PRI Principles for Responsible Investment

INSTITUTE OF DIRECTORS SOUTHERN AFRICA

REVISION OF THE KING CODE

INTRODUCTION TO PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. PRI has 1500 signatories globally with approximately ZAR 900trn (USD$60tn) in assets under management.

Corporate Governance is embedded within the Principles, as a key consideration for institutional investors' investment decision making and active ownership practices.

SUMMARY COMMENTS

PRI welcomes the opportunity to comment on revision of the King Code. Since its establishment in 1994, the King Code has been widely recognized as a source of international best practice on corporate governance. Our comments are focused on the following areas;

Aims and objectives of the revision

PRI agrees that the main objectives of the revision relating to presenting a clear, coherent standard for integrated corporate governance, have been met.

Experiences from engaging companies

PRI has worked with Investors on a series of collaborations around director nominations[1], anti-corruption, tax responsibility[2] and incorporation of environmental, social and governance issues into executive remuneration[3]. We make the following recommendations;

- **(1) King IV introduce a recommended practice that the Nominations Committee has sufficient independence of decision making.**
- **(2) King IV introduce a recommended practice relating to the sustainability skills**

1 PRI (2014): Director Nominations discussion paper 1 and discussion paper 2, and research on company disclosure and practices in the US and France.
2 **PRI (2015)** Engagement guidance on corporate tax responsibility: Why and how to engage with your investee companies
3 PRI (2016) Integrating ESG issues into executive pay: A review of global utility and extractive companies

required by the Board of Directors.

- **(3) King IV introduce a recommended practice on training and development for all Board members.**
- **(4) King IV strengthen its anti-corruption provisions. This could include actions such as establishing policies, designated board responsibility, risk assessment, integration with the code of conduct, training and reporting and escalation channels.**
- **(5) King IV strengthen its recommended practices on variable pay. This could include actions around claw-backs, gateway payments and bonus-malus structures, such as financial penalty for poor performance.**

Alignment with CRISA

PRI agrees with the framing concept of King IV (p. 21) that investors' fiduciary duties require them to include material ESG issues in active ownership and investment decision making. We recommend;

- **(6) Principle 5.2 focuses on the exercise of ownership rights and should be broadened to clarify that good governance encompasses exercise of ownership rights and incorporation of ESG factors into investment decision making.**
- **(7) Principle 5.2 recommended practices 16-18 discuss the strategic direction on responsible investment, and supporting policies. The code should clarify that these practices should be aligned with existing investment practice.**

CONTACT

PRI has experience in ESG regulation, guidance and implementation in a number of investment markets, and offers its expertise to support the revision of the King Code and development of the retirement fund sector supplement.

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DETAILED QUESTIONS

QUESTION 1

The set objectives of the King IV Report are to:

- **promote good corporate governance as integral to running an enterprise and delivering benefits to it;**
- **broaden the acceptance of good corporate governance by making it accessible and fit for application by organisations of a variety of sizes, resources and complexity of strategic objectives and operations;**
- **reinforce good corporate governance as a holistic and inter-related set of arrangements to be understood and implemented in an integrated manner;**
- **and present good corporate governance as concerned with not only structure, policy and process but also an ethical consciousness and behaviour.**

To what extent would the draft King IV Report as it stands achieve each of these objectives? Please comment on how this could be optimised.

PRI welcomes King IV, which clearly articulates the links between good governance, good management of environmental and social issues, sustainable value creation and good quality reporting. This is consistent with the six Principles[4] and backed by a growing body of evidence that demonstrates that environmental, social and governance factors drive better financial results for investors[5].

We agree that the principles-based structure will provide more flexibility to entities implementing the code, which is particularly important as the core principles of King IV are designed to be applicable to a wider range of organisations. PRI will provide detailed comments to the Phase 2 consultation of King IV, due by 11 July, which provides additional guidance to pension funds implementing King IV in their own operations.

