PRI Principles for Responsible Investment

UN environment programme | finance initiative

United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

CORPORATE GOVERNANCE FOR ASSET OWNERS

OVERVIEW

- This short guide introduces the subject of corporate governance for asset owner staff and their advisers.
- It explains the importance and relevance of corporate governance at the issuer level and implications for the investment process.
- This guide focuses on corporate governance expectations and requirements for listed companies, although it also briefly covers those applicable to private firms.

The guide is divided into two main parts:

The relevance of corporate governance		
Why it matters	Standards of practice	Regional variations
Approaches asset owners can take		
Policy, governance and strategy	Stewardship	Disclosure

AN INTRODUCTION TO
RESPONSIBLE INVESTMENT

EXPLORE THE SERIES

PART 1: THE RELEVANCE OF CORPORATE GOVERNANCE

WHY IT MATTERS

Corporate governance is described by the OECD as providing "the structure and systems through which the company is directed and its objectives are set, and the means of attaining those objectives and monitoring performance are determined". Enhancing corporate governance serves to improve decision-making and reduce the likelihood of poor outcomes arising from strategic, ethical, operational, or financial choices within an organisation.

Corporate governance helps ensure that senior managers are accountable to shareholders and their interests are aligned. Robust governance structures also help ensure that senior managers have the requisite skills and that they perform to the best of their abilities.

Academic research[1] finds that the quality of corporate governance impacts the financial performance of companies and, consequently, shareholder returns.

Corporate governance also impacts how companies handle issues such as corruption risks; cyber security; data protection and privacy; tax and climate change.

EXAMPLE OF THE FINANCIAL MATERIALITY OF CORPORATE GOVERNANCE

The cryptocurrency exchange FTX filed for bankruptcy in November 2022 amid accusations that it had misused customer funds. The new CEO brought in to manage the bankruptcy commented in a court document that he had never seen "such a complete failure of corporate control". The filing highlighted a lack of an independent board, formal board meetings and documentation of transactions. Institutional investors, including sovereign wealth and pension funds, were among the company's backers.

PRI and external resources

Academic research

- Corporate governance and equity prices
- The vote is cast: the effect of corporate governance on shareholder value

Discussion papers

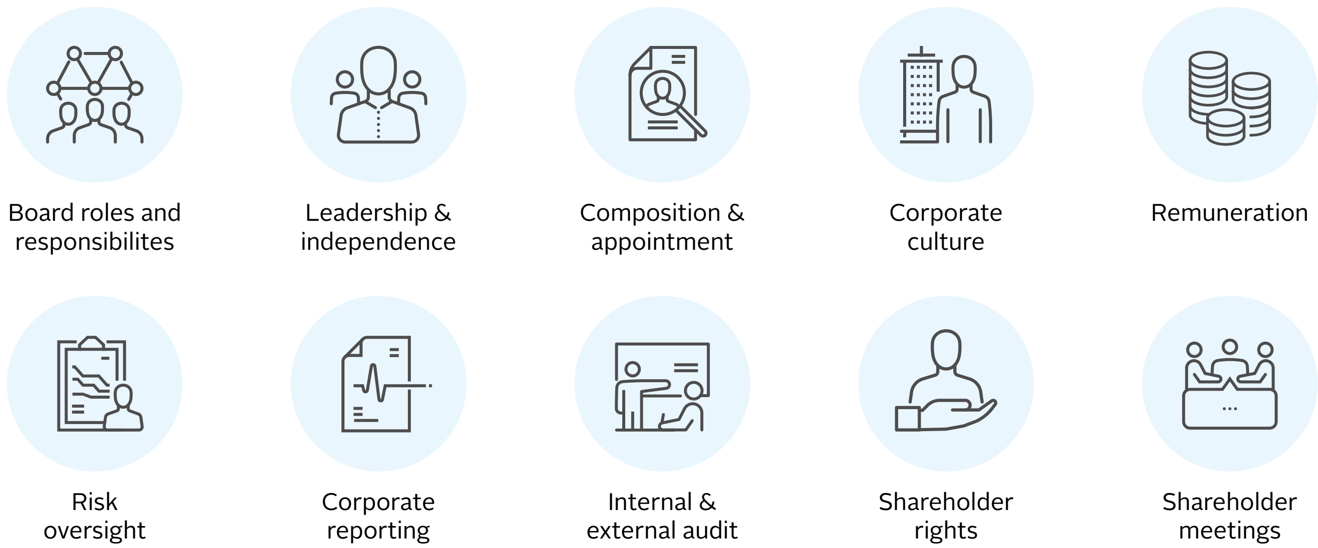
- What is tax fairness and what does it mean for investors?
- Stepping up governance on cyber security

1 Paul Gompers, Joy Ishii, Andrew Metrick (2003), Corporate Governance and Equity Prices

STANDARDS OF PRACTICE

There are a number of internationally recognised standards on effective corporate governance. Two notable examples are the G20/OECD Principles of Corporate Governance and the ICGN Global Governance Principles.

