R27 Introduction to Corporate Governance and Other ESG Considerations

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1. Introduction and Overview of Corporate Governance

This reading gives an overview of corporate governance, the stakeholders of a company, describes how companies manage various stakeholders, the role played by the board of directors, the risks in a corporate governance structure, what corporate governance issues are relevant for investment professionals, and environmental and social considerations for investors.

1.1 Corporate Governance Overview

The curriculum defines corporate governance as "the system of internal controls and procedures by which individual companies are managed." Corporate governance defines the rights, roles, and responsibilities of various groups within an organization and how they interact. One of the goals of a good corporate governance system is to minimize the conflict of interests between the stakeholders within a company and external shareholders.

Corporate governance practices differ from country to country, and even within a country several governance systems may be practiced. Most corporate governance systems are based on one of these two theories or a combination of both: *stakeholder theory* and *shareholder theory*.

Shareholder theory is based on the premise that the goal of a company is to maximize shareholder returns.

Stakeholder theory is based on the premise that a company's focus is not restricted to shareholders, but extends to other stakeholders as well such as its customers, employees, suppliers, etc.

2. Stakeholder Groups

A corporate governance system considers the needs of several stakeholder groups, some of whom may have conflicting interests. This section covers the various stakeholder groups in a corporation and the possible conflicts across these groups.

2.1. Stakeholder Groups

The primary stakeholder groups of a corporation include shareholders, creditors, managers and employees, a board of directors, customers, suppliers, and governments/regulators. We look at each group in detail now.

Shareholders

Shareholders own shares in a corporation and are entitled to certain rights, such as the right to receive dividends and to vote on certain corporate issues.

There are two types of shareholders in a company:

- *Controlling shareholders* who hold a significant percentage of shares in a company,

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which gives them the power to control how the board of directors is elected. They also have the power to not vote in favor of a resolution; due to a lack in the majority, the resolution may not be passed. Examples of a resolution put to vote include: the number of shares to buyback, merger of a company, winding up of a division, etc.
- *Non-controlling shareholders* are minority shareholders who hold a relatively smaller proportion of a company's outstanding shares. They have limited voting rights.

Creditors

Creditors are suppliers of debt financing to a company such as bondholders and banks. Some of the key characteristics and rights of creditors are listed below:
- Unlike equity shareholders, they do not have voting rights.
- They have limited influence over a company's operations.
- They may impose restrictions on what a company can and cannot do through covenants.
- In return for the capital provided, they expect to receive periodic interest payments and repayment of principal at the end.
- Unlike equity shareholders, they do not directly benefit from a company's strong performance and prefer stability in a company's cash flows.

Managers and Employees

Senior managers and employees are compensated for their work at a company through salary and bonuses linked to individual and company performance, stock options, etc. Lower level employees seek fair salary, career development through training, good working conditions, promotion, etc. Managers and employees are directly affected by a company's performance. They can expect to receive a good payout when the company does well and similarly face layoffs when the performance is poor. They have conflicting interests with other stakeholders in situations like a takeover.

A Board of Directors

A company's board of directors is elected by the company's shareholders to protect their interests, monitor the company's operations and performance of the management, and participate in strategic discussions about the company. Directors are experienced individuals and often experts in their fields who enjoy a good reputation in the business community. They must keep a tab on the company's operations to ensure shareholders' interests are protected. There are two ways in which a board is often structured:
- *One-tier* structure comprises a single board of directors. Executive directors (internal) are either employees or senior managers of a company. Non-executive directors (external) are not employees of the company. This type of board structure is often found in India, the United States, and the United Kingdom.
- *Two-tier* comprises two boards: a supervisory board of primarily non-executive

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directors, and a management board of executive directors. The supervisory board monitors the management board. This type of board structure is often found in Germany, China, Finland, etc.

Customers

Customers expect to receive products and services of good quality for the price paid. They also expect after-sales service, support, and guarantee/warranty for the period promised. In return, companies strive to keep their customers happy as this has a direct effect on its revenues. Of all the stakeholders, customers are least concerned about a company's performance.