PRI works globally with investors on collaborative projects to enhance standards of governance and disclosure from companies. In recent years, these have focused on director nominations, anti-corruption practices, ESG metrics in corporate pay and corporate tax responsibility. Based on these engagements, we make the following recommendations;

Director Nominations

A robust nominations process is of fundamental importance to board effectiveness, and hence long-term value creation prospects[6]. We identify three key principles that must underpin good

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[4] https://www.unpri.org/about/the-six-principles
[5] Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies.
[6] PRI (2014): Director Nominations discussion paper 1 and discussion paper 2, and research on company disclosure and practices in the US and France.

Director Nominations processes:

- **Accountability** (covering issues such as: independence of decision making, voting rights related to director nominations and elections, shareholder communications and engagement and duty of care to respect shareholder rights).
- **Effectiveness** (issues such as composition, diversity, succession planning, board evaluations, nomination committee scope and structure, link to company strategy and ethics, tone and sustainability awareness).
- **Transparency** (public disclosures, director information and reporting in outputs).

We therefore recommend that;

- **(1) King IV introduce a recommended practice that the Nominations Committee has sufficient independence of decision making.**

For a Board to fully integrate ESG factors in the spirit of the code, expertise and resources are required. We therefore recommend that;

- **(2) King IV introduce a recommended practice relating to the sustainability skills required by the Board of Directors.**

We support the Code's emphasis that new members should have sufficient training to ensure they are effective. We further note that Principle 3.5 details how performance of the Board, Chair and Corporate Governance Professional should be evaluated. Logically, it follows that where this evaluation identifies training needs, regular training should be provided for all members, not just those undergoing inductions. This proactive training may also be supported by reactive training triggered by events such as entering new markets, mergers and acquisitions or substantive changes in strategy. We therefore recommend that;

- **(3) King IV introduce a recommended practice on training and development for all Board members.**

Anti-corruption

The introduction to the code notes corruption as one of the key issues testing global corporate leadership. These are currently noted as one of a wide range of corporate citizenship measures. We recommend that;

- **(4) King IV strengthen its anti-corruption provisions.**

Between 2013 and 2015, PRI worked with investors on a collaborative engagement on anticorruption[7]. Of 18 actions recommended by investors, the below were the most likely to be adopted by companies, suggesting they are additional to existing practice and add value;

- Designate a Board Member responsible for anti-corruption systems.
- Establish a policy explicitly forbidding facilitation payments.
- Undertake risk assessments for individual business lines.

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[7] PRI Press Release: Institutional investors achieve greater disclosure of bribery and corruption risks

- Ensure that the code of conduct or anticorruption policy explicitly applies to contractors, subcontractors and suppliers as well as agents and other intermediaries.
- Establish anti-corruption training for employees.
- Provide channels through which employees can report potential violations of policy or seek advice (eg. Whistle-blowing channels), in confidence.

Tax responsibility

We support the code's inclusion of tax responsibility as an element of good corporate citizenship.

Our recent publication, *Engagement guidance on corporate tax responsibility: Why and how to engage with your investee companies*[8], developed from an increasing awareness in the investment community that tax is not a cost to be minimised; it is a key risk that could have a serious effect on the profitability and the sustainability of a company. An aggressive corporate tax planning approach should be a concern to investors, as it can create earnings risk and lead to governance problems, reputational damage and loss in brand value, and cause macroeconomic and societal distortions.

ESG in executive remuneration

PRI agrees with the alignment of variable remuneration with a company's long-term value creation prospects (Principle 4.4, item 33.c).

Linking environmental, social and governance (ESG) performance to pay can help hold executive management to account for the delivery of sustainable business goals. Executive pay should be aligned with performance and long-term strategy in order to protect and create value, but existing remuneration plans often do not promote sustainable value creation, which is in the interest of both companies and their investors. This lack of alignment is of concern for long-term investors, and presents opportunities for engagement to promote the consideration of ESG issues when setting pay. Our recent paper (*Integrating ESG issues into executive pay: a review of global utility and extractive companies*[9]) makes additional recommendations for implementing measures in the Utility and Extractive sectors.