Some common themes of these standards include:



In this section, we briefly cover each of these areas.

Area overview	Examples of departures from accepted corporate governance standards
Board roles and responsibilities	
Shareholders elect corporate boards to represent their interests. The role of the board of directors is to oversee management, the operational and financial performance and ethical conduct of the company. The ICGN Global Governance Principles state that boards are expected to "promote the long-term best interests of the company by acting on an informed basis with good faith, care and loyalty, for the benefit of shareholders, while having regard to relevant stakeholders".	▪ No board-level oversight of sustainability issues ▪ No disclosure of how the board provides oversight of sustainability issues ▪ The mandate of board committees not being disclosed

Area overview	Examples of departures from accepted corporate governance standards
Leadership and independence	
Corporate boards are typically made up of a mix of executive directors, who belong to the company's executive management team, and independent directors, who are separate from company management. Independent directors add an impartial perspective to board discussion and decision-making, helping to protect the interests of shareholders and other stakeholders.	▪ Combined chair and CEO positions ▪ Lack of majority independent directors on the board ▪ Directors with long tenures (e.g., 10 years or more) ▪ Presence of former CEO(s) on the board
Composition and appointment	
Board members are expected, collectively, to have the skills, experience and independence required to provide effective oversight of company strategy. The ICGN Global Governance Principles state that boards should include "individuals from different genders, age, ethnicities, nationalities, social and economic origins" who have the requisite "professional skills and personal attributes". More broadly, periodic refreshments of the board, especially for key roles (committee or board chairs), helps to ensure skills remain relevant and new perspectives are integrated. Externally facilitated board performance reviews should be commissioned regularly and the resulting impact on future board composition should be disclosed.	▪ Board directors sitting on numerous (e.g., more than three) boards. This is referred to as 'overboarding' ▪ Lack of diversity at board level ▪ Board performance review not conducted on a regular basis ▪ Significant experience or skills gaps at board level ▪ Lack of succession planning
Corporate culture	
Part of the responsibility of the board is to instil high levels of business ethics and to oversee a corporate culture that aligns with the company's purpose. In a corporate context, culture can be defined as "a combination of the values, attitudes and behaviours manifested by a company in its operations and relations with its stakeholders".[2] A company's stakeholders include its employees, customers, and communities where it operates.	▪ Board has not ensured anti-corruption policies and procedures are in place ▪ Board has not ensured independent, confidential whistleblowing mechanisms are in place ▪ Lack of response to allegations of misconduct or ethical violations ▪ Excessive employee turnover ▪ No articulation of approach to political engagement

2 Financial Reporting Council (2016), Corporate Culture and the Role of Boards

Area overview	Examples of departures from accepted corporate governance standards
Remuneration	
Well-designed pay packages incentivise employees, including executives, to contribute to the long-term success of the company. Remuneration structures should be fair, balanced, and understandable. The board must ensure that they align with the corporate strategy[3] including on environmental, social and governance objectives. In addition, appropriate balance needs to be struck between paying dividends to shareholders, investing in opportunities for future value creation and compensating staff.	▪ Lack of clear and understandable remuneration policies ▪ Executive remuneration that is not commensurate with corporate performance or pay and conditions of the wider workforce ▪ Lack of transparency on total compensation paid ▪ Overreliance on short-term financial performance indicators when setting remuneration ▪ Presence of company executive on remuneration committee
Risk oversight	
The board needs to oversee the assessment and disclosure of the company's key risks. It also needs to approve the approach to risk management and internal controls on an ongoing basis.	▪ Lack of reporting on board assessments of the emerging and principal risks facing a company and mitigation of these risks on an annual basis
Corporate reporting	
It is the board's responsibility to oversee timely and reliable disclosures, including on the company's financial position and approach to sustainability. As set out in the PRI's Investor Data Needs framework, to be decision-useful, sustainability information must be available, accessible, verifiable, comparable across multiple dimensions, a faithful representation and relevant to investors.	▪ Annual reports and accounts not presented in a way that allows comparisons to be drawn over time and between companies ▪ No or limited provision of decision-useful sustainability disclosures
Internal and external audit	
An audit assesses the quality and integrity of corporate reporting, including financial reporting. Internal audit is overseen within a business and external audit is conducted independently. The audit committee, consisting of independent board members, should be responsible for monitoring the integrity of financial statements and communicate any significant reporting adjustments.	▪ No clear allocation of responsibility for the internal audit function ▪ External auditors also providing non-audit services to the company ▪ Long-standing external audit relationships

