorrect because customers may have an interest in the company's stability and long-term viability, but they do not benefit directly from an increase in a company's value.

3. PRINCIPAL–AGENT AND OTHER RELATIONSHIPS IN CORPORATE GOVERNANCE

A **principal–agent relationship** (also known as an agency relationship) is created when a principal hires an agent to perform a particular task or service. The principal–agent relationship involves obligations, trust, and expectations of loyalty; the agent is expected to act in the best interests of the principal. In a company, agency theory stipulates that principal–agent relationships often lead to conflicts—for example, when managers do not act in the best interests of shareholders.[4] Examples of principal–agent relationships and potential conflicts between the principal and agent are discussed in the following sections. Other conflicts among stakeholder groups not involving principal–agent relationships are also discussed.

3.1. Shareholder and Manager/Director Relationships

In shareholder-owned companies, shareholders typically grant directors and managers the responsibility to make most corporate decisions. According to traditional shareholder theory (discussed earlier), the central duty of directors and managers is to act in the best interests of shareholders. In certain circumstances, however, managers may seek to maximize their personal benefits (e.g., remuneration and perquisites) to the detriment of shareholders' interests.

Shareholder interests can also diverge from those of managers and directors with respect to risk tolerance. In some cases, shareholders with diversified investment portfolios may have a relatively high risk tolerance because the risk undertaken by a specific company can be diversified across the shareholders' investments. Managers and directors, however, are typically more risk averse in their corporate decision making so they can better protect their employment status. Such behavior may differ from the company's value creation objective. In addition, compared with shareholders, managers typically have greater access to information about the business and are more knowledgeable about its operations. Such information asymmetry (that is, unequal access to information) makes it easier for managers to make strategic decisions that are not necessarily in the best interest of shareholders and weakens the ability of shareholders to exercise control. Another conflict of interest might arise between shareholders and directors when the board is influenced by insiders. In this case, the ability of the board to properly perform its monitoring and control role may be hindered. Finally, a conflict between the two groups may occur if directors favor certain influential shareholders over other shareholders.

3.2. Controlling and Minority Shareholder Relationships

In companies in which a particular shareholder holds a controlling stake, conflicts of interest may arise among the controlling and minority shareholders. In such ownership structures, the opinions of minority shareholders are often outweighed or overshadowed by the influence of the controlling shareholders. Minority shareholders often have limited or no control over management and limited or no voice in director appointments or in major transactions that could have a direct effect on the value of their shares. For instance, in companies that adopt **straight voting** (that is, one vote for each share owned), controlling shareholders clearly wield the most influence in board of director elections, leaving minority shareholders with much less representation on the board.

The decisions made by controlling shareholders, or their board representatives, could also have an effect on corporate performance and, consequently, on minority shareholders' wealth. Takeover transactions are notable situations in which controlling shareholders

[4] Agency theory considers the problems that can arise in a business relationship when one person delegates decision-making authority to another. The traditional view in the investment community is that directors and managers are agents of shareholders. More recently, however, many legal experts have argued that in several countries, corporations are separate "legal persons"; thus, directors and managers are agents of the corporations rather than shareholders (or a subset of shareholders). See https://themoderncorporation.wordpress.com/company-law-memo.

typically have greater influence than do minority shareholders with regard to the consideration received and other deal terms. A historical example of note occurred in 2007 when Qtel, Qatar's largest telecommunications company, executed a deal with a consortium of the shareholders of Wataniya, Kuwait's telecommunications company, to acquire the consortium's shares in Wataniya (representing a 51% stake in the target). The consortium of Wataniya's shareholders sold their shares to Qtel at a premium of 48% on the stock price to the exclusion of minority shareholders.

Related-party transactions are another example for which controlling shareholders may place their interests ahead of minority shareholders' interests. Such a situation could occur when a controlling shareholder maintains a financial interest in a transaction between the company and a third party and that transaction conflicts with the company's best interests. Consider, for example, a controlling shareholder that arranges a deal between the company and a third-party supplier that is owned by the shareholder's spouse whereby the supplier provides the company with inventory at above-market prices. Such a transaction would benefit the controlling shareholder and the spouse's interests but could harm the profitability of the company and the interests of minority shareholders.

Lastly, an equity structure with multiple share classes in which one class is non-voting or has limited voting rights creates a divergence between the ownership and control rights of different classes of shareholders. Under a multiple-class structure (traditionally called a *dual-class structure* when there are two share classes), the company's founders, executives, and other key insiders control the company by virtue of ownership of a share class with superior voting powers. The multiple-class structure enables controlling shareholders to mitigate dilution of their voting power when new shares are issued. Examples of companies that have adopted multiple-class stock structures are Alibaba and Facebook (each with two share classes).

3.3. Manager and Board Relationships

Given that a board of directors typically relies on management to operate the company, the board's monitoring role can be compromised in the event of limited information provided to the board. This conflict is particularly pronounced for non-executive directors who are typically not involved in the day-to-day operations of a company.

3.4. Shareholder versus Creditor Interests

Shareholders typically seek growth in corporate profitability because of the residual nature of equity returns. However, the pre-determined returns of debt obligations normally prevent creditors from receiving any cash flows beyond principal and interest payments but do expose creditors to default risk in case of extremely poor corporate performance. From an investment perspective, shareholders would likely prefer riskier projects with a strong likelihood of higher return potential, whereas creditors would likely prefer stable performance and lower-risk activities. A divergence in risk tolerance regarding the company's investments thus exists between shareholders and creditors.

Creditors may also find their interests jeopardized when the company attempts to increase its borrowings to a level that would increase default risk. If the company's operations and investments fail to generate sufficient returns required to repay the increased interest and debt obligations, creditors will be increasingly exposed to default risk. The distribution of excessive dividends to shareholders might also conflict with creditors' interests if it impairs the company's ability to pay interest and principal.

3.5. Other Stakeholder Conflicts

In a corporation, interests can also conflict among other stakeholders. Some of these situations are as follows:

- *Conflict between customers and shareholders*: For example, a company decides to charge a high price for its products or reduces product safety features to reduce costs.
- *Conflict between customers and suppliers*: A company offers overly lenient credit terms to its customers, whereby the company's ability to repay suppliers on time may be affected.
- *Conflict between shareholders and governments or regulators*: Examples of such conflicts may include a company adopting accounting and reporting practices that reduce its tax burden, thus potentially benefiting shareholders, or a bank's shareholders preferring a lower equity capital base while regulators prefer a higher capital position. This last conflict is fairly common in the banking industry and has been increasingly in focus since the global financial crisis of 2008–2009.

EXAMPLE 3 Stakeholder Relationships

A controlling shareholder of XYZ Company owns 55% of XYZ's shares, and the remaining shares are spread among a large group of shareholders. In this situation, conflicts of interest are *most likely* to arise between:

A. shareholders and regulators.
B. the controlling shareholder and managers.
C. the controlling shareholder and minority shareholders.

Solution: C is correct. In this ownership structure, the controlling shareholder's power is likely more influential than that of minority shareholders. Thus, the controlling shareholder may be able to exploit its position to the detriment of the interests of the remaining shareholders. Choices A and B are incorrect because the ownership structure in and of itself is unlikely to create material conflicts between shareholders and regulators or shareholders and managers.

4. OVERVIEW AND MECHANISMS OF STAKEHOLDER MANAGEMENT

Because interests among stakeholder groups differ, companies often adopt mechanisms to more efficiently manage stakeholder relationships. **Stakeholder management** involves identifying, prioritizing, and understanding the interests of stakeholder groups, and, on that basis, managing the company's relationships with these groups.

4.1. Overview of Stakeholder Management

Effective communication and active engagement with the various stakeholders form the basis of stakeholder management. Although the practices underlying stakeholder management may vary, companies typically seek to balance the interests of their various stakeholders and thus limit the effect of conflicts.

To help balance these interests, corporate governance and stakeholder management frameworks reflect a legal, contractual, organizational, and governmental infrastructure that defines the rights, responsibilities, and powers of each group. The *legal infrastructure* defines the framework for rights established by law and the availability or ease of legal recourse for any violation of these rights. The *contractual infrastructure* is shaped by the contractual arrangements entered into by the company and its stakeholders that help define and secure the rights of both parties. The *organizational infrastructure* refers to internal systems, governance procedures, and practices adopted and controlled by the company in managing its stakeholder relationships. Lastly, the *governmental infrastructure* refers to regulations imposed on companies.

The corporate governance systems in such countries as France, Germany, and Japan focus on a broader range of stakeholders relative to the more shareholder-driven Anglo-American systems. Globally, there is a growing movement among regulators and practitioners to more effectively balance the interests of all stakeholders. For instance, the Companies Act 2006 in the United Kingdom introduced "enlightened shareholder value," which requires directors to consider the interests of all stakeholders—not just shareholders. Several regulators, such as those in the United Kingdom and Japan, have adopted stewardship codes that encourage more active engagement of institutional investors with companies.

EXAMPLE 4 Stakeholder Management

The component of stakeholder management in which a corporation has the *most* control is:

A. legal infrastructure.
B. contractual infrastructure.
C. governmental infrastructure.

Solution: B is correct. A corporation's contractual infrastructure refers to the contractual arrangements between the corporation and stakeholders. As such, the corporation has control over these arrangements. A is incorrect because the legal infrastructure is established by law, which is outside the corporation's own control. Similarly, C is incorrect because a corporation's governmental structure is largely imposed by regulators.

4.2. Mechanisms of Stakeholder Management

Stakeholder management and governance practices attempt to manage the interests of all stakeholders. As mentioned earlier, a prescribed or standard set of rights and practices does not exist across all companies, and the principles vary across countries and jurisdictions. Still, there are some common control elements and governance mechanisms among companies.

4.2.1. General Meetings

Corporate laws grant shareholders certain powers and controls. The participation of shareholders in general meetings, also known as general assemblies, and the exercise of their voting rights are among the most influential tools available. General meetings enable shareholders to participate in discussions and to vote on major corporate matters and transactions that are not delegated to the board of directors.

Companies are ordinarily required to hold an annual general meeting (AGM) within a certain period following the end of their fiscal year. The main purpose of those meetings is to present shareholders with the annual audited financial statements of the company, provide an overview of the company's performance and activities, and address shareholder questions. Shareholders also elect the directors at the AGM and, in some countries, may be required to approve the financial statements, discharge directors of their duties, appoint external auditors, or vote on the remuneration of the board and/or top management. Extraordinary general meetings can be called by the company or by shareholders throughout the year when significant resolutions requiring shareholder approval are proposed. These resolutions might relate to proposed material corporate changes, such as amendments to the company's bylaws or rights attached to a class of shares, mergers and acquisitions, or the sale of significant corporate assets or businesses.

