Level I
of the
CFA® Program

Corporate Issuers

INTRODUCTION TO CORPORATE GOVERNANCE AND OTHER ESG CONSIDERATIONS

Learning Objectives (1/2)

- **LOS** : Describe **corporate governance**.
- **LOS :** Describe a company's **stakeholder groups** and compare interests of stakeholder groups.
- **LOS :** Describe **principal–agent and other relationships** in corporate governance and the conflicts that may arise in these relationships.
- **LOS :** Describe **stakeholder management**.
- **LOS :** Describe **mechanisms to manage stakeholder relationships** and mitigate associated risks.
- **LOS :** Describe functions and responsibilities of a **company's board of directors** and its committees.

Learning Objectives (2/2)

- **LOS :** Describe **market and non-market factors** that can affect stakeholder relationships and corporate governance.
- **LOS :** Identify **potential risks of poor corporate governance** and stakeholder management and identify benefits from effective corporate governance and stakeholder management.
- **LOS :** Describe factors relevant to the **analysis of corporate governance** and stakeholder management.
- **LOS :** Describe **environmental and social considerations** in investment analysis.
- **LOS :** Describe how **environmental, social, and governance** factors may be **used in investment analysis**.

LOS : Describe corporate governance

- A system of internal controls, processes, and procedures by which a company is **managed**, **directed** or **controlled**.

- Outlines the **rights**, **roles**, and **responsibilities** of various persons within the organization.

- The goal of corporate governance: To promote the **interests of stakeholders** in a fair, **transparent manner**.

For example: Johnson and Johnson outlines its 'Principles of Corporate Governance' on its web page, in addition to pictures of its board, a description of its management team, and a link on how to write a letter to the board.

LOS : Describe a company's stakeholder groups and compare interests of stakeholder groups

- Corporate governance systems can be influenced by several stakeholder groups which may or may not have conflicting interests.

- A company's primary stakeholders include:
  - **I.** **Shareholders**: Owners
  - **II.** **Creditors**: Banks, Bondholders, and general creditors
  - **III.** **Managers and Employees**: Corporate leadership, middle management, staff, other employees
  - **IV.** **Suppliers**: Provide resources required to produce goods and services
  - **V.** **Board of Directors**: Elected by shareholders to safeguard their interests and to provide strategic direction

- Others include **customers**, **governments**, and **regulators**.

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

- Agency relationship describes the relationship between principals and agents, where the **agent is expected to act in the best interests of the principal**.
- The principal-agent relationship involves obligations, trust and expectations of loyalty.
  - For example, hiring a contractor to refinish the kitchen or hiring a lawyer as representation in court of law.
- **Problem?** The agent may have an incentive to promote their **own interests at the expense of the principal**.

A contractor has incentive to complete the job while increasing the reputation of the quality of work, but also has incentive to cut costs in areas not visible to customer (sub flooring).

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

Shareholders vs. Managers

1. **Shareholders** expect to **maximize cash flows** over the long term; **managers** want to maximize **personal wealth**.
   - Milton Friedman (1970): Shareholder Wealth Max vs.
   - Adam Smith (1776): Self-Interest

2. **Shareholders may want to see riskier projects** undertaken to increase potential returns; **managers may be more risk averse** for the sake of their job security/career prospects/reputation.

Controlling vs. Minority shareholders

- Minority shareholders have **limited control** over managerial appointments and the day-to-day running of the firm. Their ‘silence’ allows controlling shareholders to ignore them.

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

Managers vs. the Board

- **Information asymmetry** (where managers know more than the board at any point in time) may sow seeds of discord and compromise the board's oversight role.