3 The Investment Association (2022), Principles of Remuneration

Area overview	Examples of departures from accepted corporate governance standards
Shareholder rights	
The ICGN Global Governance Principles state: "Rights of all shareholders should be equal and must be protected". It is good practice for shareholders' voting rights to be directly linked to their economic stake in the company. Some companies introduce 'sunset clauses' defining a period after which differential voting rights expire and all shares carry equal voting rights. Equity issuances, share buybacks and mergers and acquisitions can potentially dilute existing shareholders' investments or introduce conflicts of interest between shareholders and company executives. The board must exercise independent judgment to ensure that major transactions are carried out in a way that is aligned with existing shareholders' interests.	■ Divergence from the 'one-share, one-vote' standard without accompanying safeguards, such as clauses that set expiry dates on share classes with enhanced voting rights ■ Existence of structures that dilute shareholder holdings and act as an anti-takeover mechanism ■ Lack of transparency on related party transactions
Shareholder meetings	
A role of the board is to ensure that shareholders can participate effectively, raise questions and vote in shareholder meetings. It is good practice that annual general meetings (AGMs) and shareholder-called meetings are inclusive and allow physical attendance in addition to virtual access.	■ No provision for stockholders to call shareholder meetings ■ No opportunity for shareholders to physically attend AGMs or any extraordinary general meetings ■ Restriction / moderation of questions posed during the AGM

There are also corporate governance standards tailored to private companies, such as the Wates Corporate Governance Principles, published by the UK's Financial Reporting Council.

PRI and external resources

Articles

- ESG-linked pay: recommendations for investors
- Corporate purpose: what investors need to know

Discussion papers

- Diversity, equity & inclusion: key action areas for investors
- Responsible political engagement: stewardship practices and challenges

Engagement guides

- Converging on climate lobbying: aligning corporate practice with investor expectations
- Whistleblowing: why and how to engage with your investee companies
- Engaging on anti-bribery and corruption
- An investor guide to engaging on director nominations
- Engagement guidance on corporate tax responsibility: why and how to engage with your investee companies

REGIONAL VARIATIONS

Governance rules, arrangements and codes differ between countries and regions due to varying histories, cultures and local laws. Many jurisdictions have corporate governance rules embedded in regulation, supplemented by voluntary corporate governance codes that set out higher standards companies can opt to align with.

A key difference between jurisdictions is board design. A number of European countries, including Germany and Poland,[4] as well as China,[5] use 'two-tier boards'. These consist of a management board of executives overseen by a supervisory board that is typically made up of shareholder representatives.[6]

There are certain corporate governance issues which are more common among emerging markets-based companies, for example, the presence of dominant shareholders – stockholders with a significant degree of ownership or control over voting rights.[7]

In view of the differences between countries and regions, the ICGN recommends that its Global Governance Principles should be applied flexibly and that "the specific circumstances of individual companies, shareholders and the markets where they operate should be recognised". Investors should still expect proper justification from companies that diverge from sound corporate governance practices.

EXAMPLES OF EMERGING PRACTICES

Employee representatives on the board: in some regions there is growing regulatory support to ensure employee interests are represented to and considered by boards. Several jurisdictions, mainly in Europe, already allocate a portion of supervisory board seats to worker representatives. There is now an emerging trend for employees to be represented in unitary boards.

Sustainability committees: many companies have a standalone sustainability committee at board level, though the proportion of companies with such committees varies by region. The role of these committees is to provide oversight of sustainability strategy.

PRI and external resources

Case studies

- Corporate governance 2020 annual study – performance of Latin American companies
- E Fund Management: improving corporate governance in China through engagement
- ECGI corporate governance codes repository
- OECD Corporate Governance Factbook