All shareholders typically have the right to attend, speak at, and vote at general meetings. Regulations, particularly corporate laws, specify conditions for inviting shareholders to general meetings and circulating information to shareholders. These conditions vary across regulations but generally aim at ensuring the participation of a large number of shareholders in general meetings without imposing excessive restrictions on the ability of the company to hold a meeting. By engaging in general meetings, shareholders can exercise their voting rights on major corporate issues and better monitor the performance of the board and senior management. General meetings and the underlying voting procedures are among the most widely adopted practices by companies in mitigating agency problems and their associated risks.

Some resolutions, such as the approval of financial statements and the election of directors and auditors, are considered ordinary at general meetings because they require only a simple majority of votes to be passed. Decisions that are more material in nature may require a supermajority vote, such as two-thirds or 75% of votes, to be passed. Such special resolutions may include amendments to bylaws, voting on a merger or takeover transaction, or waiving preemptive rights. Depending on the ownership structure, supermajority requirements may make it harder for majority shareholders to influence corporate decisions at the expense of minority shareholders.

Proxy voting is a process that enables shareholders who are unable to attend a meeting to authorize another individual (for example, another shareholder or director) to vote on their behalf. Proxy voting is the most common form of investor participation in general meetings. Although most resolutions at most companies pass without controversy, sometimes minority shareholders attempt to strengthen their influence at companies via proxy voting. Several shareholders sometimes use this process to collectively vote their shares in favor of or in opposition to a certain resolution. **Cumulative voting** (as opposed to straight voting) enables shareholders to accumulate and vote all their shares for a single candidate in an election involving more than one director. This voting process raises the likelihood that minority shareholders are represented by at least one director on the board, but it may not be compatible with majority voting standards for director elections in which share ownership is widely dispersed. In terms of worldwide practice, the existence of cumulative voting varies; for example, it is mandated in Spain but not allowed in several countries, such as Germany, Japan, Singapore, and Turkey.

Minority shareholders are often granted rights to protect their interests in acquisitions. For example, companies in European Union member states are required to adopt sell-out rights. These rights allow minority shareholders who have voted against a merger offer to force a bidder with more than 90% of the target's voting rights to buy their shares at a fair price upon the deal's approval.

EXAMPLE 5 General Meetings

Which of the statements about extraordinary general meetings (EGMs) of shareholders is true?

A. The appointment of external auditors occurs during the EGM.
B. A corporation provides an overview of corporate performance at the EGM.
C. An amendment to a corporation's bylaws typically occurs during the EGM.

Solution: C is correct. An amendment to corporate bylaws would normally take place during an EGM, which covers significant changes to a company, such as bylaw amendments. A and B are incorrect because the appointment of external auditors and a corporate performance overview would typically take place during the AGM.

4.2.2. Board of Director Mechanisms

In companies with complex ownership structures and operations, it is impractical for shareholders to be involved in strategy formulation and day-to-day activities. Shareholders thus elect a board of directors to provide broad oversight of the company. Shareholders monitor the board's performance through exercise of voting power and participation in general meetings. The board, in turn, appoints the top management of the company. The board is accountable primarily to shareholders and is responsible for the proper governance of the company; in this regard, the board is the link between shareholders and managers. The board guides managers on the company's strategic direction, oversees and monitors management's actions in implementing the strategy, and evaluates and rewards or disciplines management performance. The board also supervises the company's audit, control, and risk management functions and ensures the adoption of proper governance systems and compliance with all applicable laws and regulations. In Section 6, we provide more detail regarding the functions and responsibilities of the board of directors and its committees.

4.2.3. The Audit Function

The audit function is an integral component of any governance structure. The function represents the systems, controls, and policies/procedures in place to examine the company's operations and financial records. Internal audits are conducted by an independent internal audit function or department. External auditors are independent from the company and conduct an annual audit of the company's financial records to provide reasonable and independent assurance of the accuracy of financial statements and their fair representation of the financial position of the company. External auditors are typically recommended by an audit committee (which we discuss later in the chapter) for appointment by shareholders or, in some jurisdictions, by the board. The board of directors is generally required to receive and review the financial statements and auditors' reports and confirm their accuracy before they are presented to shareholders for approval at the AGM. Senior management of publicly traded companies is also required to review and provide assurance of the effectiveness of the internal control systems to the board of directors or to shareholders. Overall, a company's audit function limits insiders' discretion with regard to the use of company resources and to its financial reporting. The audit function is also designed to mitigate incidents of fraud or misstatements of accounting and financial information.

4.2.4. Reporting and Transparency

Shareholders have access to a range of financial and non-financial information concerning the company, typically through annual reports, proxy statements, disclosures on the company's website, the investor relations department, and other means of communication (e.g., social media). This information may relate to the company's operations, its strategic direction or objectives, audited financial statements, governance structure, ownership structure, remuneration policies, related-party transactions, and risk factors. Such information is essential for shareholders to

- reduce the extent of information asymmetry between shareholders and managers;
- assess the performance of the company and of its directors and managers;
- make informed decisions in valuing the company and deciding to purchase, sell, or transfer shares; and
- vote on key corporate matters or changes.

4.2.5. Policies on Related-Party Transactions

The development and implementation of policies for related-party transactions and other conflicts of interest is an increasingly common practice among companies. These policies establish the procedures for mitigating, managing, and disclosing such cases. Typically, directors and managers are required to disclose any actual or potential, or direct or indirect, conflict of interest they have with the company, as well as any material interests in a transaction that may affect the company. Often, these policies require such transactions or matters to be voted on by the board (or shareholders) excluding the director (or shareholder) holding the interest. The adoption of these policies and procedures aims at ensuring that related-party transactions are handled fairly and that they do not advance the interests of the related party at the expense of the interests of the company or other shareholders.

4.2.6. Remuneration Policies

Executive remuneration plans have gained significant attention in the investment world, with a primary goal of aligning the interests of managers with those of shareholders. For this purpose, incentive plans increasingly include a variable component—typically profit sharing, stocks, or stock options—that is contingent on corporate or stock price performance. However, the granting of stock-based remuneration does not serve its purpose if managers can improve their personal gains at the expense of the company while limiting their exposure to weak stock performance. As a result, companies are increasingly designing incentive plans that discourage either "short-termism" or excessive risk taking by managers. Some incentive plans include granting shares, rather than options, to managers and restricting their vesting or sale for several years or until retirement. A long-term incentive plan delays the payment of remuneration, either partially or in total, until company strategic objectives (typically performance targets) are met.

Regulators across the world are also increasingly focused on remuneration policies. In some cases, regulators require companies to base remuneration specifically on long-term performance measures. A number of regulators are requiring companies, including many in the financial industry, to adopt clawback provisions. These provisions allow a company to recover previously paid remuneration if certain events, such as financial restatements, misconduct, breach of the law, or risk management deficiencies, are uncovered.

4.2.7. Say on Pay

Given the role of remuneration plans in aligning the interests of executives with those of shareholders, regulators and companies are increasingly seeking shareholder views on pay. The concept of **say on pay** enables shareholders to vote on executive remuneration matters. Say on pay was first introduced in the United Kingdom in the early 2000s. In an early example of shareholder rejection, in 2003 the shareholders of GlaxoSmithKline rejected the company's remuneration report because of opposition to the proposed executive pay. This was the first such rejection by the shareholders of a large UK-based company. Shortly thereafter, the practice of say on pay spread to other parts of the world and was implemented in the United States as part of the Dodd–Frank Act in 2011. In 2018, there were a number of instances in which shareholders voted against remuneration reports. In the United Kingdom, for example, Inmarsat plc's remuneration report was rejected by 58% of voters over concerns that executive compensation was not aligned with company performance. In the United States, 52% of Walt Disney Co.'s shareholders voted against what they believed was an excessive executive compensation package.

The scope and effect of say on pay varies across countries and companies. Some countries, such as Canada, have a non-mandatory and advisory (non-binding) say-on-pay system in which shareholders signal, rather than impose, their views on proposed remuneration. In other countries, such as the United States, France, and South Africa, say on pay is mandatory but non-binding. In these countries, the board is required to enable shareholders to vote on remuneration plans or packages, but the board does not have to abide by the result of the vote. Conversely, countries in which shareholder votes on say on pay are binding include the Netherlands, the United Kingdom, and China.

Say on pay has been subject to criticism because of the fact that shareholders often have limited involvement in a company's strategy and operations. These opponents argue that the board is better suited to determine remuneration matters. Conversely, by allowing shareholders to express their views on remuneration-related matters, companies can limit the discretion of directors and managers in granting themselves excessive or inadequate remuneration. This approach could thus reduce a critical agency conflict in stakeholder management by better aligning the interests of principals and agents.

5. MECHANISMS TO MITIGATE ASSOCIATED STAKEHOLDER RISKS

The rights of creditors are established by laws and according to contracts executed with the company. Laws vary by jurisdiction but commonly contain provisions to protect creditors' interests and provide legal recourse. One such provision is an **indenture**, which is a legal contract that describes the structure of a bond, the obligations of the issuer, and the rights of the bondholders. To limit creditors' risk during the term of a bond (or loan), debtholders may choose to impose **covenants** within indentures or contracts. Covenants are the terms and conditions of lending agreements, enabling creditors to specify the actions an issuer is obligated to perform or prohibited from performing. Affirmative covenants require bond issuers to perform certain actions, such as maintaining adequate levels of insurance. Restrictive covenants require bond issuers to not perform certain actions, such as allowing the liquidity level to fall below a minimum coverage ratio. **Collaterals** are another tool often used by creditors to guarantee repayment, representing assets or financial guarantees that are above and beyond an issuer's promise to repay its obligations.

To further protect their rights, creditors usually require the company to provide periodic information (including financial statements) to ensure that covenants are not violated and thus potential default risk is not increased. Because it is usually impractical and costly for individual bondholders to fully scrutinize a bond issue, companies often hire a financial institution to act as a trustee and monitor the issue on behalf of a class of bondholders. In some countries, credit committees, particularly for unsecured bondholders, are established once a company files for bankruptcy. Such committees are expected to represent bondholders throughout the bankruptcy proceedings and protect bondholder interests in any restructuring or liquidation.

5.1. Employee Laws and Contracts

Employee rights are primarily secured through labor laws, which define the standards for employees' rights and responsibilities and cover such matters as labor hours, pension and retirement plans, hiring and firing, and vacation and leave. In most countries, employees have the right to create unions. Unions seek to influence certain matters affecting employees. In the European Union, companies meeting specific size and geographic criteria are required to establish European Works Councils that are composed of employees who meet with management at least annually. Although not a common practice in the United States and many other parts of the world, employees are sometimes represented on the board of directors—or supervisory boards—of companies meeting certain size or ownership criteria (e.g., in Germany, Austria, and Luxembourg). In Japan, the employee model stresses reaching a consensus between management and employees in decision making.

At the individual level, employment contracts specify an employee's various rights and responsibilities. Employment contracts typically do not cover every situation between employees and employers, and thus there is some area of discretion in the employment relationship. Human resources policies also help companies manage their relationships with employees. Effective human resources policies seek to attract and recruit high-quality employees while providing remuneration, training/development, and career growth to improve employee retention. Some companies have employee stock ownership plans (ESOPs) to help retain and motivate employees. As part of an ESOP, a company establishes a fund consisting of cash and/or company shares. The shares, which have designated vesting periods, are granted to employees.

