PART I

LEARNING OBJECTIVES, SUMMARY OVERVIEW, AND PROBLEMS

CHAPTER 1

INTRODUCTION TO CORPORATE GOVERNANCE AND OTHER ESG CONSIDERATIONS

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.

SUMMARY OVERVIEW

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.