QUESTION 2

Part 2 of the draft King IV Report: Content Elements and Development, deals with outcomes, principles and practices. Clear differentiation of these content elements is key to reinforcing qualitative governance which is outcomes driven rather than about mindless compliance. Is the rationale and the difference between these content elements clearly explained? Please provide suggestions on how this could be further enhanced.

We agree that the rationale and difference between these content elements is clearly explained, and that this approach clearly establishes the intent behind the recommended practices.

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[8] PRI (2016) [Engagement guidance on corporate tax responsibility: Why and how to engage with your investee companies]()
[9] PRI (2016) [Integrating ESG issues into executive pay: a review of global utility and extractive companies]()

QUESTION 3

King IV uses the broader form of address namely: 'organisations'; 'governing body'; and 'those charged with governance duties'. Does this make the King IV Report more broadly relevant to all organisations and sectors?

Yes, as far as we are aware these terms are broadly applicable to institutional investors and investee companies. We will provide further comment on application of these terms to pension funds, as well as roles and responsibilities in the pension sector supplement consultation.

QUESTION 4

The King IV Code recommends that as a minimum, the chief executive officer (CEO) and one other executive should be appointed to the governing body. Other than in King III, it does not specifically recommend the inclusion of the chief financial officer (CFO) as a member of the governing body. This allows flexibility for another executive to be appointed as a member of the board, depending on the nature and needs of the business. Would a recommendation specifically providing for inclusion of the CFO be more appropriate or is flexibility preferable in light thereof that organisations differ?

PRI does not have a view on this issue.

QUESTION 5

Do the independence criteria in Chapter 3 of the Code provide clear and useful guidance for assessment of independence on a substance over form basis?

We agree that the requirements provide clear and useful guidance. The chapter provides clear principles, supplemented by possible indicators of lack of independence and a strong disclosure requirement. This ensures that the governing body understands the intent of ensuring independence, has sufficient flexibility, and is transparent enough to allow stakeholder accountability.

QUESTION 6

Will the new disclosure and voting requirements on remuneration in Chapter 4 of the Code lead to increased transparency and more meaningful engagement on remuneration between organisations and their stakeholders? Please provide suggestions for further enhancement.

We agree that this will increase transparency and engagement. The PRI sees a biennial advisory vote on remuneration policy and annual vote on remuneration reports as good practice, recognising that there is variation across markets (for example the use of binding votes in the UK). We support the code's clarity on how variable pay is vested. However, we recommend that;

- **(5) King IV strengthen its recommended practices on variable pay.**

This could include statements around claw-backs, gateway payments and bonus-malus structures, such as financial penalty for poor performance.

As noted in our response to question 1, PRI agrees with the alignment of variable remuneration with a company's long term value creation prospects.

QUESTION 7

King IV introduces in Chapter 4 of the Code, the 5 lines on assurance in the place of the traditional 3 lines of defence. It also expands on the implementation of the combined assurance model. Will this assist with more effective co-ordination and alignment of assurance? Please provide suggestions for further enhancement.

The PRI is not in a position to provide a view on whether this will be more or less effective than the King III model, noting however that we remain in favour of assurance of all financially material corporate reporting, including ESG issues. A strong control environment will facilitate assurance of reporting and build confidence that the strategic direction is being implemented.

QUESTION 8

The governing body as the focal point of corporate governance and is therefore the primary audience of the King IV Report. King IV requires the governing body of an institutional investor to ensure that the organisation exercises its rights as holders of beneficial interest in companies, responsibly. Does this principle establish the necessary linkage between King IV and the Code for Responsible Investing in South Africa (CRISA) so that governance is reinforced by all role players? How can King IV further reinforce responsible investing practices? (For access to CRISA go to www.iodsa.co.za.)