Codes of ethics and business conduct also serve an important role in the relationship between employees and the company. Such codes establish the company's values and the standards of ethical and legal behavior that employees must follow. Companies typically assign a compliance or corporate governance officer (or a board committee) to implement these codes, receive violation reports, and resolve ethical matters. In addition, whistleblower protection policies are another mechanism to ensure misconduct can be safely reported so as to mitigate associated stakeholder risks.

By managing its relationships with its employees, a company seeks to comply with employees' rights and mitigate legal or reputational risks in violation of these rights. Employee relationship management also helps ensure that employees are fulfilling their responsibilities toward the company and are qualified and motivated to act in the company's best interests.

5.2. Contractual Agreements with Customers and Suppliers

Both customers and suppliers enter into contractual agreements with a company that specify the products and services underlying the relationship, the prices or fees and the payment terms, the rights and responsibilities of each party, the after-sale relationship, and any guarantees. Contracts also specify actions to be taken and recourse available if either party breaches the terms of the contract.

5.3. Laws and Regulations

As part of their public service roles, governments and regulatory authorities develop laws that companies must follow and monitor companies' compliance with these laws. Such laws may address or protect the rights of a specific group, such as consumers or the environment. Some industries or sectors whose services, products, or operations are more likely to endanger the public or specific stakeholders' interests are usually subject to a more rigorous regulatory framework. Examples of these industries are banks, food manufacturers, and health care companies.

Many regulatory authorities have also adopted corporate governance codes that consist of guiding principles for publicly traded companies. Publicly traded companies, in turn, are generally required to annually publish corporate governance reports describing their governance structure and explain any deviations from guiding principles. Companies normally seek to adopt internal governance and compliance procedures and adhere to the relevant financial reporting and transparency requirements imposed by regulators.

EXAMPLE 6 Stakeholder Relationships

Which of the following is **not** typically used to protect creditors' rights?

A. Proxy voting
B. Collateral to secure debt obligations
C. The imposition of a covenant to limit a company's debt level

Solution: A is correct. Proxy voting is a practice adopted by shareholders, not creditors. B and C are incorrect because both collateral and covenants are used by creditors to help mitigate the default risk of a company.

6. COMPANY BOARDS AND COMMITTEES

As discussed earlier in the chapter, the board of directors is a central component of a company's governance structure. The board serves as the link between shareholders and managers and acts as the shareholders' monitoring tool within the company. As the relevance of corporate governance has grown within the investment field, the responsibilities of the board of directors have also increased in importance.

6.1. Composition of the Board of Directors

The structure and composition of a board of directors vary by company and geography. There is no single or optimal structure, and the number of directors may differ depending on the company size, structure, and complexity of operations. Most corporate governance codes require that the board include a diverse mix of expertise, backgrounds, and competencies. Such qualifications may include specialized knowledge of the company's industry as well as experience in certain functions, such as strategy, finance/audit, risk management, human resources, or legal. Moreover, many companies seek age, gender, and racial diversity in board composition.

Boards with one-tier structures comprise a mix of executive and non-executive directors. Executive (or internal) directors are employed by the company and are typically members of senior management. Non-executive (or external) directors provide objective decision making, monitoring, and performance assessment. Additionally, non-executive directors can serve an important role in challenging management and using past expertise in strategy and board issues. An *independent director* is a specific type of non-executive director that does not have a material relationship with the company with regard to employment, ownership, or remuneration.

In two-tier structures, the supervisory and management boards are independent from each other. Regulators generally prohibit members of the management board from serving on the supervisory board or limit the number of individuals serving on both boards. Employee representatives are typically elected by the company's employees and could make up half of the supervisory board in large companies.

In many countries, the chief executive officer (CEO) and chairperson roles are increasingly separated. In the United States, many companies have historically had "CEO duality," in which the CEO also serves as chairperson of the board. Nevertheless, the percentage of companies separating the two roles, particularly in the United States, has increased considerably since the global financial crisis of 2008–2009. The appointment of a lead independent director is an alternative that is sometimes practiced by boards of companies with CEO duality. The lead independent director generally has the authority to request and oversee meetings of all independent directors. Duality is not applicable in two-tier structures that prohibit the members of the management board from serving on the supervisory board. In these models, the chairperson of the supervisory board is typically external and the CEO usually chairs the management board.

Staggered Boards

The general practice for boards is that elections occur simultaneously and for specified terms (three years, for example). Some companies, however, have **staggered boards**, whereby directors are typically divided into three classes that are elected separately in consecutive years—that is, one class every year. Because shareholders would need several years to replace a full board, this election process limits their ability to effect a major change of control at the company. The positive aspect of a staggered board, though, is that it provides continuous implementation of strategy and oversight without constantly being reassessed by new board members thereby bringing short-termism into company strategy. This staggered board model was historically prevalent in the United States but has been generally replaced by regular board election terms. In contrast, the practice is common in Australia.

6.2. Functions and Responsibilities of the Board

As mentioned earlier, a company's board of directors is elected by shareholders to act on their behalf. In fulfilling their functions, directors have a responsibility to consider the interests of all stakeholders. The duties of directors are mandated by law in many countries but vary across jurisdictions. Two widely established elements of directors' responsibilities are the *duty of care* and the *duty of loyalty*. According to the OECD's *Principles of Corporate Governance*, duty of care "requires board members to act on a fully informed basis, in good faith, with due diligence and care." The OECD further notes that duty of loyalty "is the duty of the board member to act in the interest of the company and shareholders. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and all shareholders."

A board of directors does not typically engage in the company's day-to-day activities; rather, those activities are delegated to management. The board guides and approves the company's strategic direction, taking into consideration the company's risk profile. It delegates the implementation of the company's strategy to senior management, oversees the execution of the strategy, and establishes milestones to monitor the progress in reaching the objectives. The board also reviews corporate performance and determines relevant courses of action accordingly. In doing so, the board can monitor and evaluate management's performance and determine whether senior executive remuneration is aligned with the long-term interests of the company. The board is also responsible for selecting, appointing, and terminating the employment of senior managers (or the management board in case of a two-tier structure). One of the board's main responsibilities is to ensure leadership continuity through succession planning for the CEO and other key executives.

The board plays a central role in ensuring the effectiveness of the company's audit and control systems. It sets the overall structure of these systems and oversees their implementation, including oversight of the financial reporting practices and review of the financial statements for fairness and accuracy. The board also oversees reports by internal audit, the audit committee, and the external auditors and proposes and follows up on remedial actions. The board has the ultimate responsibility to ensure that the company adopts and implements proper corporate governance principles and complies with all applicable internal and external laws and regulations, including ethical standards.

In addition, the board typically ensures that the company has an appropriate enterprise risk management system in place, whereby risks are identified, mitigated, assessed, and managed appropriately. The board monitors the effectiveness of these systems through regular reviews and reports received from both management and the company's risk function. The board also has the responsibility to review any proposals for corporate transactions or changes, such as major capital acquisitions, divestures, mergers, and acquisitions, before they are referred to shareholders for approval, if applicable.

6.3. Board of Directors Committees

A company's board of directors typically establishes committees that focus on specific functions. Such committees, in turn, provide recommendations that are reported to the board on a regular basis. Despite the delegation of responsibilities to committees, the overall board remains ultimately responsible to shareholders and is not discharged of its liabilities to shareholders. Although board committees may vary by organization, some of the most common committees are discussed in the following sections.

6.3.1. Audit Committee

The audit committee is perhaps the most common board committee among companies worldwide. The audit committee plays a key role in overseeing the audit and control systems at the company and ensuring their effectiveness. In this regard, the committee monitors the financial reporting process, including the application of accounting policies; ensures the integrity of financial statements; supervises the internal audit function and ensures its independence and competence; and presents an annual audit plan to the board and monitors its implementation by the internal audit function. The audit committee is also responsible for recommending the appointment of an independent external auditor, periodically assessing the independence of the external auditor, and proposing the auditor's remuneration. Both internal and external auditors report their findings to the audit committee, which in turn proposes remedial action for highlighted issues or matters.

6.3.2. Governance Committee

The primary role of the governance (or corporate governance) committee is to ensure that the company adopts good corporate governance practices. In doing so, the committee develops and oversees the implementation of the corporate governance code, the charters of the board and its committees, and the company's code of ethics and conflict of interest policy. The governance committee reviews these policies on a regular basis to incorporate any regulatory requirements or relevant developments in the field. Most importantly, the committee monitors the implementation of the governance policies and standards as well as the compliance with applicable laws and regulations throughout the company. Remedial actions are recommended if any flaws or breaches of laws or regulations are identified. In some companies, the governance committee may be responsible for overseeing an annual evaluation of the board to ensure that its structure and activities are aligned with the governance principles.

6.3.3. Remuneration or Compensation Committee

The remuneration (or compensation) committee of the board specializes in remuneration matters. This committee develops and proposes remuneration policies for the directors and key executives and presents them for approval by the board or shareholders. The committee may also be involved in handling the contracts of managers and directors as well as in setting performance criteria and evaluating the performance of managers. The responsibilities of the remuneration committee may extend to establishing human resources policies for the company when remuneration matters are involved. In some companies, the remuneration committee also sets and oversees the implementation of employee benefit plans, including insurance, pension, severance benefits, and retirement plans (including monitoring the investment performance of benefit plan funds).

6.3.4. Nomination Committee

The nomination committee identifies candidates who are qualified to serve as directors and recommends their nomination for election by shareholders. The committee also establishes the nomination procedures and policies, including the criteria for board directors, the search process, and the identification of qualified candidates for director positions. Director independence, including what constitutes an independent director, is also a function of the nomination committee. Through these roles, the nomination committee can help ensure that the board's composition is well balanced and aligned with the company's governance principles.

6.3.5. Risk Committee

The risk committee assists the board in determining the risk policy, profile, and appetite of the company. Accordingly, the committee oversees establishing enterprise risk management plans and monitors their implementation. It also supervises the risk management functions in the company, receives regular reports, and reports on its findings and recommendations to the board.

6.3.6. Investment Committee

The investment committee of the board reviews material investment opportunities proposed by management and considers their viability for the company. Such opportunities may include large projects, acquisitions, and expansion plans, as well as divestures or major asset disposals. The committee often challenges, when necessary, management assumptions underlying investment prospects, monitors the performance of investments, and reports its findings to the board. The committee also is typically responsible for establishing and revising the investment strategy and policies of the company.