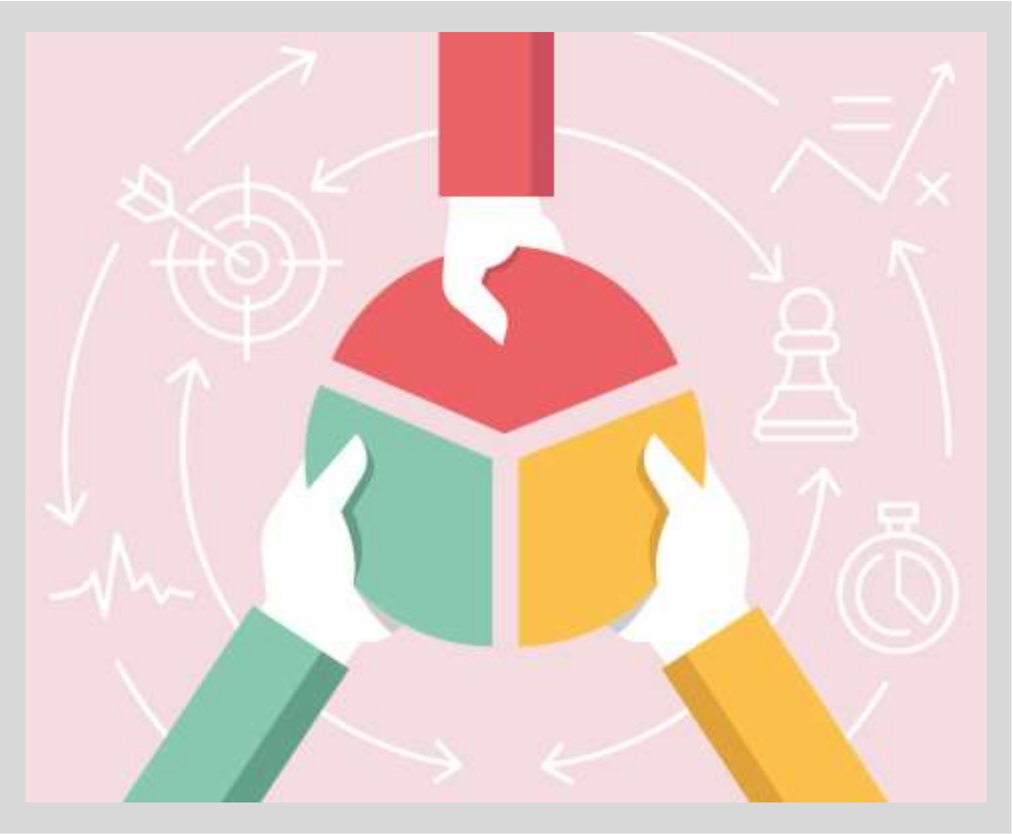
Shareholders vs. Creditors

- Shareholders tend to prefer high-risk projects that have the maximum return potential; **creditors prefer a safety-first approach** and prefer less risky projects.

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

Other stakeholder conflicts:

- Customers vs. Shareholders
- Customers vs. Suppliers
- Shareholders vs. Governments



LOS d: Describe stakeholder management

- **Stakeholder management involves taking the appropriate steps:**
  i. To identify;
  ii. To prioritize; and
  iii. To understand each stakeholder group in order to properly manage the relationships with them.

- **Components of stakeholder management:**
  i. A well-established legal infrastructure that clearly **specifies stakeholder rights** and the remedial actions taken when such rights are violated.
  ii. A robust contractual infrastructure that accommodates **legally binding contracts**.
  iii. A well-established **organizational infrastructure** with sound internal systems and governance practices.
  iv. A stable **government infrastructure** that formulates the rules and regulations to be observed by organizations.

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

- **General meetings:** Bring together shareholders and management to review past performance and formulate future strategy.
- **Board of Directors:** Bears the ultimate responsibility over overall corporate governance.
- **Audit function:** Independently review policies and procedures to ensure compliance with laid down rules/regulations.
- **Reporting and Transparency:** Access to information reduces asymmetry between shareholders and managers.
- **Policies on Related-Party Transactions:** Disclose information relating to related party transactions to mitigate and manage any conflicts of interest that may arise.
- **Remuneration Policies:** Establishing remuneration policies that discourage short-term focus and excessive risk taking **.**
- **Say on Pay:** Shareholders voting on executive remuneration matters.

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

The **board of directors** provides **oversight** and serves as the **link** between its shareholders and managers. It has the **ultimate responsibility** of ensuring that the company adopts proper corporate governance principles and complies with all **applicable laws and regulations**.