Suppliers

A supplier's interest in a company is limited to being paid for the products and services supplied to a company. Some suppliers are keen to maintain a good long-term relationship with companies as it is recurring business. Suppliers are primarily concerned that a company has a good operating performance and steady cash flow so as to pay their dues.

Governments/Regulators

Government is a stakeholder as it collects taxes from companies. It is in the interest of governments and regulators to pass laws and regulations to ensure the interests of the investors are protected. The state of a country's economy, output, import/export, employment, and capital flows are all affected by how well companies function in a country.

3. Principal-Agent and Other Relationships in Corporate Governance

A principal-agent relationship arises when a principal hires an agent to carry out a task or a service. An agent is obliged to act in the best interests of the principal and should not have a conflict of interest in performing a task. However, in reality, there are several conflicts of interest that arise in a principal-agent relationship and we look at a few of them in this section.

3.1 Shareholder and Manager/Director Relationships

In this relationship, shareholders are the principals and managers/directors are the agents. Shareholders elect the board of directors and assign them the responsibility to act in their best interests by maximizing equity value. Examples of situations that may lead to a conflict of interest between shareholders and managers/directors are as follows:

- *Firm value versus personal benefits of managers*: Investors want the firm value to be maximized, whereas managers are more interested in maximizing their compensation.
- *Levels of risk tolerance*: Investors with diversified portfolios may have the ability to tolerate higher levels of risk taken by a specific company in their portfolio as the risk

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will be diversified. Managers and directors, however, tend to play safe and avoid taking risky decisions so as to protect their employment.

- *Information asymmetry*: Managers have greater access to information, and they may leverage this knowledge to make decisions that are not necessarily aligned with the best interests of the shareholders.
- *Insider influence*: If insiders exert influence over directors which prevents them from exercising control or monitoring properly, then this leads to a conflict of interest.
- *Preferential treatment of shareholders:* If directors are biased towards certain powerful investors, then it will not be fair to the other shareholders.

3.2 Controlling and Minority Shareholder Relationships

Controlling shareholders are shareholders with a controlling stake and significant authority to influence decision-making in a company. Minority shareholders, on the other hand, have limited or no control over the management. Situations where the two ownership structures lead to a conflict of interest are as follows:

- *Electing board of directors:* Controlling shareholders have greater representation and influence in electing the board of directors that use straight voting. As a result, minority shareholders do not have much representation on the board.
- *Impact on corporate performance:* Corporate decisions taken by controlling shareholders impact the performance of a company, and consequently, shareholders' wealth. Controlling shareholders exercise their influence on significant decisions such as takeover transactions.
- *Related-party transactions:* When a controlling shareholder enters into a financial transaction between the company and a related third-party supplier that is not in the best interests of the company, it leads to conflicting interests for the minority shareholders. For example, if the third-party supplier is a relative/spouse of the controlling shareholders who supplies products at above-market prices, then the controlling shareholder stands to gain at the expense of the company/minority shareholders.
- *Difference in voting powers*: An equity structure with multiple share classes tends to assign superior voting powers to one class and limited voting rights to other classes leading to a conflict of interest.

3.3 Manager and Board Relationships

The management of the company is primarily responsible for the operations of a company and has access to all information about the company. Since the board relies on the management for information, its powers and monitoring ability is limited if information is withheld by the management or only selective information is provided.

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3.4 Shareholder versus Creditor Interests

There is a conflict of interest between the two suppliers of capital to a company under the following circumstances:

- *Distribution of dividends:* Creditors are concerned if a company pays excess dividends to shareholders that may impair its ability to service debt.
- *Risk tolerance*: Shareholders have a higher risk tolerance and prefer a company takes on more risk to generate higher returns. The better the performance of a company, the higher is the return shareholders can expect. Creditors are conservative and prefer a stable operating cash flow over higher returns as they do not have a claim to residual income.
- *Increased borrowing*: When a company increases its borrowing and fails to generate returns to service the debt, then the default risk faced by the creditors increases.

3.5 Other Stakeholder Conflicts

Examples of other conflict of interests among other stakeholders are as follows:

- *Conflict between customers and shareholders*: When a company charges higher prices for its products but lowers its safety features.
- *Conflict between customers and suppliers*: When a company offers lenient credit terms to customers that affects its ability to pay suppliers.
- *Conflict between shareholders and governments/regulators*: When a company uses reporting practices to reduce its tax burden that benefits shareholders.