The specific board committees discussed in previous sections are the most commonly used, although the composition and number of committees may vary depending on the jurisdiction or on company-specific factors (e.g., company size, industry, complexity of operations, or regulatory requirements). An audit committee, for instance, is a regulatory requirement in a large number of jurisdictions. For banks and other financial institutions, a risk committee is strongly recommended by some regulators and required by others. In Brazil, the Central Bank of Brazil requires financial institutions to establish a remuneration committee at the board level. Some companies choose to combine two or more committees into one—for example, a nomination and remuneration (or compensation) committee or an audit and risk committee. Companies may also find it valuable to establish committees with other specializations, such as a compliance committee, an ethics committee, a human resources committee, or a health/environmental/safety committee.

The composition of a board committee is normally aligned with its scope of responsibilities. For instance, many regulators request that executive (internal) directors do not rule on matters underlying conflicts of interest or on matters requiring an unbiased judgment (such as audit, remuneration, or related-party transaction matters). As such, a large number of rules, including those adopted by the London Stock Exchange and the New York Stock Exchange, require that the audit and the compensation committees be composed of independent directors only. Countries with less-stringent regulations may require the audit committee to be composed of external (non-executive) directors, the majority of which should be independent (including the chairperson).

EXAMPLE 7 Responsibilities of Board Committees

A primary responsibility of a board's audit committee does **not** include the:

A. proper application of accounting policies.
B. adoption of proper corporate governance.
C. recommendation of remuneration for the external auditor(s).

Solution: B is correct. The adoption of proper corporate governance is the responsibility of a corporation's governance committee. Both A and C are incorrect because proper application of accounting policies and the remuneration of external auditors fall under the domain of the audit committee.

7. RELEVANT FACTORS IN ANALYZING CORPORATE GOVERNANCE AND STAKEHOLDER MANAGEMENT

This section explores ways in which certain factors, both market and non-market related, can affect stakeholder relationships and corporate governance. For this section, market factors include those that relate to capital markets, whereas non-market factors do not.

7.1. Market Factors

This section focuses on shareholder engagement, shareholder activism, and competitive forces, all of which are influential market factors for a company. Shareholder engagement involves a company's interactions with its shareholders to better understand how it manages its material risks and opportunities. Shareholder activism, on the other hand, involves more aggressive and sometimes public efforts by large shareholder(s) to create a significant change in a corporation's behavior. Meanwhile, competitive dynamics can help align managerial interests with those of its stakeholders.

7.1.1. Shareholder Engagement

The engagement of companies with shareholders—called **shareholder engagement**—has traditionally involved certain events, such as the annual shareholder meeting and analyst calls, the scope of which was limited to financial and strategic matters. There is a growing trend, however, for greater engagement between companies and their shareholders beyond these venues and topics. Companies have increasingly recognized the benefits that frequent, year-round engagement with shareholders can provide, such as building support against short-term activist investors, countering negative recommendations from proxy advisory firms, and receiving greater support for management's position.

7.1.2. Shareholder Activism

Shareholder activism refers to strategies used by shareholders to attempt to compel a company to act in a desired manner. Although shareholder activism can focus on a range of issues, including those involving social or political considerations, the primary motivation of activist shareholders is to increase shareholder value. Activist shareholders often pressure management through such tactics as initiating proxy battles (fights), proposing shareholder resolutions, and publicly raising awareness on issues of contention.

Shareholder activists may pursue additional tactics, such as shareholder derivative lawsuits, which are legal proceedings initiated by one or more shareholders against board directors, management, and/or controlling shareholders of the company. The theory behind this type of lawsuit is that the plaintiff shareholder is deemed to be acting on behalf of the company in place of its directors and officers who have failed to adequately act for the benefit of the company and its shareholders. In many countries, however, the law restricts shareholders from pursuing legal action via the court system—in some cases, by imposing thresholds that enable only shareholders with interests above a minimum amount to pursue legal actions or by denying legal action altogether.

Hedge funds are among the most predominant shareholder activists. Compared with most traditional institutional investors, the fee structure of hedge funds often provides a significant stake in the financial success of any activist campaign. Furthermore, unlike regulated investment entities that are typically subject to restrictions on their investments (e.g., limitations on leverage or ownership of distressed or illiquid securities), hedge funds are loosely regulated and can thus pursue a greater range of activist opportunities.

7.1.3. Competition and Takeovers

Metrics that measure a company's success, such as market share or earnings growth, provide information that is useful for shareholders to judge the performance of a company's management team or board of directors and compare such performance with that of competitors. Senior managers risk their employment status in the event of underperformance, and directors, in turn, can be voted out by shareholders.

The traditional view of the market for corporate control (often known as the takeover market) is one in which shareholders of a company hire and fire management to achieve better resource utilization. Corporate takeovers can be pursued in several different ways. One mechanism is the **proxy contest** (or proxy fight). In a proxy contest, shareholders are persuaded to vote for a group seeking a controlling position on a company's board of directors. Managerial teams can also be displaced through a **tender offer**, which involves shareholders selling their interests directly to the group seeking to gain control. A contest for corporate control may attract arbitrageurs and takeover specialists, who facilitate transfers of control by accumulating long positions from existing shareholders in the target company and later selling the positions to the highest bidder. Finally, a **hostile takeover** is an attempt by one entity to acquire a company without the consent of the company's management.

Preservation of their employment status serves as an incentive for board members and managers to focus on shareholder wealth maximization. This threat of removal, however, can also have negative implications for a company's corporate governance practices if the company chooses to adopt anti-takeover measures, such as a staggered board or a shareholder rights plan (also known as a poison pill) to reduce the likelihood of an unwanted takeover. Staggering director elections can dilute the value of shareholder voting rights by extending the term that each director serves and eliminating the ability of shareholders to replace the entire board at any given election. Shareholder rights plans enable shareholders to buy additional shares at a discount if another shareholder purchases a certain percentage of the company's shares. These plans are designed to increase the cost to any bidder seeking to take over a company.

EXAMPLE 8 Shareholder Activism

Which of the following is true of shareholder activism?

A. Shareholder activists rarely include hedge funds.
B. Regulators play a prominent role in shareholder activism.
C. A primary goal of shareholder activism is to increase shareholder value.

Solution: C is correct. Although the subject of shareholder activism may involve social and political issues, activist shareholders' primary motivation is to increase shareholder value. A is incorrect because hedge funds commonly serve as shareholder activists. B is incorrect because regulators play a prominent role in standard setting, not shareholder activism.

7.2. Non-market Factors

This section focuses on certain non-market factors, such as a company's legal environment, the role of the media, and the corporate governance industry, that can have an effect on stakeholder relationships and corporate governance.

7.2.1. Legal Environment

The legal environment in which a company operates can significantly influence the rights and remedies of stakeholders. Countries that have a common law system (such as the United Kingdom, the United States, India, and Canada) are generally considered to offer superior protection of the interests of shareholders and creditors relative to those that have adopted a civil law system (such as France, Germany, Italy, and Japan). The key difference between the two systems lies in the ability of a judge to create laws. In civil law systems, laws are created primarily through statutes and codes enacted by the legislature. The role of judges is generally limited to rigidly applying the statutes and codes to the specific case brought before the court. In contrast, in common law systems, laws are created both from statutes enacted by the legislature and by judges through judicial opinions. In common law systems, shareholders and creditors have the ability to appeal to a judge to rule against management actions and decisions that are not expressly forbidden by statute or code, whereas in civil law systems, this option is generally not possible.

Regardless of a country's legal system, creditors are generally more successful in seeking remedies in court to enforce their rights than shareholders are because shareholder disputes often involve complex legal theories, such as whether a manager or director breached a duty owed to shareholders. In contrast, disputes involving creditors, such as whether the terms of an indenture or other debt contract have been breached, are more straightforward and therefore more easily determinable by a court.

7.2.2. The Media

The media can affect corporate governance and influence stakeholder relationships through its ability to spread information quickly and shape public opinion. As an example, negative media attention can adversely affect the reputation or public perception of a company or its managers and directors. Senior management's concern over reputational risk can thus reduce the cost of monitoring management activities by stakeholders. Media attention can motivate politicians and regulators to introduce corporate governance reforms or enforce laws that protect stakeholders and society at large. This influence was evident in the aftermath of the 2008–2009 global financial crisis, when significant media attention was a factor in the adoption of new laws and regulations designed to address perceived deficiencies in corporate governance.

Social media has become a powerful tool that stakeholders have increasingly used to protect their interests or enhance their influence on corporate matters. Prior to the advent of social media, companies typically had an advantage in distributing information because of their considerable resources as well as relationships with traditional media organizations. Through social media, stakeholders can instantly broadcast information with little cost or effort and are thus better able to compete with company management in influencing public sentiment.

7.2.3. The Corporate Governance Industry

An important catalyst for the rise of the corporate governance industry occurred in 2003, when the Securities and Exchange Commission (SEC) required US-registered mutual funds to disclose their proxy voting records annually. The same rule also required US mutual funds to adopt policies and procedures designed to reasonably ensure that proxies would be voted in the best interests of their clients. In the years following the SEC's 2003 mutual fund rule, institutional investors have, to varying degrees, committed additional resources to monitor and vote proxies for the large number of companies in which they invest.

With the increased importance and relevance of corporate governance among investors, the demand for external corporate governance services has grown considerably. In particular, some institutional investors have retained proxy voting firms to assist with corporate governance monitoring and proxy voting. In response to this demand, an industry that provides corporate governance services, including governance ratings and proxy advice, has developed. Because the corporate governance industry is relatively concentrated, these vendors have considerable influence in corporate governance practices, and in turn, corporations are generally compelled to pay attention to ratings and recommendations produced by the corporate governance industry.

8. RISKS AND BENEFITS OF CORPORATE GOVERNANCE AND STAKEHOLDER MANAGEMENT

As illustrated thus far, good corporate governance and stakeholder management can have a meaningfully positive effect on a company. A company will likely not meet the expectations of all stakeholders if one group is able to extract private benefits at the expense of another group. Depending on their nature and magnitude, unmanaged conflicts of interest and weak control over a company's operations may expose the company to various risks, such as legal, regulatory, reputational, or default risks. By adopting effective guidelines for managing the interests of stakeholder groups and instituting adequate levels of control, corporate governance can be reflected in better company relationships, superior levels of efficiency in operations, and improved financial performance.

8.1. Risks of Poor Governance and Stakeholder Management

Weaknesses in stakeholder management mechanisms or the adoption of poor governance structures can create various risks for a company and its stakeholders. A weak control environment can encourage misconduct and hinder the ability of the company to identify and manage risks.

8.1.1. Weak Control Systems

In a company with weak control systems or inefficient monitoring tools, such as poor audit procedures or insufficient scrutiny by the board, one stakeholder group may benefit at the expense of the company or other stakeholders. This could consequently have an adverse effect on the company's resources, performance, and value. The audit deficiencies at Enron, for instance, prevented the uncovering of the acts of fraud, erroneous accounting records, and other related issues that led to one of the largest corporate bankruptcies in US history.

