Perspectives on the Integration of Corporate Governance in Equity Investments: From the Periphery to the Core, from Passive to Active

Mikkel Skougaard

1 Introduction

Historically, non-financial data, including corporate governance, was not considered in mainstream equity valuation methodologies, analysis and investments. However, past as well as recent corporate scandals have led to a rising acknowledgement within the investor community that governance factors may have the potential to affect corporate performance and by extension corporate valuation. And although far from universally accepted, an increasing number of mainstream investors are gradually incorporating corporate governance factors (agency risk) into their equity investment processes. However, different approaches with very different purposes remain among the investor community to corporate governance integration.

Two main activities demonstrate, more than any other the integration of corporate governance in equity investments. On the one hand, the increasing incorporation of governance factors alongside financial ones at the onset of an investment process and subsequent stock selection in actively managed portfolios as investors seek valuable sources of risk-related information and/or excess returns: From the Periphery to the Core. Whilst on the other hand, the increasing number of investor engagements with portfolio companies on a wide range corporate governance matters, partially explained by the rise of index tracking investments, as investors seek to fulfill their stewardship responsibilities with the purpose of realizing change through dialogue, confrontation, voting, or a combination of these: From Passive to Active.

This short paper aims to provide perspectives on the wide spectrum of different methods applied by investors when seeking to integrate corporate governance in

M. Skougaard (✉)
MOL Group, Budapest, Hungary
e-mail: mikkel_skougaard@hotmail.com

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their equity investments, highlighting the pitfalls and benefits attached to each approach.

2 Misunderstandings in Sustainable and Responsible Investments

The emergence of sustainable and responsible investments, and more recently, the rise of the integration of non-financial information in the investment process (including corporate governance) have led to the rise of a wide number of industry names and acronyms, which for an outsider, can often be confusing. Responsible Investment (RI), Socially Responsible Investment (SRI), Impact Investing, Environmental, Social and Governance (ESG) investing or integration, and even Corporate Social Responsibility (CSR) are some of the names that are often used interchangeably, and wrongly. Although they may all sound similar, there are fundamental differences between them as they represent markedly different approaches to investment and clearly need to be distinguished.

The primary differentiator between the SRI or RI type of investments and ESG is purpose (Hawley, Kamath, & Williams, 2011). SRI is in essence driven by ethical and moral imperatives, as the investor aims to match his or her believes with his or hers investment decisions, which means that the investor will consider both future returns and the social good when investing, and may be willing to sacrifice returns to meet those goals (although there is evidence to suggest that SRI related investing at times yield higher returns). SRI types of investments can both be positive through investment that targets and favours corporations that have strong records in a particular area such as labour relations or low emissions (a.k.a. inclusionary or positive screening), but can also be negative through the exclusion of certain industries like tobacco or weapon manufacturers (a.k.a. exclusionary or negative screening). On the other side of the spectrum, ESG integration is driven solely by economic imperatives. ESG integration aims at determining the potential impact of environmental, social and governance factors (risks) on the future performance of the company and by extension its valuation.

Separating the G from the E and S

From a very early stage, the integration of non-financial with the means of assessing and more accurately pricing risk has been bundled together in what is commonly known as ESG. However, a blanket, non-differentiated approach to ESG integration across multiple equities is flawed for two reasons. First because E, S and G represent different risks, as the Environment represents an externality risk, the Social aspect represents a reputational risk, whereas Governance represents an agency risk for the investor. The second reason why bundling ESG integration across equities might be flawed is because E and S tend to be, to a large extent, sector specific, whereas G is sector neutral, or sector agnostic. Good governance, or for that matter, bad governance, tends not to discriminate between sectors, nor do specific sectors need better governance than others. The point being that any sector needs good governance, just as any company, regardless of the sector, will be affected by poor corporate governance.

This short paper will only deal with the integration of Governance into equity investing, and will neither deal with any SRI type investments nor the integration of E or S.