4. Overview and Mechanisms of Stakeholder Management

Stakeholder management deals with identifying, prioritizing, communicating, effectively engaging, and managing the interests of various stakeholder groups and their relationships with a company.

4.1. Overview of Stakeholder Management

A stakeholder management framework to balance the interests of various stakeholder groups consists of the following:

- *Legal infrastructure*: This defines the rights allowed by law and the course of action one can take for violation of these rights.
- *Contractual infrastructure*: This defines the contractual agreement a company and its stakeholders enter into with the objective that the rights of both the parties are defined and protected.
- *Organizational infrastructure*: This defines the internal systems, procedures, and processes a company follows to manage its relationships with its stakeholders.
- *Governmental infrastructure*: This refers to the regulations imposed on companies.

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4.2. Mechanisms of Stakeholder Management

Although governance practices for managing the interest of all stakeholders may vary from company to company and across countries, there are some common control elements and practices that are listed below:

1. General Meetings

General meetings provide an opportunity to shareholders to exercise their vote on major corporate issues. There are typically two types of general meetings:

- *Annual general meetings:* These are usually held within a certain period after the end of the fiscal year. During an AGM, a company's annual performance is presented and discussed, and shareholders' questions are answered.
- *Extraordinary general meetings:* These can be called anytime during the year, either by the company or shareholders, whenever a major resolution has to be passed such as an amendment to a company's bylaws, mergers or acquisitions, or the sale of businesses.

Number of votes required may be one of the following two types based on the type of resolution to be passed:

- For simple decisions, a simple majority of votes is sufficient.
- For material decisions, a supermajority vote is required, i.e., 75% of the votes must be in favor of a resolution to be passed.

Proxy voting allows shareholders to authorize another individual to vote on their behalf at the AGM. In *cumulative voting*, shareholders may accumulate their votes to vote for one candidate in an election that involves more than one director.

2. Board of Director Mechanisms

The board is the bridge between shareholders and the management of the company. Since shareholders cannot be involved in every decision or day-to-day operations of the company, they exercise their voting rights to elect a board of directors that will participate in strategic decisions, oversee operations, perform audits, monitor management's actions, and ensure governance systems are in place.

3. The Audit Function

The audit function refers to the controls, systems, and processes in place to ensure the company's financial reporting/records are accurate. The objective is to prevent fraudulent reporting of financial information. There are two types of audits: internal and external. Internal audits are performed by an independent internal audit department, while external audits are conducted by independent auditors not associated with the company. The board of directors reviews the auditors' reports for fairness and accuracy before presenting the

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financial statements to shareholders at the AGM.

4. Reporting and Transparency

Shareholders have access to all audited financial information of a company, its strategy, governance policies, remuneration policies, and other information through the company's financial statements, website, press releases, etc. They use this information to assess a company's performance, evaluate whether to buy or sell the shares of a company, and vote on key corporate issues.

5. Policies on Related-party Transactions

Policies on related-party transactions require directors and managers to disclose any transactions they have with the company that is a conflict of interest. Any transaction with a potential conflict of interest must be cleared by the board, excluding the director who has an interest.

6. Remuneration Policies

Remuneration packages have evolved from including variable components such as options and profit sharing to more restrictive ones such as granting shares that can be vested only after several years, or remuneration only after certain objectives are met. The objective is to align the interests of executives with the interests of shareholders and prohibit them from taking excessive risks for personal gains.

7. Say on Pay

Say on pay is what the term literally means, that is, the shareholders may express their views and vote on the remuneration of executives. First introduced in the United Kingdom in the early 2000s, it is now a widely accepted concept worldwide. Of course, whether the board accepts the shareholders' views on pay varies from country to country, and is non-binding in many countries such as Canada, the United States, South Africa, etc.