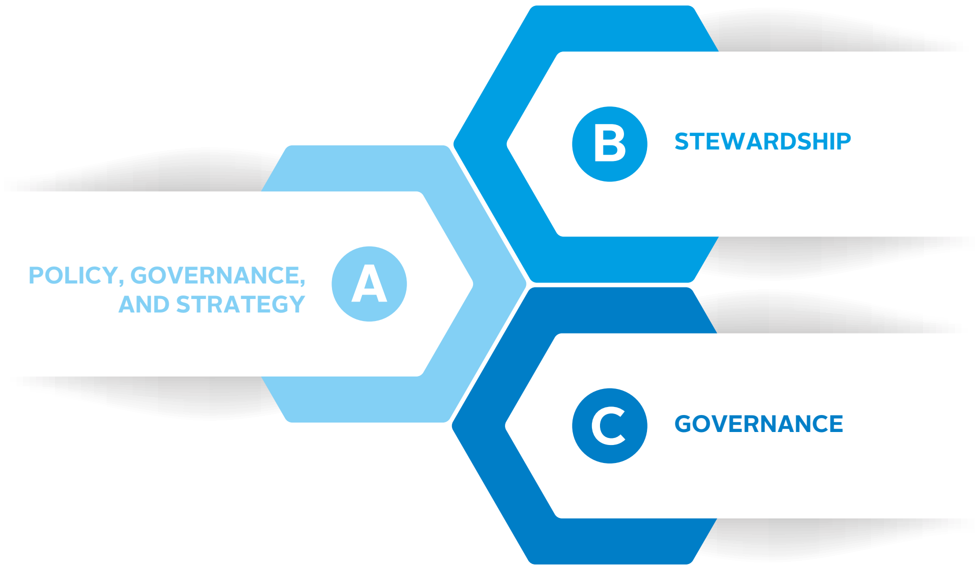
Webinars

- Corporate governance in China: what investors need to know
- Corporate governance in India
- Corporate governance in South East Asia: what investors need to know

4 Klaus J. Hopt (2022), The German Supervisory Board
5 George Ribeiro and Dominic Hui (2022), Corporate Governance And Directors' Duties in China: Overview
6 Maria Aluchna (2013), Encyclopaedia of Corporate Social Responsibility
7 MSCI (2022), Ownership and Control 2022: Global Equities Concentration on the Rise

PART 2: APPROACHES THAT ASSET OWNERS CAN TAKE

This section sets out ways asset owners can promote robust corporate governance practices among investees. The levers available to asset owners depend on their resources and on whether they manage assets internally or externally. Actions fall into three areas:



A. POLICY, GOVERNANCE AND STRATEGY

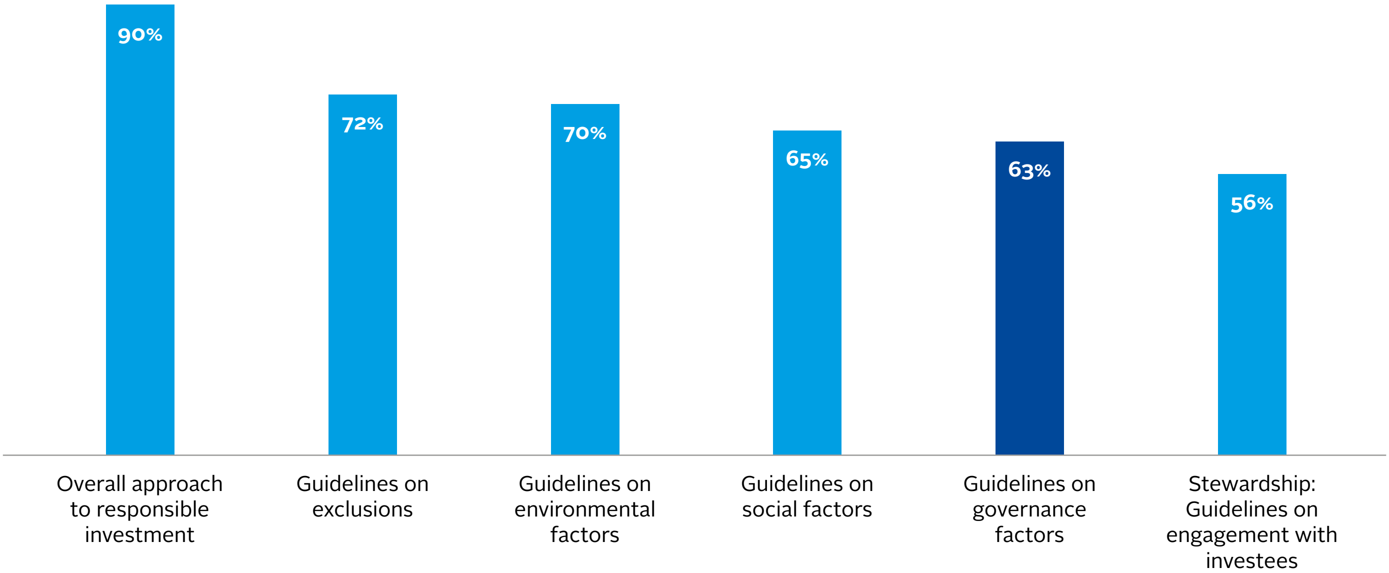
PRI Principle 1: *"We will incorporate ESG issues into investment analysis and decision-making processes."*

There is no one-size-fits-all approach to integrating the corporate governance performance of investee companies into investment strategy. Some of the possible actions asset owners can take are set out below.