3 The Integration of Corporate Governance into Equity Investing

Fund managers, and analysts supporting them, are aware of factors that can *affect* a security's *value. O*perational, financial, industrial and macroeconomic are all familiar factors that impact the future value of an investment and are at the core of fundamental analysis. However, factors that are challenging, not only to measure, but ultimately to quantify, and that do not form part of traditional financial metrics, such as corporate governance (or agency risk), have likewise the capacity to affect the risk and return of investments. Non-financial measures, incl. corporate governance, have historically, for most investors, belonged to the periphery of fundamental analysis, if included in any analysis at all.

However, past as well as recent corporate scandals have led an increasing number of institutional investors, fund managers and analysts to incorporate corporate governance factors alongside financial ones in their equity investments. Motivated by economic imperatives, portfolio managers and analysts as well as governance specialists working closely with these two are attempting to capture the effects of corporate governance and the impact that it may have on the financial performance of the company they are analyzing, the impact it may have on the value of the security and the overall risk to the portfolio.

The process of integrating agency risk basically attempts to determine, to the extent that is possible, the impact that a firm's corporate governance may have on performance and by extension on asset pricing. Although quantifying in monetary terms the potential impact of agency risk may be difficult, such integration may, everything else being equal, achieve a much more comprehensive risk assessment and valuation of the underlying security. Although an increasing body of evidence suggests that better governance results in better performance (Bebchuk, Cohen, & Ferrell, 2009; Deutsche Bank, 2004; Gompers, Ishii, & Metrick, 2003; La Porta et al. 1999), the evidence linking good corporate governance to performance still remains inconclusive (Bebchuk et al. 2012; Bhagat and Black 1998; Bhagat and Bolton 2009), but there is ample real evidence that poor governance is value destructive, hence why the increasing interest in the matter.

3.1 Governance Set-Up Within Institutional Investors

The increasing interest in the integration of non-financial criteria into the investment process has led to the build-up of resources within institutional investment houses solely dedicated to the purpose and execution of this integration task. The teams responsible for such as task are often given different names within each institutional investor, being labelled anything from ESG Team, Responsible Investment Team, Proxy Team, Stewardship Division, to Corporate Governance Department etc. Yet however different their names may be, these teams have been built to fulfill a largely similar aim, which is ultimately, to integrate, to one extent or another, corporate governance in the investment process. Although their functions can be long and varied, two main activities demonstrate, more than any other the functions of such a team and the subsequent integration of corporate governance in equity investments: before the investment is made (ex-ante) and after the investment has been made (ex-post) (Fig. 1).

1. Ex-ante: Measuring corporate governance risk at the onset of an investment decision (i.e. before deciding whether and/or where to invest), and only applicable to actively managed portfolios. Governance specialist teams will provide a corporate governance risk measurement to the fund manager in the form of a score (more of that later), who in turn will incorporate these corporate governance factors alongside financial ones at the onset of an investment process and subsequent stock selection in their actively managed portfolios (risk identification). Alternatively, integrating corporate governance at the onset may provide the investor with the possibility to build a portfolio containing only those companies with the highest scores in the pursuit of excess returns (alpha generation), or alternatively to build a portfolio that excludes those companies with poor governance scores as the risk is deemed too high (risk minimization).
2. Ex-post: For the purposes of active ownership (engagement and voting) after the investment has been made, which is possible for securities held through both index tracking and actively managed funds, and/or for the purposes of potentially exiting their investment (selling their shares), only possible for actively managed ones. For index tracking funds (passive funds) as well as for actively managed portfolios, governance specialist teams will seek out companies held in

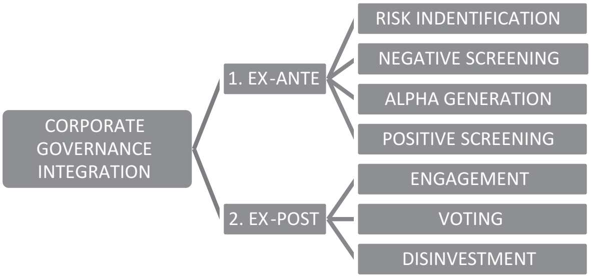

Fig. 1 Ex-ante vs. ex-post integration. Source: Own compilation

a portfolio and engage the target, with the purpose to understand a potential governance risk, expressing their views to encourage, and in some cases, demand change (engagement), complementing these engagement efforts with voting at shareholder meetings (force through change). Furthermore, continually scoring companies, not only at the onset of an investment, but also once the investment has been made allows for the continuous review of the rise of potential agency risks that may prompt a fund manager to either sell its shares (disinvestment) or to engage on the matter, the latter an alternative option to selling shares, although the choice of either will ultimately depend on the circumstances and the fund manager.