5. Mechanisms to Mitigate Associated Stakeholder Risks

There are laws that often vary by jurisdiction, to protect creditors' interests. Some of the most common provisions are:

- *Indenture:* It is a legal contract that defines the bond structure, the obligations of the issuer, and the rights of the bondholders.
- *Covenants:* These are terms specified within a bond indenture that state what a bond issuer may and may not do. The objective is to limit the risk of bondholders.
- *Collaterals:* These are financial guarantees that may be used to repay bondholders if an issuer defaults on periodic payments.
- *Periodic information:* Creditors expect the company to provide periodic financial information to monitor the risk exposure and ensure covenants are not violated.

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5.1 Employee Laws and Contracts

Standard rights of employees in any country such as hours of work, pension and retirement plans, vacation and leave, are defined in labor laws. Companies strive to manage relationships with their employees to protect their best interests and avoid legal repercussions on violation of these rights. Employees form unions in many countries to collectively influence the management on issues they may face. Individual employee contracts define an employee's rights and responsibilities, remunerations, and other benefits such as ESOPs. Companies might establish a code of ethics which defines the ethical behavior expected of employees.

5.2 Contractual Agreements with Customers and Suppliers

Companies enter into contracts with both customers and suppliers that define the products, services, any guarantee, after-sales support, payment terms, etc. It also defines the course of action in case one party violates the contract.

5.3 Laws and Regulations

Governments and regulatory agencies pass laws to protect the interests of consumers or specific stakeholders. Sensitive industries such as banks, health care, and food manufacturing companies have to comply with a rigorous regulatory framework.

6. Company Board and Committees

In this section, we look at the functions and responsibilities of a company's board of directors.

6.1 Composition of the Board of Directors

There is no standard structure or composition for the board of a company. It varies by company size, complexity of operations, and geography. Some common board structures are discussed below:

- *One-tier structure*: It is a mix of executive (internal) and non-executive (external) directors.
- *Two-tier structure*: Consists of two tiers, a supervisory board and a management board. Members serving on one board are generally restricted from serving on other board, or there is a limit on members that can serve on both boards.
- *CEO Duality:* CEO duality is when the CEO also serves as the chairperson. The roles are usually kept separate in most countries to maintain independence. If there is no CEO duality, then, as an alternative, a lead independent director is appointed to oversee the functioning of independent directors.

Staggered board is a commonly followed practice where directors are divided into three groups and elected into office in consecutive years, so that all of them are not replaced

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simultaneously.

6.2 Functions and Responsibilities of the Board

Two primary responsibilities of the board are:

- Duty of care: Requires board members to act on a fully informed basis, in good faith, with due diligence and care.
- Duty of loyalty: A board member must act in the best interests of the company and shareholders, and not act in their own self-interest.

Other responsibilities of the board are as follows:

- Guides and approves the company's strategic direction.
- Evaluates the performance of senior executives.
- Ensures effectiveness of audit and control systems.
- Ensures that an appropriate enterprise risk management system is in place.
- Reviews proposals for corporate transactions and changes.

6.3 Board of Directors Committees

The board of directors delegates specific functions to individual committees that, in turn, report to the board on a regular basis. The number of committees and their composition may vary based on jurisdiction and industry. Some committees such as the audit is a regulatory requirement in most jurisdictions.

Audit Committee

The functions of the audit committee are as follows:

- Oversee the audit and control systems.
- Monitor the financial reporting process.
- Supervise the internal audit function.
- Appoint the independent external auditor.

Governance Committee

The functions of the governance committee are as follows:

- Develop and oversee implementation of good corporate governance policies and a code of ethics.
- Periodically review and update the policies for any regulatory changes.
- Ensure compliance of the policies.

Remuneration or Compensation Committee

The functions of the remuneration committee are as follows:

- Develop remuneration policies for directors and executives, and present them to the board for approval.
- Set performance criteria for managers and evaluate their performance.

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- Oversee implementation of employee benefit plans, pension plans, and retirement plans.

Nomination Committee

The functions of the nomination committee are as follows:
- Identify and recommend qualified candidates who can serve as directors.
- Establish nomination procedures and policies to keep the board independent as per good-governance principles.

Risk Committee

The risk committee is responsible for defining the risk policy and risk appetite of the company. It monitors the implementation of risk management and periodically reviews, reports, and communicates its findings to the board.

