- Corporate governance and ESG: An introduction

Corporate governance and ESG: An introduction

Corporate governance

- Minimize and manage conflicting interests between insiders and external shareowners
- Shareholder theory
    - Maximize market value of firm's common equity
    - Conflicts between firm's managers and its owners (shareholders)
- Stakeholder theory
    - Conflicts among several groups that have an interest in the activities and performance of the firm
    - Shareholders, employees, suppliers, customers,

Stakeholder groups

- Shareholders
    - Residual interest in the firm
    - Claim net assets after liabilities have been settled
    - Voting rights for election of BOD
- BOD
    - Protect the interests of **shareholders**
    - Senior manager's compensation
    - Strategic direction
    - One-tier structure
        - Company executive and non-executive board server a single BOD
    - Two-tier structure (Supervisory oversee management board)
        - Supervisory board: non-executive members
        - Management board: executives
- Senior managers
    - Salary, bonus
- Employee
    - Sustainability and success of the firm
- Creditors
    - Supply debt capital, outstanding bonds
    - Banks made loans to firms
    - No **voting** rights
    - Do not participate in firm growth beyond receiving promised interest and principal
    - Use **covenants** to protect interest
- Suppliers
    - Preserve an ongoing relationship with the firm

Principal-agent conflicts

- Principal: shareholders, agents: management and board members (directors)
- **shareholders – Managers or directors**
    - Manager choose low level risk

    - Directors who are also managers favor management interests at the expense of shareholders
    - Directors favor one group of shareholders at the expense of another
    - **Information asymmetry**
        - Managers know more than shareholders
        - Use **non-executive** directors to monitor and evaluate managers
- **Group of shareholders (majority and minor)**
    - Majority shareholder act against the interest of minority shareholders
    - Controlling shareholders in good position
    - Majority shareholders cause **related party** transactions
- **Shareholders and creditors (risk seeking or aversion)**
    - Shareholders – risk seeking
        - Prefer more risk
        - Issue new debt, pay greater dividend -> increase creditor's risk of default
    - Creditors – risk aversion
        - prefer less risks
- **shareholders – other stakeholders**
    - customers
        - raise prices or reduce quality

Shareholder Management

- management of relation with stakeholders
    - have good understanding of stakeholder **interests**
    - maintain effective communication with stakeholders
- infrastructures
    - legal
    - contractual
    - organization
        - corporate governance
    - governmental
        - regulation
- **annual general meeting** - shareholder
    - at the end of firm's fiscal year
    - audited financial statements
    - proxy: assign voting right to another
- simple majority voting
    - approval of auditor
    - election of directors
- **supermajority** vote (two-thirds or three-fourth)
    - for special resolutions
    - call **extraordinary** general meetings anytime
        - merge or takeover
        - amendment of corporate bylaws
- voting
    - **majority** voting
        - candidate with most votes for each single board position is elected

- **cumulative** voting
    - cast all votes (shares times board positions) for a single candidate or divide them among board candidates
    - greater minority shareholder representation
- minority shareholders
  - may have special rights by law when company is acquired

Board Structure
- **one-tier board**
  - single board, both internal and external directors
  - internal directors - executive directors 内部董事、执行董事
    - senior managers of the firm
  - external directors – non-executive directors 外部董事、非执行董事
    - not company management
  - independent directors 独立董事
    - external directors who have no relationship with the company
  - chairman
    - used to be CEO, now separate CEO and chairman
  - lead independent director
    - call meeting of independent directors
- **two-tier board**
  - **supervisory board 监事**
    - external directors
    - oversee management board
  - management board
    - executive directors
    - lead by CEO

Board Member Election
- normal board
  - elect board members at the **same** time and for **multiple** years
- staggered board
  - elect board members every year
  - limit the ability of shareholder to replace board members in any one year
  - less used now

Board Responsibilities
- elected by shareholders to act in their interest
- select senior management
- strategic direction
- approve capital structure changes
- review company performance
- plan for continuity of management
- establish, monitor, and oversee firm’s internal controls and risk management system
- ensure quality of financial reporting and internal audit, as oversight of external auditors

Board Committees

- committees based on **function**
  - audit, compensation, governance often made up of only **non-executive** or **independent** directors
- **audit** committee
- governance committee
- nomination committee
- compensation committee
- risk committee – financial service firms
- investment committee
  - large acquisitions or projects
  - sales or disposal of company assets or segments

Market and non-market factors

- activist shareholders
  - hold a significant number of shares
  - engage in shareholder activism
- proxy flight
  - seek proxies of shareholder to vote
- tender offer (gain control to take over)
  - an activist group make a tender offer for a specific number of shares to gain enough votes to take over the company
- hostile takeover
  - incentive to influence company management and board to align interests
  - staggered board election makes hostile takeover more costly and difficult
- legal
  - common-law system
    - judge's rulings become law
  - civil law system
    - judges are bound to rule based only on specifically enacted laws

Risks – reduce company value

- accounting fraud
- choose lower-than-optimal risk
- pursue own benefits

Benefits

- **operational** efficiency and financial performance
- effective control and monitoring
- avoid legal and regulatory risks
- reduce risk of debt default
- reduce cost of debt financing

Corporate Analysis

- company ownership and voting structure
  - dual class structure

        - one class have more votes per share
        - ensure founding shareholders can control
        - traded at a discount to single class of shares
    - **controlling** shareholders interests
- board composition
    - executive, non-executive, or independent directors
    - related-party transactions
    - diversity of expertise that suits company current strategy
    - have served for many years and have become too close to the company's management
- management incentive and remuneration
    - short-term
        - cash bonus
    - longer-term
        - shares or options
- shareholder composition
    - cross-holding between companies -> greater stability
- relative strength of shareholders' rights
    - week rights of shareholder
        - anti-takeover
        - staggered board
        - class of super voting shares
- management of long-term risks

ESG investing
- consider environment, social, governance factors
- sustainable/responsible/socially responsible investing
- using ESG factors are not violation of fiduciary duty of managers

ESG investing in portfolio construction
- **negative screening – exclude companies**
    - corruption, human rights
- **positive screening**
    - **best-in-class**
        - identify companies within each industry group with the best ESG practices
- **impact** investing
    - **invest** in order to promote specific social or environment goals
- **thematic** investing
    - based on a single goal, sustainable energy, clean water, climate changes