The board has two main responsibilities:

I. **Duty of care**: Requires board members to act on a fully informed basis, in good faith, with due diligence and care.

   Example: Product recalls.

II. **Duty of loyalty**: Requires members to act in the interest of the company and shareholders (avoid conflicts of interest).

   Example: Takeovers.

LOS f: Describe functions and responsibilities of a company’s board of directors and its committees

Specific duties of the board:

i. Guides and approves the company’s **strategic direction**.
ii. Delegates **strategy** implementation to senior management.
iii. Reviews **corporate performance** and determines relevant course of action.
iv. Hires and fires senior managers.
v. Ensure **leadership continuity** through succession planning for the CEO and other key executives.
vi. Sets the overall structure of the company’s **audit** and **control systems**.
vii. Oversees reports by internal **audit**, the audit committee, and external auditors.

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

- **Audit committee:** Recommends the appointment of an independent external auditor and proposes the auditor's remuneration; and monitors the company's financial reporting process.
- **Governance committee:** Oversees the formulation and implementation of sound governance practices.
- **Remuneration/Compensation Committee:** Develops total remuneration policies, including benefits.
- **Nomination committee:** Establishes the nomination procedures and policies, including eligibility criteria for board directorship.
- **Risk committee:** Oversees the formulation and implementation of a robust risk management framework.
- **Investment committee:** Considers the viability of investment projects proposed by the management.

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

Market Factors

i. **Shareholder engagement**: Through AGMs and analyst calls.

ii. **Shareholder activism**: Sustained efforts by shareholders to bring about a change in the company's policies and force the management's hand (**poison pills**).

iii. **Competition and Takeovers**: Comparing a company's performance with that of competitors. The threat of a takeover bid from competitors serves to keep the management focused (**golden parachutes** and other **anti-takeover defenses**).

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Non-Market Factors

i. **Legal environment**: The prevailing system of law immensely impacts the protection of interest of shareholders and creditors.

  - **Common law** systems are more protective to shareholders and creditors than **civil law** systems.

ii. **The media**: Fast flow of information serves to keep shareholders apprised of the happenings in a firm, thus helping to protect their interests.

iii. **Corporate governance**: Unlike in the past when corporate governance was merely a ‘textbook concept,’ it is now fully integrated into companies’ leadership models.

Illustration

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McDonald's Corporate Governance Fact Sheet

Size of Board	**11**
Number of Independent Directors	10
Annual Review of Independence of Board	Yes
Separate Chairman and CEO	Yes
Independent Chairman	Yes
Charters for Board Committees	Yes
Independent Audit & Finance Committee	Yes
Number of Financial Experts on Audit & Finance Committee	2
Independent Governance Committee	Yes
Independent Compensation Committee	Yes
Compensation Consultant Independence Policy	Yes
Number of Board Meetings Held in 2016	**8**
Independent Directors Hold Meetings Without Management Present	Yes
Annual Board Elections	Yes
Directors Elected by the Vote of a Majority of Votes Cast in Uncontested Elections	Yes
Annual Board and Committee Evaluations	Yes
Annual Individual Director Evaluations	Yes
Director Stock Ownership and Holding Requirements	Yes
Executive Stock Ownership and Holding Requirements	Yes
Corporate Governance Guidelines Approved by Board	Yes
Charter Poison Pill	**No**
Corporate Compliance Program	Yes
Standards of Business Conduct (which includes special provisions for finance professionals)	Yes
Board Orientation and Education Program	Yes
Proxy Access Bylaws	**Yes**

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

Potential risks of poor corporate governance:

i. Fosters **unfairness**.

ii. Chances of managers making **poor investment decisions** increase.

iii. It increases exposure to **legal/regulatory/reputational risks**.

iv. It raises the **specter of bankruptcy** due to the failure to honor obligations to creditors.

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Potential rewards/benefits of effective corporate governance

i. Improved operational **efficiency**.

ii. Enhanced **control systems** as a result of improved audit functions.