- **Policies:** addressing corporate governance issues in responsible investment or equivalent policies. Examples of corporate governance factors that may be covered include executive remuneration, board composition, and audit procedures.
- **Asset allocation:** considering corporate governance in asset allocation modelling, analysing governance trends within asset classes and in specific sectors.
- **Investment mandates:** adding corporate governance-related clauses to investment mandates.
- **Manager selection:** assessing the capabilities of external investment managers to effectively incorporate analysis of corporate governance issues into investment decisions.
- **Research:** asking investment service providers to produce additional research and analysis on corporate governance issues. Encouraging academic and other research on this theme.
- **Training:** advocating greater training on corporate governance for investment professionals.

During the 2023 PRI reporting cycle, 63% of asset owners reported including guidance on governance issues in publicly available policy documents, as shown in the graphic below.

PRI's asset owner signatories' publicly available policy elements



Data source: PRI 2023 Reporting Framework

PRI and external resources

Case study

- Aberdeen Standard Life on incorporating corporate governance considerations in asset allocation

Model contractual terms

- ICGN-GISD Alliance Model Mandate
- ESG integration in listed equity: a technical guide
- Responsible investment due diligence questionnaires for asset owners

Webinar

- Governance assessments: a similar approach for equities vs debt investors?

EXAMPLE OF ASSET OWNER ACTION

Policies: The UK's Greater Manchester Pension Fund (GMPF) provides guidelines on corporate governance factors in its responsible investment policy. The document states: "GMPF considers good corporate governance practices continue to provide protection to shareholders and to our beneficiaries." It lists corporate governance topics on which it has taken positions, including division of responsibilities, board independence, board diversity, remuneration and audit quality.

B. STEWARDSHIP

PRI Principle 2: *"We will be active owners and incorporate ESG issues into our ownership policies and practices."*

Asset owners can conduct stewardship on corporate governance issues at different levels. They can engage with policy makers, external investment managers and directly with corporate issuers.

Some of the possible stewardship actions asset owners can take are set out below.

(Proxy) voting

- Developing and disclosing voting policies with guidelines covering corporate governance factors.
- Exercising voting rights or monitoring compliance with voting policy (if outsourced) to uphold principles of good governance or to hold companies accountable for poor practices.
- Using the Resolution Database within the PRI Collaboration Platform to track corporate governance resolutions.

Engagement

- Engaging on corporate governance with issuers (either directly or through service providers).
- Joining collaborative engagement initiatives on corporate governance.
- Participating in the development of policy, regulation and standard setting.

Escalation

- Filing shareholder resolutions relating to corporate governance.

EXAMPLES OF ASSET OWNER ACTION

Proxy voting: In this case study, the Hong Kong Monetary Authority describes how it assesses its external managers' voting decisions on corporate governance issues and how it follows up when there are questions over the way votes were cast.

Policy engagement: In 2022, a number of asset owners contributed to a statement supporting a proposed EU Corporate Sustainability Reporting Directive that would anchor human rights and environmental considerations in companies' corporate governance, whilst suggesting ways in which it could be strengthened.

PRI resources

Case study

- Previ: Collective engagement on integrity and anti-corruption

Article

- Are corporate boards responding to successful shareholder ESG proposals?

C. DISCLOSURE

PRI Principle 3: *"We will seek appropriate disclosure on ESG issues by the entities in which we invest."*

PRI Principle 6: *"We will each report on our activities and progress towards implementing the Principles."*

Public reporting is a crucial accountability mechanism. Some of the possible actions asset owners can take to promote and support transparent disclosure are set out below.

- **Investee disclosure requirements:** requiring additional disclosures from companies when they depart from corporate practices recommended by internationally recognised standards. For example, in cases where firms have dual-class shares.
- **Investment manager disclosure requirements:** requiring disclosure from investment managers on how corporate governance issues are incorporated into investment analysis, investment decision-making and stewardship activities.
- **External disclosures:** reporting publicly to beneficiaries and / or other stakeholders on actions taken on corporate governance as part of the investment process.

EXAMPLE OF ASSET OWNER ACTION

External disclosures: In its annual responsible investment supplement, the Australian asset owner CBUS provides a breakdown of the issues it voted on by theme and the percentage of resolutions on key corporate governance issues it voted against.

PRI and external resources

- PRI Investor Reporting Framework
- CFA Institute's Global ESG Disclosure Standards for Investment Products Handbook

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