8.1.2. Ineffective Decision Making

When the quality and quantity of information available to managers are superior to those available to the board or shareholders, in the absence of sufficient monitoring tools, managers have an opportunity to make decisions that benefit themselves relative to the company or shareholders. Without proper scrutiny, such practices might go unnoticed. Deficient decisions could include managing the company with a lower risk profile relative to shareholders' tolerance, thus avoiding investment opportunities that could create value for the company. Conversely, manager overconfidence may result in poor investment decisions without proper examination of their effect on the company or on shareholders' wealth.

Remuneration policies for management could also have significant implications for the company. Outsized remuneration packages for executives could have an adverse effect on shareholders' wealth, constitute a burden on corporate performance, and affect the interests of other stakeholders, such as employees, customers, or creditors. Remuneration policies that are not carefully designed may also encourage managers to seek immediate personal gains by taking excessive risks or focusing on creating short-term performance or stock price increases. Related-party transactions that underlie unfair terms for the company are another example of activities that are not aligned with the objective of value creation and that could be facilitated by a poor governance system.

8.1.3. Legal, Regulatory, and Reputational Risks

Compliance weaknesses in the implementation of regulatory requirements or lack of proper reporting practices may expose the company to legal, regulatory, or reputational risks. In such cases, the company may become subject to investigation by government or regulatory authorities for violation of applicable laws. A company could also be exposed to lawsuits filed by shareholders, employees, creditors, or other parties for breach of contractual agreements or company bylaws or for violation of stakeholders' legal rights. In today's markets, information flows rapidly. Improperly managed conflicts of interest or governance failures could bring reputational damage to the company, and its associated costs could be significant. Such risks are particularly acute for publicly listed companies subject to scrutiny by investors, analysts, and other market participants.

8.1.4. Default and Bankruptcy Risks

Poor corporate governance, including weak management of creditors' interests, can affect the company's financial position and may hinder its ability to honor its debt obligations. To the extent that the deterioration of corporate performance results in a debt default, the company may be exposed to bankruptcy risk if creditors choose to take legal action. The adverse consequences of corporate failures are not limited to the company's shareholders; they extend to other stakeholders, such as managers and employees and even society and the environment.

8.2. Benefits of Effective Governance and Stakeholder Management

The development of good governance practices can play a vital role in aligning the interests of managers and the board of directors with those of shareholders, while balancing the interests of the company's stakeholders. A good governance structure can be reflected in operational efficiency, improved control processes, better financial performance, and lower levels of risk.

8.2.1. Operational Efficiency

As part of a good governance structure, an organization clarifies the delegation of responsibilities and reporting lines across the company and ensures that all employees have a clear understanding of their respective duties. When balanced with adequate internal control mechanisms, the governance structure can ensure that corporate decisions and activities are properly monitored and controlled to mitigate risk and help improve the operational efficiency of the company.

8.2.2. Improved Control

Governance practices seek to institute more effective control exercised at all corporate levels, from shareholders to the board of directors and management. These practices can help identify and manage risk at early stages that can otherwise hinder corporate performance and/or damage reputation. Control can be enhanced by the proper functioning of a company's audit committee and the effectiveness of its audit systems. By adopting procedures for monitoring compliance with internal policies and external regulations and for reporting any violations, the company can better mitigate regulatory or legal risks and their associated costs. Additionally, the adoption of formal procedures with regard to conflicts of interest and related-party transactions allows the company to ensure fairness in its relationships with those parties.

8.2.3. Better Operating and Financial Performance

Good governance and stakeholder management can help a company improve its operating performance and reduce the costs associated with weak control systems. The costs of poor investments, legal proceedings against the company, and excessive perquisites are just a few examples that could be mitigated by well-functioning governance systems. Enhanced corporate governance could also allow the company to improve its decision-making process and respond faster to market factors. Proper remuneration policies are another governance tool that can motivate managers to make decisions with the objective of creating corporate value.

8.2.4. Lower Default Risk and Cost of Debt

Good corporate governance can lower business and investment risk. Governance arrangements that manage conflicts of interest with creditors, and that help protect creditor rights, can reduce a company's cost of debt and default risk. Default risk can also often be mitigated by proper functioning of audit systems, improved transparency (e.g., reporting of earnings), and the control of information asymmetries between the company and its capital providers.

With regard to credit risk, corporate governance mechanisms are increasingly relevant criteria among credit rating agencies when assessing a company's creditworthiness.

EXAMPLE 9 Benefits of Corporate Governance

Which of the following is **not** a benefit of an effective corporate governance structure?

A. Operating performance can be improved.
B. A corporation's cost of debt can be reduced.
C. Corporate decisions and activities require less control.

Solution: C is correct. A benefit of an effective corporate governance structure is to enable adequate scrutiny and control over operations. B is incorrect because an effective governance structure can reduce investors' perceived credit risk of a corporation, thus potentially lowering the corporation's cost of debt. A is incorrect because operating efficiency may indeed be a benefit of an effective corporate governance structure.

9. FACTORS RELEVANT TO CORPORATE GOVERNANCE AND STAKEHOLDER MANAGEMENT ANALYSIS

In the past, analysts may have considered corporate governance and stakeholder management issues to be only peripherally related to traditional fundamental analysis. Generally, these issues were seen as obscure and unlikely to be material drivers of performance. Following a number of governance failures since the early 2000s, the global financial crisis, and the rise of shareholder activism around the world, there is little doubt that governance and stakeholder issues have become increasingly important topics for analysts.

Some key questions that analysts may consider when assessing a company's corporate governance or stakeholder management system are as follows:

- What is the company's ownership and voting structure among shareholders?
- Who represents shareholders on this company's board?
- What are the main drivers of the management team's remuneration and incentive structure?
- Who are the significant investors in the company?
- How robust are the shareholder rights at the company, including relative to peers?
- How effectively is the company managing long-term risks, such as securing access to necessary resources, managing human capital, exhibiting integrity and leadership, and strengthening the long-term sustainability of the enterprise?

A qualitative analysis of these issues—typically provided by a company's proxy statements, annual reports, and sustainability reports, if available—can provide important insights about the quality of management and sources of potential risk.

9.1. Economic Ownership and Voting Control

Generally speaking, corporations with publicly traded equity have a voting structure that involves one vote for each share. That is, any shareholder's voting power is equal to the percentage of the company's outstanding shares owned by that shareholder. When there are exceptions to this norm and economic ownership becomes separated from control, investors can face significant potential risks.

In a small number of markets, dual-class structures are allowed under the local regulatory framework or exchange rules, which is the most common way that voting power is decoupled from ownership. In these cases, common shares may be divided into two classes, one of which has superior voting rights to the other. A common arrangement is when a share class (for example, Class A) carries one vote per share and is publicly traded, whereas another share class (for example, Class B) carries several votes per share and is held exclusively by company insiders or family members. This structure is used by Facebook, for example. In this way, the founders and/or insiders of a company may continue to control board elections, strategic decisions, and all other significant voting matters for a long period—even once their ownership level declines to less than 50% of the company's shares.

Another mechanism used to separate voting control from economic ownership is when one class of stock (held by insiders) elects a majority of the board; outside shareholders who hold a different share class would then be entitled to elect only a minority of the board. Technically, each share carries equal voting rights, but with this structure, the insiders retain substantial power over the affairs of the corporation because they control a majority of the board. Alibaba's partnership structure is one example of this type of control.

Proponents of dual-share systems, such as those just mentioned, argue that the systems promote company stability and enable management to make long-term strategic investments, insulated from the short-term pressures of outside investors. Critics of these structures believe they create conflicts of interest between the providers of capital and the management of the business.

It is virtually impossible for outside investors to dismantle dual-class structures because of the inherent design of their unequal voting rights. Therefore, these structures can remain in place even through generational changes within a founding family. Investors with long time horizons may want to consider the motivations of the controlling stockholders, generational dynamics, succession planning, and the relationship between the board and management. In addition, there may be potential valuation implications because dual-class companies tend to trade at a discount to their peers.

9.2. Board of Directors Representation

In most markets, investors have access to basic biographical information about the non-executive members of corporate boards. Analysts can assess the available information to determine whether the experience and skill sets on the board match the current and future needs of the company.

In particular, questions regarding directors' independence, tenure, experience, and diversity may bring useful investment insights. For example, if the board has multiple directors engaging in related-party transactions with the company, investors may have cause for concern about any conflicts of interest that arise. The issue of board tenure can also be a useful tool for investors. Directors with long periods of service to a company clearly offer valuable experience and expertise, but if the board composition is dominated by such long-tenured members, it may have a negative effect on the board's diversity and adaptability.

An example in which board composition had a significant effect on company performance occurred at a European pharmaceutical company. At one point in its history, the company had become overleveraged and faced significant financial distress. In response, non-executive directors with banking and turnaround experience were added to the board. With the help of these directors, the company recovered. Seven years later, the most promising product in the company's pharmaceutical portfolio began to cause serious side effects in its patient population. The situation required both a meaningful understanding of the medical issues involved and a rapid response from the company. However, the board was still composed of directors with financial expertise rather than medical training. The company struggled with its response to the crisis, and its stock price fell sharply. This situation was one in which the board's composition had been ideal for a certain point in the company's history, but ultimately the directors failed to refresh the board's membership as the needs of the business changed.

9.3. Remuneration and Company Performance

The availability and quality of information about executive remuneration plans varies widely across markets. In those markets where such disclosures are available, analysts can assess the elements of the remuneration program to determine whether they support or conflict with the key drivers of performance for the company.

Generally speaking, current executive remuneration programs consist of a base salary, a short-term bonus usually delivered in the form of cash, and a multi-year incentive plan delivered in one or more forms of equity (options, time-vested shares, and/or performance-vested shares). Often, these short-term and long-term plans are contingent on achieving financial or operational objectives, and often these objectives are disclosed. In these situations, an analyst can assess whether the primary drivers of the remuneration plan are the same factors that, in the analyst's view, drive overall company results.

Assessment of the suitability of a remuneration plan for a particular company is a subjective exercise and is highly dependent on industry and geographic norms. But there are some warning signs that may warrant particular scrutiny:

- **Plans offering little alignment with shareholders.** As an example, if a plan offers only cash-based payouts and no equity, there may be a misalignment of incentives between executives and investors unless management already owns a significant stake in the company.
- **Plans exhibiting little variation in results over multiple years.** If an award is described as performance-based but still pays in full every year regardless of the company's results, investors may have concerns about the rigor of the performance hurdles underlying the awards.
- **Plans with excessive payouts relative to comparable companies with comparable performance.** Investors may want to understand the cause of the anomaly and whether it is a temporary issue or a result of flawed remuneration plan design.
- **Plans that may have specific strategic implications.** As an example, some remuneration plans contain payouts tied to specific milestones, such as regulatory approval of a product, completion of an acquisition, or achievement of specific cost reductions. In addition, some companies offer particularly high post-employment pay arrangements tied to the sale of the company, whereas others offer no such arrangements. These factors are not necessarily negative features, but investors may want to understand whether the milestones driving the incentive plan align with the company's objectives.