Investment Committee

The functions of the investment committee are as follows:
- Review investment plans proposed by the management, such as new projects, acquisitions and expansion plans, and divestitures.
- Formulating the investment strategy and policies for a company.

7. Relevant Factors in Analyzing Corporate Governance and Stakeholder Management

7.1 Market Factors

Among the market factors that affect stakeholder relationships in a company, we focus on shareholder engagement, shareholder activism, and competitive forces.

Shareholder Engagement

Companies engage with shareholders periodically through events such as annual general meetings and analyst calls to primarily discuss financial performance and any strategic issues. However, companies see a benefit in interacting with them more often to counter negative recommendations.

Shareholder Activism

Shareholder activism refers to the tactics used by shareholders to influence companies to act in their favor. Often, their primary objective is to increase shareholder value. The strategies used by shareholders include shareholder derivative lawsuits, proxy battles, proposing shareholder resolutions, and publicity on issues of contention.

Competition and Takeovers

Shareholders prefer corporate takeover if the management of a company underperforms.

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The commonly used methods for corporate takeovers are as follows:

- *Proxy contest*: A group attempting to take a controlling position on a company's board of directors influences shareholders to vote for them.
- *Tender offer*: An offer by a group seeking to gain control to purchase a shareholder's shares.
- *Hostile takeover*: One company tries to acquire another company by bypassing the management and directly going to the company's shareholders.

7.2 Non-market Factors

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

Legal Environment

The rights of stakeholders depend on the law of the country the company operates in. There are primarily two law systems.

- Common law system: This is considered to offer better protection for stakeholders as laws can be created both by legislature and judges. This system is found in the United Kingdom, United States, India, etc.
- Civil law system: This is considered restrictive for stakeholders as laws can be created only by passing legislation.

Creditors are more successful in winning legal battles when the terms of indenture are violated. In contrast, shareholders find it difficult to prove in court that a manager/director has not acted in their best interests.

The Media

Regulators are keen on introducing corporate governance reforms or pass new laws to protect the stakeholders, especially in the aftermath of 2008-09 financial crisis. Social media is a low-cost, effective tool used by stakeholders to protect their interests, garner support on corporate issues, or use it for negative publicity against a corporate.

The Corporate Governance Industry

The corporate governance industry is a concentrated one. The genesis for the demand for external corporate governance services was a rule introduced by the Securities and Exchange Commission (SEC) in 2003. The SEC mandated that all US-registered mutual funds must disclose their proxy voting records annually. As a result, institutional investors hire experts to help them with proxy voting and corporate governance monitoring.

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8. Risks and Benefits of Corporate Governance and Stakeholder Management

8.1 Risks of Poor Governance and Stakeholder Management

In this section, we analyze the risks a company faces due to a poor governance structure.

Weak Control Systems

Weak control systems and poor monitoring can affect a company's performance and value. One example is that of Enron where auditors failed to uncover fraudulent reporting that ultimately affected many stakeholders.

Ineffective Decision-Making

Poor decisions include managers avoiding good investment opportunities to maintain a low-risk profile or taking on excessive risk without properly evaluating potential investments. Both decisions are not in the interests of shareholders. Such decisions may result from:

- *Information asymmetry:* When managers have access to more information than board members/shareholders.
- *Outsized remuneration:* High remuneration not aligned with long-term strategic goals may result in managers taking excessive risks for personal gains.
- *Related-party transactions:* Transactions in which managers have a material interest and are not in the interest of the company, will affect the value of the company.

Legal, Regulatory, and Reputational Risks

Improper implementation and monitoring of corporate governance procedures may result in the following risks:

- Legal: Stakeholders such as shareholders, creditors and employees may file lawsuits against the company if their rights are violated.
- Regulatory: Government/regulator may choose to take action if the applicable laws are violated.
- Reputational: A company may be subjected to negative publicity by investors/analysts if there is an improperly managed conflict of interest.

Default and Bankruptcy Risks

Poor corporate governance may affect the company's performance, which in turn may affect the company's ability to service its debt. If creditors' rights are violated and they choose to take legal action on defaulting debt, the company may be forced to file for bankruptcy.