These corporate governance teams will usually be positioned within the equities investment department and are placed physically close to portfolio managers. There will always be some degree of separation between the fund managers and the governance specialists, either down to potential conflicts of interests, or the ability to shield fund managers from insider information. But the separation comes down mostly to the fact that corporate governance integration is a specialist function in and by itself, and therefore considered best left to governance analysts, especially when it comes to proxy voting. However a level of cooperation and integration between the two camps does exist, although the strength of this varies very much from investor to investor.

One common aspect among large institutional investors is that governance integration tasks have been handed over to governance specialists as opposed to the fund manager themselves. Although the ideal situation would be for fund managers themselves integrated governance risk, meaning that corporate governance would be fully integrated into the investment process, but the reality is that such a scenario, whilst ideal, is still a distant reality.

4 From the Periphery to the Core

The active integration of corporate governance risk into the investment decision making process (ex-ante) is only possible for those fund managers who hold actively managed portfolios, as the integration of corporate governance risk alongside traditional metrics is only possible for those of actively considering alternative investment targets. Furthermore, corporate governance integration is especially motivating for those active investors who invest in the long-term, as long term investors tend to be more exposed to the effects of poor corporate governance on performance over time, as the build-up and the potential negative eruption of these effects tend to take place over time.

Quantifying the Unquantifiable?

However, the process of integrating corporate governance into an investment decision before such a decision is made is inherently complicated. When trying to estimate the value of the security, the portfolio manager will usually apply a range of traditional, quantitative, measureable, standardized, industry-recognized and accepted metrics and benchmarks, providing him or her with the capacity to track financial and operational performance and, ultimately, returns. However, when it comes to integrating corporate governance alongside these metrics, the undertaking of trying to quantify agency risk becomes rather challenging.

Driven by a desire for measurability, the portfolio manager, the corporate governance specialist team, or both, will attempt to reach a quantified output (numerical score), but will be doing so by applying mostly qualitative input. The difficulty faced by those attempting such integration is twofold. On the one hand, there is the difficulty of having to assign an economic value to mostly qualitative factors (board independence, incentive schemes, auditor independence etc.). On the other hand, the varying levels of disclosure and often very limited disclosure of governance factors, especially for companies in emerging markets, makes the process even more challenging.

Corporate governance, the effect it has on decision making within a firm, the associated risk, and its effect on performance and valuation is ultimately the outcome of a complex web of relationships between the shareholders, the board and the management, all under the influence of a set of national and increasingly supranational laws, regulations, codes and cultural norms, making it even more complex to understand, let alone quantify. Furthermore, the ultimate corporate governance risk, the one that is simply impossible to quantify ex-ante relates to human behavior. According to the Principal-Agent (Investor-Executive) theory (Berle & Means, 1932; Jensen & Meckling, 1976) that has historically served as the basis for research, debate, law making and shareholder understanding of governance risks, the interests between the two sides may, and often do, diverge as the principal (the executive) is driven by self-interest with little regard for what is best for the agent (the shareholders). The principal, so the theory goes, will pursue his or her own interests ahead of those of the agent, and given the opportunity, the management will maximize their own individual wealth at the expense of the shareholders. Although arguably this is a minority phenomenon, the tail risk (the risk or probability of rare events) in corporate governance will arguably always lie in human behavior and decision making, and therefore outliers and other large scandals will not be possible to capture through any form of integration either ex-ante or ex-post.

Yet despite the challenges faced in quantifying corporate governance risk, some level of quantification, along with subjective interpretation of the governance risk of a specific corporation is necessary in order to achieve at least some measure of risk, as all things equal, a better understanding of corporate governance risk should lead to a more comprehensive investment analysis and subsequently a more informed investment decision.