- **Plans based on incentives from an earlier period in the company's life cycle.** A frequent example of such a plan relates to a company that has matured beyond its fast growth phase. The company's business may have matured, and competition may have limited the opportunity for market share gains. Investors may believe the company should become more focused on both returns and disciplined capital allocation. Even after the company communicates to the investor community a more returns-oriented strategy, the financial incentives in the remuneration plan may still be based purely on revenue growth. Investors may want to understand such potential misalignment of interests.

9.4. Investors in the Company

Examining the composition of investors in a company can be another source of useful insight for analysts. The behavior of these investors can result in both limitations and catalysts with regard to changes in the corporation. For example, cross-shareholdings are still prevalent in a number of markets. This situation occurs when a company, particularly a publicly listed one, holds a large, passive, minority stake in another company. Such holdings generally help to protect management from shareholder pressures because implicit in a cross-shareholding arrangement is the guarantee that the owner of the shares will support management on all voting issues. In effect, these shareholdings act as takeover defenses.

Similarly, the presence of a sizable affiliated stockholder (such as an individual, family trust, endowment, or private equity fund) can shield a company from the effects of voting by outside shareholders. As an example, a US consumer goods company has an affiliated charitable foundation that owns more than 20% of the outstanding shares. The company also has a provision in its corporate charter requiring that any changes to the charter must be approved by two-thirds of outstanding shares. As a result, it is virtually impossible for any measure to pass without the support of the foundation. The interests of the foundation thus conflict with the interests of the overall shareholder base. In effect, this single minority shareholder most likely holds the power to block the votes of the majority.

Analysts should note that market context is important in assessing the potential effects of affiliated stockholders. In certain countries, the presence of such shareholders is common, viewed by local market participants as a means of enhancing stability, strengthening the relationship between companies and their business partners, and fostering a long-term perspective by protecting the company against hostile takeover bids.

A final aspect of investor composition that has become increasingly relevant relates to activist shareholders, which we discussed earlier. The presence of activist shareholders can meaningfully and rapidly change the investment thesis for a company. Experienced activists, together with short-term-oriented investors who follow their activities, can create substantial turnover in a company's shareholder composition in a short amount of time. This is because an activist often serves as a catalyst for new strategic alternatives at a company and can attract new investors and/or arbitrageurs.

9.5. Strength of Shareholders' Rights

Within a framework of regional regulations and corporate governance codes, analysts may want to understand whether the shareholder rights of a particular company are strong, weak, or average compared with other companies. For example, if an analyst's viewpoint includes the possibility that a company will enter into a merger transaction in the future, he or she may want to understand whether there are significant structural obstacles to transactions that are embedded in the company's charter or bylaws. Similarly, if the thesis involves an outside catalyst, such as an activist shareholder who will introduce change at the company and improve performance, the analyst must take a position on whether shareholders are sufficiently empowered to advance such a change. If it is impossible for shareholders to remove directors from the board or to convene special stockholder meetings, it will be difficult for external initiatives to be successful.

In a number of developed markets, including the United Kingdom, the Netherlands, and Japan, regulatory agencies or stock exchanges have adopted governance codes, which are standards of governance reflecting local investors' expectations with regard to disclosure, board composition, shareholder rights, and other related issues. Often, these governance codes are implemented on a "comply or explain" basis, which indicates that standards are voluntary in nature. However, any deviation from the code must be explained by the company in a public disclosure. If a company has elected to deviate from the locally accepted governance practice, the analyst may want to understand the reasoning behind the decision.

9.6. Managing Long-Term Risks

Analysts may uncover useful insights regarding how a company manages various issues, such as long-term environmental risks, management of human capital, transparency, and treatment of investors and other stakeholders. Of particular note, the academic evidence linking these and other management quality issues to share price performance remains mixed, in part because indicators of management quality are often correlated with each other and, therefore, difficult to isolate. However, poor stakeholder relations and inadequate management of long-term risks have indeed had an enormous negative effect on share value in certain instances. Therefore, analysts may consider the assessment of such issues to be a useful component of their overall risk assessment of the company.

One way to evaluate management quality issues is to assess whether the company demonstrates a persistent pattern of wrongdoings, fines, regulatory penalties, investigations, and the like. A notable example is Toshiba Corp., beginning in 2015 when an investigation revealed that company managers had manufactured nearly $2 billion in profits since 2008. Poor internal controls allowed the fraudulent accounting to remain undetected for seven years. Over the next several years, Toshiba experienced the massive write-down of its Westinghouse Electric Co. unit, clashes with its auditors, negative equity, and legal disputes. Toshiba's dividend was withdrawn, Westinghouse filed for bankruptcy protection, and the company was forced to sell its profitable semiconductor unit along with other business units. Ultimately, the company's shares were moved to the second section of the Tokyo Stock Exchange, triggering forced sales from funds that track the first section (TOPIX) or the Nikkei 225 indexes. Even in the absence of circumstances as extreme as these, poor management of stakeholder interests can have a significant effect on company operations, reputation, and valuation.

9.7. Summary of Analyst Considerations

The analysis of corporate governance, stakeholder management, and other non-financial (often termed "extra-financial") considerations is inherently a subjective exercise. Governance practices that may raise the risk profile of one company may be perfectly acceptable in a different context, depending on geographic norms, mitigating circumstances, or the investor's risk tolerance and investment thesis. In this section, we have provided a basic framework for investors interested in uncovering incremental insights about a company by analyzing its governance standards, practices, and risks.

EXAMPLE 10 Analyst Considerations

1. Which of the following *best* describes dual-class share structures?
   A. Dual-class share structures can be easily changed over time.
   B. Company insiders can maintain significant power over the organization.
   C. Conflicts of interest between management and stakeholder groups are less likely than with single-share structures.
2. An investment analyst would likely be *most* concerned with an executive remuneration plan that:
   A. varies each year.
   B. is consistent with a company's competitors.
   C. is cash-based only, without an equity component.
3. Which of the following *best* describes activist shareholders? Activist shareholders:
   A. help stabilize a company's strategic direction.
   B. have little effect on the company's long-term investors.
   C. can alter the composition of a company's shareholder base.

Solution to 1: B is correct. Under dual-class share systems, company founders or insiders may control board elections, strategic decisions, and other significant voting matters. A is incorrect because dual-share systems are virtually impossible to dismantle once adopted. C is incorrect because conflicts of interest between management and stakeholders are more likely than with single-share structures because of the potential control element under dual systems.

Solution to 2: C is correct. If an executive remuneration plan offers cash only, the incentives between management and investors and other stakeholders may be misaligned. A is incorrect because a plan that varies over time would typically be of less concern to an analyst compared with one that did not change. B is incorrect because an analyst would likely be concerned if a company's executives were excessively compensated relative to competitors.

Solution to 3: C is correct. The presence of activist shareholders can create substantial turnover in the company's shareholder composition. A is incorrect because the presence of activist shareholders can materially change a company's strategic direction. B is incorrect because long-term investors in a company need to consider how activist shareholders affect the company.

10. ESG CONSIDERATIONS FOR INVESTORS AND ANALYSTS

10.1. Introduction to Environmental, Social, and Governance issues

The inclusion of governance factors in investment analysis has evolved considerably. Management and accountability structures are relatively transparent, and information regarding them is widely available. Also, the risks of poor corporate governance have long been understood by analysts and shareholders. In contrast, the practice of systematically considering environmental and social factors, which collectively with governance form the commonly used acronym ESG, has evolved more slowly. Issues driving the inclusion of environmental and social information in the investment process include scarcity of natural resources, physical impacts of climate change, global economic and demographic trends, diversity and inclusion, treatment of workers, and the rise of social media. A non-exhaustive list of ESG issues are shown in Exhibit 1 Typically, a smaller set of ESG factors are material for each company, influenced by the business segments it operates in as well as its geography of operation.

EXHIBIT 1 Example of ESG Factors

Environmental Issues	Social Issues	Governance Issues
• Climate change and carbon emissions • Air and water pollution • Biodiversity • Deforestation • Energy efficiency • Waste management • Water scarcity	• Customer satisfaction & product responsibility • Data security and privacy • Gender and diversity • Occupational health & safety • Treatment of workers • Community relations & charitable activities • Human rights • Labor standards	• Board composition (independence & diversity) • Audit committee structure • Bribery and corruption • Executive compensation • Shareholder rights • Lobbying & political contributions • Whistleblower schemes

ESG factors were once regarded as intangible or qualitative information. Increased corporate disclosures and refinements in the identification and analysis of ESG factors have resulted in increasingly quantifiable and decision-useful information. Social issues, such as human capital management, are less quantifiable; however, they are not necessarily more difficult to integrate as qualitative factors into investment analysis. The process of reflecting quantitative ESG-related information and data—both quantitative and qualitative—in financial valuation continues to evolve.

10.2. ESG Investment Strategies

There is a lack of consensus on several ESG strategy-related terms used in the investment community. For the purposes of this chapter, we define ESG investment strategies as the following:

Responsible investing is the broadest (umbrella) term used to describe investment strategies that incorporate ESG factors into their approaches. Overall, responsible investing includes the following:

- ESG integration
- Socially responsible investing (SRI)
- Thematic investing
- Impact investing

Sustainable investing is a term used in a similar context to responsible investing, but its key focus is on factoring in sustainability issues while investing.

ESG integration generally refers to the careful consideration of *material* ESG factors in the investment analysis and portfolio construction processes. **ESG investing** is often used interchangeably with ESG integration. A material factor is one whose omission or misstatement could influence an investment decision and ultimately the product's investment objectives.

The materiality of ESG factors in investment analysis, particularly environmental and social factors, often differs meaningfully among sectors. An ESG factor is considered material when it has a potential to impact a company's ability to generate sustainable returns in the long term. For example, environmental factors, such as carbon emissions and water usage, will likely be material for utilities or mining companies yet are relatively inconsequential for financial institutions.

Socially responsible investing (SRI) is a related term that tends to have multiple meanings, creating confusion among investors. SRI has traditionally referred to the practice of excluding investments in companies or industries, such as controversial weapons or tobacco, that deviate from an investor's beliefs, either moral or faith based. The term has evolved to include investment objectives that promote positive environmental or social attributes, often by investing in companies with favorable environmental or social profiles.

Thematic investing refers to investment in themes or assets specifically related to ESG factors. This approach is often based on needs arising from economic or social trends.

Impact investing refers to investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.

Green Finance

Green finance is a responsible investing approach that utilizes financial instruments that support a green economy. According to the Organisation for Economic Co-operation and Development (OECD), green finance relates to "achieving economic growth while reducing pollution and greenhouse gas emissions, minimising waste and improving efficiency in the use of natural resources."[5] As with other previously mentioned ESG terms, there are several definitions for green finance in practice. The primary investment vehicles used in green finance are **green bonds**, in which issuers earmark the proceeds toward environmental-related projects. Green bond issuance has grown significantly. According to the Climate Bonds Initiative, total worldwide green bond issuance for 2019 totaled USD255 billion, compared to USD171.1 billion for 2018. The United States continues to be the largest green bond market in the world, with China being the second largest, accounting for about 12% of global green bond issuance in 2019. China's first green bond was issued in July 2015 as the country prioritized environmental projects to address air and water pollution issues resulting from its rapid growth. In addition to green bonds, **sustainability linked loans** (including **green loans**) are also gradually being employed across the globe. Sustainability linked loans are any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines, or letters of credit) that incentivize the borrower's achievement of ambitious, predetermined sustainability performance objectives.