PRI agrees with statement in King IV's framing remarks (p. 21), that fiduciary duty requires investors to consider long-term value drivers, including material ESG factors, in their decision making and the decision making of their agents.

There appears to be a disconnect between the wording of Principle 5.2 and the recommended practices. The wording of Principle 5.2 focusses on the exercise of ownership rights;

> *Principle 5.2: The governing body of an institutional investor should ensure the organisation responsibly exercises its rights, obligations, legitimate and reasonable needs, interests and expectations, <u>as holder of beneficial interest in the securities of the company</u>.*

The recommended practices embrace responsible investment in its widest sense, including incorporation of ESG factors into investment decision making. Investors have a range of tools and techniques for responsible investment, which include, but are not limited to, exercise of ownership rights. For this reason, we recommend;

- **(6) Principle 5.2 should be amended to clarify that good governance encompasses exercise of ownership rights <u>and</u> incorporation of ESG factors into investment decision making.**

An institutional investor's governance structure should therefore ensure that they are fulfilling these duties. The recommended practices under Principle 5.2 for the most part align with PRI's recent analysis and recommendations to asset owners[10] on ensuring effective implementation;

1. Understand the investment environment, define investment goals and define investment beliefs
2. Agree investment strategy
3. Establish investment governance processes
4. Formulate investment mandates
5. Monitor, review and report

However, the recommended practices could be strengthened by ensuring that they are aligned with existing investment processes. For this reason, PRI recommends that;

- **(7) Principle 5.2 recommended practices 16-18 discuss the strategic direction on responsible investment, and supporting policies. The code should clarify that these practices should be aligned with existing investment practice.**

With these governance practices, King IV provides a framework for implementation of commitments to CRISA and PRI. We therefore agree that the recommended practices provide appropriate alignment between CRISA and King IV for institutional investors.

QUESTION 9

King IV introduces 'risk and opportunity' governance to emphasise risk as being about uncertainty and the effect of it occurring or not occurring having a possible negative or positive effect on the organisation achieving its objectives. Is it useful to refer to risk and opportunity governance and will it reinforce it as a value-add rather than conformance exercise?

We agree that reference to the risk and opportunity governance is useful. The materiality of risks and opportunities, including those of an ESG character, evolves over time. This evolution is driven by changes in legislation and policy, by changes in risk and the understanding of risk, by changes in the social, environmental and economic impacts of the ESG issue in question, and by changes in societal (and beneficiary) expectations and norms.

Our view is that good governance of risks and opportunities will help to ensure that companies and investors are aware of current and emerging issues, and are well set to respond. In our analysis of the fiduciary duties of investors[11], we argue that this should take the form of a strong process for establishing the materiality of ESG factors, based on credible, defensible assumptions.

QUESTION 10

The application regime of King IV is 'apply and explain' as opposed to 'apply or explain' in

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[10] PRI (2016): How asset owners can drive responsible investment – beliefs, strategies, mandates

[11] PRI, UNEP Finance Initiative, UNEP Inquiry and UN Global Compact (2015): Fiduciary Duty in the 21st Century

King III. The main difference between the application regime of King III and King IV is that application of the principles is assumed in King IV as they are basic to good corporate governance. Furthermore, the 75 principles in King III have been replaced with 17 principles in King IV. For the 'apply and explain' regime, explanation is required in the form of a high level narrative of the practices that have been implemented and the progress made in the journey towards giving effect to each principle. Will 'apply and explain' encourage greater transparency and qualitative narrative? Should disclosure on King IV application be required to be signed off by the governing body? (For further information on the application regime refer to Part 3: Application of King IV and to Part 7 for a template of the application register.)

PRI agrees that disclosure on King IV should be signed off by the governing body. This will ensure that implementation of the code has strong oversight. A similar requirement was put in place for the UK's Modern Slavery Act[12], which has been credited with high levels of board awareness.

[12] http://www.legislation.gov.uk/ukpga/2015/30/section/54/enacted