8.2 Benefits of Effective Governance and Stakeholder Management

The benefits of good corporate governance and balancing the interests of managers, board members, company's stakeholders, and shareholders are as follows:

- *Operational efficiency*: A good governance structure ensures that all employees of a

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company have a clear understanding of their responsibilities and reporting structures. The operational efficiency of a company is improved when good governance structure is combined with strong internal control mechanisms.

- *Improved control:* Good governance implies improved control at all levels to help a company manage its risk efficiently. Control can be improved with a good audit committee, complying with laws and regulations, and introducing procedures to handle related-party transactions.
- *Better operating and financial performance*: A company's operating and financial performance can be improved with good governance practices. Proper remuneration for management, mitigation of lawsuits against the company, and improving the decision-making of its managers to make the right investments are ways that will help in improving the performance of a company.
- *Lower default risk and cost of debt*: A company's cost of debt and default risk can be reduced by protecting creditors' rights, ensuring proper audits are conducted, and that there is no information gap between the company and its creditors.

9. Factors Relevant to Corporate Governance and Stakeholder Management Analysis

In the aftermath of several corporate scandals in the early 2000s and global financial crisis of 2008-09, fundamental analysts have now begun focusing on corporate governance issues as part of their analysis of a company. In this section, we look at the areas analysts focus on when assessing a company's corporate governance and stakeholder management system.

9.1 Economic Ownership and Voting Control

Analysts must examine the voting structure of publicly traded companies. Any structure where voting power is not equal to the percentage of shares owned or one vote for one share results in risks for investors. Examples of voting structures where economic ownerships are separate from control are as follows:

- Dual-class structures: In this structure, there are two classes where one class has a superior voting power than the other. For example, one class may carry one vote per share, whereas another may carry several votes per share.
- Electing board members: Another mechanism is where one class of stock has the power to elect a majority of the board, while another class has the right to elect only a minority of the board.

9.2 Board of Directors Representation

Analysts assess whether the experience, tenure, diversity, and skills of the current board of directors match the current and future needs of a company. The curriculum cites the example of a European pharmaceutical company going through financial distress. The company's performance turned around for the better when non-executive directors with

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financial expertise were added to the board. Several years later, when a medical crisis hit the company, the company failed to respond by bringing in someone with medical expertise to the board. The shares fell as they continued to retain the previous directors.

9.3 Remuneration and Company Performance

If information on executives' remuneration is available, then analysts must assess whether the remuneration plans are aligned with the performance drivers of the company. Some of the warning signs analysts must look out for are as follows:

- Plans such as cash payout and no equity, offer little alignment with shareholders.
- Performance-based plans that have a full payout irrespective of a company's performance.
- Plans that have an excessive payout relative to comparable companies with a comparable performance.
- Remuneration plans or payouts that are based on achieving specific strategic objectives. Analysts must assess whether these are also aligned with company's long-term objectives. For example, FDA approval for a drug, or cost savings on a production process.
- Plans based on incentives from an earlier period in the company's life cycle. For example, remuneration plans for executives in a company that is currently in mature phase is still based on revenue growth as earlier.

9.4 Investors in the Company

Analysts must assess the composition of investors in a company. They must examine, in particular, if the following types of investors are present as it can affect the outside shareholders:

- *Cross-shareholdings* where a large publicly traded company holds a minority stake in another company.
- *Affiliated stakeholders* can protect a company from the results of voting by outside shareholders.
- *Activist shareholders* have the ability to change the shareholder composition in a short span of time.

9.5 Strength of Shareholders' Rights

Analysts must assess whether the shareholder rights of a company are strong, average, or weak relative to investors' rights of other comparable companies. They must assess if shareholders have the rights to remove the directors from a board or support/resist external initiatives.

9.6 Managing Long-Term Risks

Analysts must assess the management quality of the company to understand how it manages

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long-term risks. There are several instances where poor management of long-term risks has resulted in a fall of share prices and negatively impacted the company's reputation. Poor management may result in repeated fines, lawsuits, regulatory investigations, etc.