10.3. ESG Investment Approaches

ESG investment approaches range from *value*-based to *values*-based. The objective of a *value*-based approach is to mitigate risks and identify opportunities by analyzing and incorporating material ESG considerations in addition to traditional financial metrics. Conversely, the objective of a *values*-based approach is to express the moral or faith-based beliefs of an investor. Between the value-based and the values-based approaches lie a continuum of approaches that strives for value creation through values investing.

[5] Organisation for Economic Co-operation and Development, "Green Finance and Investment," OECD iLibrary. www.oecd-ilibrary.org/environment/green-finance-and-investment_24090344.

There is a lack of consensus in the investment community on terminology to classify specific ESG investment approaches. For the purposes of this chapter, we define six generic ESG investment approaches:

- Negative screening
- Positive screening
- ESG integration
- Thematic investing
- Engagement/active ownership
- Impact investing

Negative screening is the exclusion of certain sectors, companies, or practices from a fund or portfolio based on specific ESG criteria. Examples of a negative screen include excluding the fossil fuel extraction/production sector or excluding companies that deviate from globally accepted standards, in areas such as human rights or environmental management, from a portfolio. Many of these negative screens use a specific set of standards, such as the UN Global Compact's Ten Principles on human rights, labor, the environment, and corruption.

In contrast to negative screening, **positive screening** focuses on investments that manage their material ESG risks well relative to industry peers. Positive screening, typically implemented through an ESG ranking or scoring approach, is the inclusion of certain sectors, companies, or practices in a fund or portfolio based on specific ESG criteria. For example, positive screening may include seeking companies that promote employee rights, exhibit diversity in the workplace and in board rooms, or perform well in customer safety. While seeking to invest in sectors, companies, or projects that demonstrate best-in-class ESG performance relative to industry peers, this approach does not exclude any sectors. Instead, it focuses on finding the companies within each sector that perform best on the chosen criteria. This approach typically maintains sector weightings comparable to a relative benchmark index to avoid excessively overweighting or underweighting risk exposures.

ESG integration entails a systematic consideration of material ESG factors in asset allocation, security selection, and portfolio construction decisions for the purpose of achieving the product's stated investment objectives. There is an explicit inclusion of ESG factors into traditional financial analysis of individual stocks or bonds, such as inputs into cash flow forecasts, credit/default risk forecasts, and/or cost-of-capital estimates. The focus of ESG integration is to identify risks and opportunities arising from material ESG factors and to determine whether a company is properly managing these or not.

Thematic investing is investment in themes or assets specifically related to ESG factors, such as clean energy, green technology, sustainable agriculture, gender diversity, or affordable housing. This approach is often based on needs arising from economic or social trends. Two common investment themes focus on increased demand for energy and water, as well as the availability of alternative sources of each. Global economic development has raised the demand for energy at the same time as increased greenhouse gas emissions are widely believed to negatively affect the earth's climate. Similarly, rising global living standards and industrial needs have created a greater demand for water along with the need to prevent drought or increase access to clean drinking water in certain regions of the world. While these themes are based on trends related to environmental issues, social issues—such as access to affordable health care and nutrition, especially in the poorest countries in the world—are also of great interest to thematic investors.

Engagement/active ownership is the use of shareholder or bondholder power to influence corporate behavior through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is directed by ESG guidelines. Engagement/active ownership seeks to achieve targeted social or environmental objectives along with measurable financial returns. Engagement/active ownership can be executed through various asset classes and investment vehicles and often through direct transactions, such as venture capital investing. Collaborative engagement initiatives entail multiple investors collectively engaging with company management to influence positive action in managing their material ESG risks. Climate Action 100+, backed by more than 450 investors with over USD40 trillion in assets collectively under management (as of July 2020), is one such widely supported initiative that aims to influence the world's largest corporate greenhouse gas emitters to take necessary action on climate change. Other key ESG issues on which investors frequently engage are air pollution, plastic waste management, human and labor rights in the supply chain, and executive remuneration.

Impact investing is a relatively smaller segment of the broader sustainable and responsible investing market. Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return.[6] An example would include investing in products or services that help achieve one (or more) of the 17 Sustainable Development Goals (SDGs) launched by the United Nations in 2015, such as "SDG 6: Clean Water and Sanitation—Ensure availability and sustainable management of water and sanitation for all" and "SDG 11: Sustainable Cities and Communities—Make cities and human settlements inclusive, safe, resilient and sustainable."

A summary of the six generic ESG Investment approaches and mapping to other classifications is shown in Exhibit 2.

EXHIBIT 2 ESG Investment Approaches

		Mapping to Other Classifications	
ESG Investment Approach	**Description**	*Financial Analysts Journal*	*Global Sustainable Investment Review*
Negative screening	Excluding companies or sectors based on business activities or environmental or social concerns	Negative screening	Negative/Exclusionary screening
			Norms-based screening
Positive screening	Including sectors or companies based on specific ESG criteria, typically ESG performance relative to industry peers	Positive screening Relative/Best-in-class screening	Positive/Best-in-class screening
ESG integration	Systematic consideration of material ESG factors in asset allocation, security selection, and portfolio construction decisions for the purpose of achieving or exceeding the product's stated investment objectives	Full integration Overlay/Portfolio tilt Risk factor/Risk premium	ESG integration

[6]Global Impact Investing Network, "About Impact Investing." https://thegiin.org/impact-investing/.

EXHIBIT 2 Continued

Thematic investing	Investing in themes or assets related to ESG factors	Thematic investing	Sustainability-themed investing
Engagement/ Active ownership	Using shareholder power to influence corporate behavior to achieve targeted ESG objectives along with financial returns	Engagement/Active ownership	Corporate engagement/ Shareholder action
Impact investing	Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return	N/A	Impact/Community investing

Notes: For information on the *Financial Analysts Journal* column under "Mapping to Other Classifications," see www.tandfonline.com/doi/full/10.2469/faj.v74.n3.2. For the *Global Sustainable Investment Review* column, see http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf.

10.4. Catalysts for Growth in ESG Investing

ESG considerations have become increasingly relevant for two key reasons. First, ESG issues are having more material financial impacts on a company's fair value. Many investors have suffered substantial losses due to mismanagement of ESG issues by corporations, which resulted in environmental disasters, social controversies, or governance deficiencies. Second, a greater number of younger investors are increasingly demanding that their inherited wealth or their pension contributions be managed using investment strategies that systematically consider material ESG risks as well as negative environmental and societal impacts of their portfolio investments.

Historically, environmental and social issues, such as climate change, air pollution, and societal impacts of a company's products and services, have been treated as negative externalities—ones whose costs are not borne by the concerned company. However, increased stakeholder awareness and strengthening regulations are internalizing environmental and societal costs onto the company's income statement either explicitly or implicitly by responsible investors.

At a *macro level*, such environmental risks as physical impacts of climate change—floods, droughts, wildfires, air pollution—are impacting our day-to-day lives both more frequently and on a larger scale than ever imagined. Wildfires in California, the Amazon forest, and Australia have caused loss of human life and billions of dollars in damages. Major cities, like Cape Town and Chennai, have had severe water shortages. The 2020 global slowdown due to Covid-19 demonstrated that such social factors as inequality, access to health care, and vulnerable labor can also have significant impacts on growth. While macro-level environmental and social risks have received widespread attention only since 2010, investors have been evaluating macro-level governance risks, such as quality of institutions and corruption, into their analysis since the 1990s.

At a *micro level*, there have been numerous examples of stakeholders penalizing companies that are unable to manage material ESG risks well. Facebook's Cambridge Analytica scandal, in which the personal data of over 80 million users were allegedly shared without consent and used in influencing voters, not only led to one of the largest US government fines in the technology sector (USD5 billion), but it also made a significant dent on user trust. Other examples of ESG risks materializing are shared later in this chapter. As prudent fiduciaries, investors are paying more attention to these factors while constructing portfolios and engaging with company management.

Another investor development that has supported ESG growth is the adoption of more sophisticated views about sustainable growth and its effect on investment performance. To this end, some large institutional asset owners embrace the concept of being "universal owners." **Universal owners** are long-term investors, such as pension funds, that have significant assets invested in globally diversified portfolios. Given their size and scope, the investment portfolios of universal owners are linked to economic growth and unavoidably exposed to costs resulting from external factors or externalities, such as environmental damages. Some universal owners strive to positively influence the way companies conduct business to minimize exposure to ESG-related costs because both their funds' long-term performance and the interests of their beneficiaries are at stake. Institutions that adhere to the universal owner philosophy believe that sustainable global economic growth is essential to successful investment performance.

10.5. ESG Market Overview

Reflecting the growth of ESG-related information in the marketplace, the amount of global assets under management (AUM) dedicated to the consideration of ESG factors in portfolio selection and management has increased substantially. According to the Global Sustainable Investment Alliance (GSIA), a collaboration of organizations dedicated to advancing sustainable investing in the financial markets, nearly USD31 trillion of AUM were dedicated toward sustainable investment mandates at the start of 2018, a 34% increase in two years. Europe (49%) and the United States (39%) accounted for the vast majority of these AUM. Determining the true size of the ESG investment universe is difficult, however, because managers and investors define and implement sustainable and ESG mandates in many different ways. There are often differences regarding which ESG factors should be considered—as well as how they are considered—in the investment analysis and portfolio construction processes.

The increased interest in sustainable investing has led to increased corporate disclosures of ESG issues, as well as a growing number of companies that collect and analyze ESG data. In addition to the GSIA, several organizations have been formed to monitor and advance the mission of sustainable investing. For example, the Global Reporting Initiative (GRI), a non-profit organization formed in 1997, produces a sustainability reporting framework that measures and reports sustainability-related issues and performance. In 2006, the United Nations and a consortium of institutional investors launched the Principles for Responsible Investment (PRI) Initiative to support investors committed to including ESG issues in their investment decision-making and ownership practices. In 2011, the non-profit Sustainability Accounting Standards Board (SASB) was formed to develop sustainability accounting standards for companies when disclosing material ESG information. To help educate investors, CFA Institute and PRI published "Guidance and Case Studies for ESG Integration: Equities and Fixed Income" in 2018. In addition to these key organizations, several others exist that promote the advancement of sustainable investing.