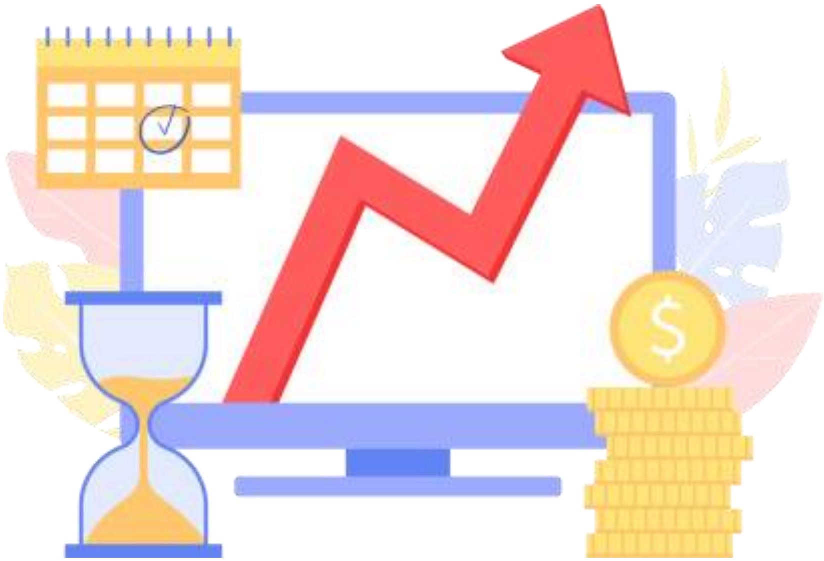
iii. Improved operational and **financial performance**.

iv. Reduced business and investment risk.

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

Economic Ownership and Voting Control

- The extent to which **ownership has been separated from control** in a company directly affects the amount of risk borne by shareholders (more separation = more risk).
- This risk can be tamed by **giving shareholders voting rights** and therefore a voice in crucial decision-making scenarios.



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Board of Directors Representation

- Analysts seek to establish if the board's membership composition reflects the firm's present needs.
- **A dynamic board membership is desirable** if the firm is to actualize effective governance.

Remuneration and Company Performance

- Remuneration should be **commensurate with performance**.

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The Strength of Shareholders’ Rights

- Analysts are interested in determining whether the **rights of the shareholders** in a company are **strong**, **weak**, or **average** when compared with other companies.

The Management of Long-Term Risks

- Analysts may consider how a company manages its long-term risks as a significant factor in their overall assessment of the company.

The Effect of Investors in the Company

- Investor's behaviour can limit or enhance the process of effecting corporate changes. Shareholder activism can also create a substantial turnover in a company’s shareholder composition.

LOS j: Describe environmental and social considerations in investment analysis

- ESG integration is the practice of **considering environmental, social, and governance factors in the investment process**, and can be implemented across all asset classes, including equities, fixed income, and alternative investments.

- ESG factors **considered in the investment analysis** process include:
  i. Pollution prevention
  ii. Energy efficiency
  iii. Reduced emissions
  iv. Adherence to environmental safety and regulatory standards.

LOS j: Describe environmental and social considerations in investment analysis

ESG Investment Strategies

- **Sustainable investing**: This involves factoring in sustainable issues while investing.
- **Social responsible investing:** This involves excluding investments in companies/industries that deviate from an investor's beliefs and including investment objectives that promote positive environmental and social attributes.
- **Thematic investing:** This involves investments in assets related to ESG factors.
- **Impact investing:** This involves investments made with intention to generate positive, measurable social and environmental impact alongside a financial return.

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

- **Negative screening**: Excluding certain sectors or companies from investment consideration due to the nature of their underlying business activities or other environmental or social concerns.

- **Positive screening**: Selecting investments which have favorable ESG characteristics.

- **Best-in-class approach**: Seeks to identify companies which record the highest ESG score in their industry (MSCI Ratings).

- **Thematic investing**: Emphasizes a single factor such as energy efficiency or climate change.

- **Impact investing**: Seeks to achieve targeted social or environmental objectives along with measurable financial returns through engagement with a company or by directly investing in projects or companies.

- **Engagement/active ownership**: This is the use of shareholder or bondholder to influence corporate behavior that is directed by ESG guidelines.

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