10. ESG Considerations for Investors and Analysts

10.1 Introduction to Environmental, Social, and Governance Issues

ESG is an acronym for environmental, social and governance issues. The importance of good corporate governance has long been understood by analysts and shareholders. Therefore, the practice of considering governance factors in investment analysis has evolved considerably. However, the practice of considering environmental and social factors in investment analysis has evolved more slowly.

Some examples of ESG factors are presented in Exhibit 1 from the curriculum:

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

10.2 ESG Investment Strategies

ESG investment strategies include:

Responsible investing: This is the broadest definition used to describe investment strategies that incorporate ESG factors. It can be further classified into:

- <u>ESG integration (also called ESG investing)</u>: Refers to the practice of including *material* ESG factors in the investment process. An ESG factor is considered material when it can impact the company's ability to generate sustainable returns in the long term.
- <u>Socially responsible investing (SRI)</u>: The term has traditionally referred to the practice of excluding investments that are against the moral values of investors such as investing in tobacco companies. The term has now evolved to include investing in companies with favorable environmental or social profiles.
- <u>Thematic investing</u>: Refers to investments based on a theme or single factor, such as

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energy efficiency or climate change.

- Impact investing: Refers to the practice of investing in companies with an objective of meeting social or environmental targets along with financial returns.

Sustainable investing: A term used in a similar context to responsible investing, but the emphasis is on factoring in sustainability issues while investing.

Green finance: It is a responsible investing approach that uses financial instruments to support a green economy. For example, green bonds are bonds where the proceeds are used by the issuer to fund environmental-related projects.

10.3 ESG Investment Approaches

The six main ESG investment approaches are:

- **Negative screening**: This involves exclusion of certain sectors or companies or practices from a fund or portfolio on the basis of specific ESG criteria. For example, companies engaged in fossil fuel extraction or garment companies employing child labor.
- **Positive screening**: Positive screening strategy involves inclusion of certain sectors, companies, or practices in a fund or portfolio on the basis of specific ESG criteria. For instance, these companies may have policies focused on the well-being and safety of its employees, and strive towards protecting employee rights.
- **ESG integration**: Refers to the practice of including *material* ESG factors in the investment process. Traditional financial analysis metrics such as cash flow forecasts, credit/default risk forecasts, and/or cost of capital estimates are adjusted to account for the ESG factors.
- **Thematic investing:** This strategy picks investments based on a theme or single factor, such as energy efficiency or climate change. An increasing trend world over is the increasing demand for energy and water. Companies that provide solutions to these socio-economic problems make for attractive investments.
- **Engagement/active ownership:** This strategy involves achieving targeted social or environmental objectives along with measurable financial returns by using shareholder power to influence corporate behavior. Examples include: venture capital investing and green bonds.
- **Impact investing:** Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. For example, investments that help achieve one of the United Nations sustainable development goals such as SDG6: Clean Water and Sanitation.

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10.4 Catalysts for Growth in ESG Investing

The two main catalysts for growth in ESG investing are:

1. ESG issues are having more financial impacts. Many investors incurred significant losses when the companies they invested in mismanaged ESG issues.
2. A greater number of younger investors are increasingly demanding that their inherited wealth or pension contributions be managed responsibly.

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 have led to inclusion of environmental and societal costs in the company's income statement by responsible investors.

10.5 ESG Market Overview

The amount of global assets under management (AUM) related to responsible and sustainable investing has increased substantially. This has led to increased corporate disclosures of ESG issues, as well as a growing number of firms that collect and analyze ESG data. Also, several organizations have been formed to monitor and advance the mission of sustainable investing.

10.6 ESG Factors in Investment Analysis

Some environmental and social factors considered in investment analysis are listed below:

Environmental factors

- Natural resource management.
- Pollution prevention.
- Water conservation.
- Energy efficiency and reduced emissions.
- Existence of carbon assets.
- Compliance with environmental and safety standards.

Social factors

- Human rights and welfare concerns in the workplace
- Data privacy and security
- Access to affordable health care products
- Community impact

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Summary

LO.a: Describe corporate governance.

Corporate governance refers to the system of controls and procedures by which individual companies are managed. It outlines the rights and responsibilities of various groups, and how conflicts of interest among the various groups are to be resolved.