10.6. ESG Factors in Investment Analysis

Environmental factors that are generally considered material in investment analysis include natural resource management, pollution prevention, water conservation, energy efficiency and reduced emissions, the existence of carbon assets, and adherence to environmental safety and regulatory standards. A specific concern among investors of energy companies is the existence of "stranded assets," which are carbon-intensive assets at risk of no longer being economically viable because of changes in regulation or investor sentiment. Analysts may find it difficult to assess potentially significant financial risks of energy companies because of limited information on the existence of these companies' carbon assets, as well as the difficulty in determining political and regulatory risks. Material environmental effects can arise from strategic or operational decisions based on inadequate governance processes or errors in judgment. For example, oil spills, industrial waste contamination events, and local resource depletion can result from poor environmental standards, breaches in safety standards, or unsustainable business models. Such events can be costly in terms of regulatory fines, litigation, clean-up costs, reputational risk, and resource management.

Toxic Emissions and Waste as an Environmental Risk

Historically, environmental issues, such as toxic emissions and waste, have been treated as externalities and thus not fully provisioned for in a company's financial reporting. However, with growing awareness among all stakeholders, including the regulators, companies may now face financial liabilities associated with pollution, contamination, and the emission of toxic or carcinogenic substances and hence are required to manage these risks well. Gross mismanagement of these risks could not only lead to a permanent loss of a company's license to operate but also to other severe financial penalties.

In one notable example, the 2019 collapse of Dam I of the Córrego do Feijão Mine in Brumadinho, Brazil, resulted in the spillage of millions of tons of non-toxic mud. The plant and surrounding communities experienced the loss of 270 lives as well as the contamination of the nearby Paraopeba River. The mine was owned and operated by Vale, which has since been accused of hiding information about the dam's instability for many years to avoid hurting the company's reputation. Several employees from the company, including its ex-CEO, and its auditor, TÜV SÜD, were charged with murder and environmental crimes. Vale was also fined millions of dollars in addition to bearing clean-up costs.

Social factors considered in ESG implementation generally pertain to the management of the human capital of a business. These include human rights and welfare concerns in the workplace; data privacy and security; access to affordable health care products; and, in some cases, community impact. Staff turnover, worker training and safety, employee morale, ethics policies, employee diversity, and supply chain management can all affect a company's ability to sustain its competitive advantage. In addition, minimizing social risks can lower a company's costs (e.g., through higher employee productivity, lower employee turnover, and reduced litigation potential) and reduce its reputational risk.

Data Privacy and Security as a Social Risk

Data privacy and security focuses on how companies gather, use, and secure personally identifiable information and other meta-data collected from individuals. In some industries, such as internet software and services, this includes managing the risks associated with government requests that may result in violations of civil and political rights.

With the proliferation of the internet across the globe, more and more services are offered online. Consumers of such services are leaving a large digital footprint behind, often unknowingly. Some of this information may be personally identifiable in nature, leaving users vulnerable in case of theft or misuse. As per the "2019 Cost of a Data Breach Report" released by IBM and Ponemon Institute, the average cost of data breach is USD3.9 million, with cost per record lost being USD150.

Given the large amounts of sensitive data being managed by some of the largest internet and financial services companies today, mismanagement of data privacy and security risk can have materially damaging consequences both for a company's business model as well as financial performance. As an example, lax cybersecurity measures at Equifax, Inc., led to a data breach and the theft of identity and financial data belonging to more than 140 million US citizens in 2017. Equifax has since incurred hundreds of millions of dollars in expenses resulting from the breach and has faced numerous lawsuits and investigations.

As mentioned earlier, governance factors have long been recognized in investment analysis. Many performance indicators can help evaluate risks arising from governance issues, such as ownership structure, board independence and composition, and compensation. Although several governance factors may apply across industries and geographic regions, other factors are unique, such as systemic risk management for financial services companies. Wider adoption of responsible investing strategies enhances mainstream governance analysis via the addition of such factors as management oversight of environmental and social issues and tax transparency.

Corporate Governance: An All-Encompassing Risk

An example of investor loss related to corporate governance occurred in 2015 at German automaker Volkswagen. Volkswagen's "Dieselgate" scandal involved use of software to manipulate diesel vehicle emissions of more than 11 million cars globally. Specifically, many investors believed that inadequate governance oversight at Volkswagen permitted its diesel cars to pass emissions tests yet emit unlawful amounts of nitrogen oxide. Many investors attributed their losses to internal audit and compliance shortcomings as well as a lack of independence in Volkswagen's board of directors. The company has already incurred several billion dollars of civil and criminal penalties, and the scandal continues to pose significant legal and financial risks for the company.

One area of debate has been whether the consideration of ESG factors is consistent with fiduciary duty—particularly when overseeing and managing pension fund assets. (See Example 11.) Pension fund regulation regarding ESG considerations varies globally, however. PRI and the United Nations Environment Programme Finance Initiative (UNEP FI) promote the belief that ESG integration is a key part of investment analysis: "Investors that fail to incorporate ESG issues are failing their fiduciary duties and are increasingly likely to be subject to legal challenge."

EXAMPLE 11 ESG Investment Approach

The ESG investment approach that is *most* associated with excluding certain sectors or companies is:

A. thematic investing.
B. negative screening.
C. positive screening.

Solution: B is correct. Negative screening entails excluding certain companies or sectors, such as fossil fuel extraction, from a portfolio. A is incorrect because thematic investing typically focuses on investing in companies within a specific sector or following a specific theme, such as energy efficiency or climate change, as opposed to merely excluding a set of companies or industries from a portfolio. Likewise, C is incorrect because positive screening focuses on including companies that rank (or score) most favorably compared to their peers with regard to ESG factors.

SUMMARY

The investment community has increasingly recognized the importance of corporate governance as well as environmental and social considerations. Although practices concerning corporate governance (and ESG overall) will undoubtedly continue to evolve, investment analysts who have a good understanding of these concepts can better appreciate the implications of ESG considerations in investment decision making. The core concepts covered in this chapter are as follows:

- Corporate governance can be defined as a system of controls and procedures by which individual companies are managed.
- There are many systems of corporate governance, most reflecting the influences of either shareholder theory or stakeholder theory, or both. Current trends, however, point to increasing convergence.
- A corporation's governance system is influenced by several stakeholder groups, and the interests of the groups often diverge or conflict.
- The primary stakeholder groups of a corporation consist of shareholders, creditors, managers and employees, the board of directors, customers, suppliers, and government/regulators.
- A principal–agent relationship (or agency relationship) entails a principal hiring an agent to perform a particular task or service. In a corporate structure, such relationships often lead to conflicts among various stakeholders.
- Stakeholder management involves identifying, prioritizing, and understanding the interests of stakeholder groups and on that basis managing the company's relationships with stakeholders. The framework of corporate governance and stakeholder management reflects a legal, contractual, organizational, and governmental infrastructure.
- Mechanisms of stakeholder management may include general meetings, a board of directors, the audit function, company reporting and transparency, related-party transactions,

remuneration policies (including say on pay), and other mechanisms to manage the company's relationship with its creditors, employees, customers, suppliers, and regulators.
- A board of directors is the central pillar of the governance structure, serves as the link between shareholders and managers, and acts as the shareholders' internal monitoring tool within the company.
- The structure and composition of a board of directors vary across countries and companies. The number of directors may vary, and the board typically includes a mix of expertise levels, backgrounds, and competencies.
- Executive (internal) directors are employed by the company and are typically members of senior management. Non-executive (external) directors have limited involvement in daily operations but serve an important oversight role.
- Two primary duties of a board of directors are duty of care and duty of loyalty.
- A company's board of directors typically has several committees that are responsible for specific functions and report to the board. Although the types of committees may vary across organization, the most common are the audit committee, governance committee, remuneration (compensation) committee, nomination committee, risk committee, and investment committee.
- Stakeholder relationships and corporate governance are continually shaped and influenced by a variety of market and non-market factors.
- Shareholder engagement by a company can provide benefits that include building support against short-term activist investors, countering negative recommendations from proxy advisory firms, and receiving greater support for management's position.
- Shareholder activism encompasses a range of strategies that may be used by shareholders when seeking to compel a company to act in a desired manner.
- From a corporation's perspective, risks of poor governance include weak control systems; ineffective decision making; and legal, regulatory, reputational, and default risk. Benefits include better operational efficiency, control, and operating and financial performance, as well as lower default risk (or cost of debt).
- Key analyst considerations in corporate governance and stakeholder management include economic ownership and voting control, board of directors representation, remuneration and company performance, investor composition, strength of shareholders' rights, and the management of long-term risks.
- ESG investment approaches range from value-based to values-based. There are six broad ESG investment approaches: Negative screening, Positive screening, ESG integration, Thematic investing, Engagement/active ownership, and Impact investing.
- Historically, environmental and social issues, such as climate change, air pollution, and societal impacts of a company's products and services, have been treated as negative externalities. However, increased stakeholder awareness and strengthening regulations are internalizing environmental and societal costs onto the company's income statement by responsible investors.

PROBLEMS

1. Corporate governance:
   A. complies with a set of global standards.
   B. is independent of both shareholder theory and stakeholder theory.
   C. seeks to minimize and manage conflicting interests between insiders and external shareholders.

2. Which group of company stakeholders would be *least* affected if the firm's financial position weakens?
   A. Suppliers
   B. Customers
   C. Managers and employees
3. Which of the following represents a principal–agent conflict between shareholders and management?
   A. Risk tolerance
   B. Multiple share classes
   C. Accounting and reporting practices
4. Which of the following issues discussed at a shareholders' general meeting would *most likely* require only a simple majority vote for approval?
   A. Voting on a merger
   B. Election of directors
   C. Amendments to bylaws
5. Which of the following statements regarding stakeholder management is *most* accurate?
   A. Company management ensures compliance with all applicable laws and regulations.
   B. Directors are excluded from voting on transactions in which they hold material interest.
   C. The use of variable incentive plans in executive remuneration is decreasing.
6. Which of the following represents a responsibility of a company's board of directors?
   A. Implementation of strategy
   B. Enterprise risk management
   C. Considering the interests of shareholders only
7. Which of the following statements about non-market factors in corporate governance is *most* accurate?
   A. Stakeholders can spread information quickly and shape public opinion.
   B. A civil law system offers better protection of shareholder interests than does a common law system.
   C. Vendors providing corporate governance services have limited influence on corporate governance practices.
8. Which of the following statements regarding corporate shareholders is *most* accurate?
   A. Cross-shareholdings help promote corporate mergers.
   B. Dual-class structures are used to align economic ownership with control.
   C. Affiliated shareholders can protect a company against hostile takeover bids.
9. Which of the following statements about environmental, social, and governance (ESG) in investment analysis is correct?
   A. ESG factors are strictly intangible in nature.
   B. ESG terminology is easily distinguishable among investors.
   C. Environmental and social factors have been adopted in investment analysis more slowly than governance factors.
10. Which of the following statements regarding ESG investment approaches is *most accurate*?
    A. Negative screening is the most commonly applied method.
    B. Thematic investing considers multiple factors.
    C. Positive screening excludes industries with unfavorable ESG aspects.