4.1 The Ratings Game

During the last years, in light of the number of corporate scandals, the subsequent destruction of value created by poor governance and the increasing attention that this has created, it is not surprising the considerable the attention and significant resources that have been devoted by investors in seeking to develop a method that will aid with the analysis, measurement and capturing of agency risk. The quest for such measurement has led a number of corporate governance services providers to create corporate governance ratings (or indexes) using a wide number of corporate governance factors by which to measure agency risk. These ratings, whose final risk measure (or score) fusions into a single number, are offered to institutional investors as aid to their corporate governance integration efforts, either at the onset of an investment (ex-ante), or after the investment has been made (ex-post). Although the factors applied by such rating agencies vary, there are a number of typical KPIs that are usually applied in the rating irrespective of the provider. Some of these KPIs are as follows (Table 1):

As highlighted above, there is a variety of KPIs that are usually included and typically applied as measure of how well the investor is protected through various channels such as equal treatment of shareholders, accountability, transparency, overall alignment etc. A wider range of measures allows the fund manager and the corporate governance team to highlight potential risks that might otherwise go undetected (not analyzed), and which could lead to investing in alternative securities with lower risk, lead to potential disinvestment and/or lead to engagement action.

However, a prevalent criticism of these ratings has been based on the generally understood and acknowledged view in corporate governance circles that there is no one-size-fits-all approach. Criticism has been based on the argument that trying to create a uniform set of governance standards to measure and compare agency risk across very different companies is flawed. The main risk is that such a rating approach without any differentiation of the companies that are being analyzed

Table 1 Governance rating items

Board structure	Executive remuneration	Audit	Shareholder rights
• Composition • Independence • Diversity • Director election • Policies • Committee composition and independence	• Design • Long vs short term • Use of equity • Transparency of performance metrics and targets	• Auditor fees • Auditor independence • Non-audit fees • Audit rotation • Audit controversies	• Restriction in voting • Dual class shares • Anti-takeover devices • Related party transactions • Bylaws

Source: Own compilation

can lead to misclassification in the scores, and at worst, making portfolio investment decisions based on a misunderstanding of the risk.

It is often the case that these rating agencies apply a blanket approach to ratings without differentiating. However, this is understandably done so as rating an entire universe of companies on an individual basis often numbering in the thousands cannot be reasonably be done without applying such an approach, especially not if investors are looking for comparability. Another problem lies in the fact that these rating omit, for some reason or other, to look at a key factor. As the list of commonly used KPIs illustrates, none of these rating agencies factor in the ownership structure of the listed corporation they are analyzing, yet they often claim that their ratings models, data and scores help investors to identify governance risk.

For an investor, a main determining corporate governance risk factor is the ownership structure, as this largely determines the risk that investors run when investing in a listed corporation (Bebchuk & Hamdani, 2009). There are fundamental differences in the nature of the agency risk that investors run in controlled and full free float firms, as it is not the same risks that an investor faces when investing in a controlled company (where more than half the issued shares, or votes are controlled by a single shareholder) or a listed company with a full free float where the largest shareholder may hold no more than five percent. In a controlled company with an owner holding more than half the shares, half the votes, or both, the nature of the agency risk is usually concentrated in specific matters often relating to the abuse of minority shareholders, related party transactions, minority shareholder rights, financial tunneling etc. Whereas in a company with a full free float, risks are usually found in matters concerning rent-seeking though executive remuneration, anti-takeover devices, entrenched management etc. The fact that there are fundamental differences in the nature of the agency risk, and the fact that none of these key differences are reflected in either the design or the use of ratings is a systemic weakness leading to incorrect measurement of risk and misranking, and at worst, erroneous investment decisions.

There are however certain governance factors risks that remain neutral to differences in ownership structure, and this correctly includes some of the KPIs used by rating agencies. Items like audit related risk, board composition (independence) and overall transparency are key governance risks irrespective of ownership. However, assigning the same weight to certain KPIs regardless of ownership structure means the investor ends up underweighting the importance of measures that protect them, say in a full free float company, whilst potentially overweighting irrelevant ones in a controlled company (Bebchuk & Hamdani, 2009), anti-takeover devices being an illustrative example.