LO.b: Describe a company's stakeholder groups and compare interests of stakeholder groups.

The primary stakeholders of a company include:

- Shareholders
- Creditors
- Managers and employees
- Board of Directors
- Customers
- Suppliers
- Government/Regulators

LO.c: Describe principal–agent and other relationships in corporate governance and the conflicts that may arise in these relationships.

A principal-agent relationship arises when a principal hires an agent to carry out a task or a service. An agent is obliged to act in the best interests of the principal and should not have a conflict of interest in performing a task. However, such relationships often lead to conflicts among stakeholders in a corporate structure. Examples of relationships that lead to such conflicts include:

- shareholder and manager/director.
- controlling and minority shareholder.
- manager and board.
- shareholder and creditor.
- customer and shareholder.
- customer and supplier.
- shareholder and government/regulator.

LO.d: Describe stakeholder management.

Stakeholder management deals with identifying, prioritizing, communicating, effectively engaging, and managing the interests of various stakeholder groups and their relationships with a company. A stakeholder management framework to balance the interests of various stakeholder groups consists of a legal, contractual, organizational, and governmental infrastructure.

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LO.e: Describe mechanisms to manage stakeholder relationships and mitigate associated risks.

Mechanisms to manage stakeholders may include general meetings, a board of directors, the audit function, reporting and transparency, policies on related-party transactions, remuneration policies, say on pay, contractual agreements with creditors, employee laws and contracts, contractual agreements with customers and suppliers, and laws and regulations.

LO.f: Describe functions and responsibilities of a company's board of directors and its committees.

A company's board of directors is elected by the company's shareholders to protect their interests, monitor the company's operations and performance of the management, and participate in strategic discussions about the company. The board of directors is the bridge between shareholders and the management. The structure and composition of the board vary by company size, complexity of operations, and geography. The two primary responsibilities of the board are duty of care and duty of loyalty. A company's board of directors delegates specific functions to individual committees that, in turn, report to the board on a regular basis. The number of committees and their composition may vary based on jurisdiction and industry. But some committees are standard such as the audit committee, governance committee, remuneration committee, nomination committee, risk committee, and investment committee.

LO.g: Describe market and non-market factors that can affect stakeholder relationships and corporate governance.

Stakeholder relationships and corporate governance are affected by a number of market and non-market factors. Market factors include shareholder engagement, shareholder activism, and competitive forces. Non-market factors include legal environment, the media, and the corporate governance industry.

LO.h: Identify potential risks of poor corporate governance and stakeholder management and identify benefits from effective corporate governance and stakeholder management.

The risks of poor corporate governance include weak control systems; ineffective decision-making; legal, regulatory, and reputational risks; and default and bankruptcy risks. Benefits include operational efficiency, improved control, better operating and financial performance, and lower default risk and cost of debt.

LO.i: Describe factors relevant to the analysis of corporate governance and stakeholder management.

Key factors considered by analysts in corporate governance and stakeholder management

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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.

LO.j: Describe environmental and social considerations in investment analysis.

Some environmental and social factors considered in investment analysis are listed below:

<u>Environmental factors</u>

- Natural resource management.
- Pollution prevention.
- Water conservation.
- Energy efficiency and reduced emissions.
- Existence of carbon assets.
- Compliance with environmental and safety standards.

<u>Social factors</u>

- Human rights and welfare concerns in the workplace
- Data privacy and security
- Access to affordable health care products
- Community impact

LO.k: Describe how environmental, social, and governance factors may be used in investment analysis.

The six main investment approaches are:

ESG Investment Style	Description
Negative screening	Excluding certain sectors or companies or practices from a fund or portfolio on the basis of specific ESG criteria.
Positive screening	Including certain sectors, companies, or practices in a fund or portfolio on the basis of specific ESG criteria.
ESG integration	Refers to the practice of including *material* ESG factors in the investment process.
Thematic investing	This strategy picks investments based on a theme or single factor, such as energy efficiency or climate change.
Engagement/ active ownership	This strategy involves achieving targeted social or environmental objectives along with measurable financial returns by using shareholder power to influence corporate behavior.

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

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