However, despite the reasonable criticism, despite the agreed view that governance risk is ultimately contextual and dependent on firm specific circumstances, and despite the fact that the degree of predictability of these ratings is at best inconclusive (Bhagat, Bolton, & Romano, 2008; Renders et al. 2010), some level of measurement and comparability of governance risk in a standardized and quantified manner across multiple securities is needed. If anything because the absence of such measurement would make fundamental analysis incomplete, omitting the analysis of certain risks.

4.2 Rating Usage

Despite the imbedded weakness, the widespread acceptance and use of these corporate governance ratings among institutional investors suggests that there is a general perception of their perceived usefulness, and rightfully so. Very few investors produce their own scores or measurements of governance risk given the resources that such an undertaking would require, especially for those whose investment universe numbers the thousands, as even applying a differentiated analysis (and score) to each corporation would be excessively time consuming and would potentially hinder comparability efforts. Therefore, corporate governance teams, and by extension, fund managers, are heavily reliant on these rating agencies for corporate governance integration, either for the purpose of making portfolio investment decisions (buying or selling), for their active ownership activities (engagement and proxy voting), or both.

5 From Passive to Active

As earlier mentioned, according to corporate governance theory the agent (the executive) remains intrinsically opportunistic, in that there is an ever-present possibility of opportunism to the detriment of the principal (the shareholder) unless it is curbed through controls and continuous monitoring (Davis, Schoorman, & Donaldson, 1997). Energy from investors is therefore spent, among other things, controlling for assumed human weaknesses inside those who control the corporation in the form of mismanagement, shirking, rent-seeking etc, and correcting it if necessary. A mechanism that serves to overcome these problems is active ownership through engagement between shareholders and companies. Engagement being understood as direct communication between the investors and the board/ management.

The increasing number of investor engagements with portfolio companies on a wide range corporate governance matters is partially explained by the rise of index tracking investments. But the rise in engagement is likewise explained by the gradual rise of stewardship codes around the globe, encouraging investors to responsibly make use of the rights provided to them. Furthermore, investors are aware that there is an ever greater scrutiny within society and among their client base (asset owners) in how they ensure that the companies that they are invested in on their behalf, act in the best interest of shareholders over time.

Index tracking investors, or colloquially also known as "passive investors", are invested across the market, and unlike investors pursuing an active strategy (i.e. buying and selling securities on the basis of fundamental analysis), they are not in a position to sell their shares. Passive investors are therefore exposed to every single issue affecting every single company every single day in perpetuity, including management self-interest.

Non-experienced observers to the industry tend to confuse and often misunderstand institutional investors when these invest via index tracking funds, and the role that they play in active ownership (or the lack of it). A surprisingly large number of observers tie passive investment with passive behavior. Such observers argue that since investors are invested in the company it is because the securities they hold belong to a particular index in which the investor owns every security regardless of their view on that specific share, and in the absence of the ultimate sanction possibility (to sell the shares), the shareholder is, as Berle and Means argued although in a somewhat different context, "practically powerless through his own efforts to affect the underlying property" (Berle & Means, 1932).

However, passive investments have nothing to do with passive behavior (Scott, 2014). For passive investors invested through indexed strategies, active ownership through engagement and voting represents the only option for signaling concern to the management of the companies whose securities they hold, and they have arguably therefore the highest incentive to pursue an active ownership strategy with the companies in their portfolios, as they need to ensure that their investments perform, or at least that they do not destroy value. Ultimately however, there are also ownership responsibilities as investors seek to fulfill their stewardship duties towards the asset owners (their clients).

For index tracking investors, it is common for corporate governance teams to be responsible for the active ownership, that is, to carry out the engagements and exercise the voting, as effectively no fund manager is behind the investment, but rather the holding of such a security is the result of an index tracking product. One of the key engagements topics among passive investors are corporate governance related matters. This is especially so as although better corporate governance, however understood, may not necessarily mean better performance, investors are painfully aware that poor governance can be, and usually is, value destructive over time.

Despite the inability to divest their shares, "passive" investors, contrary to popular belief, have the power to yield a considerable amount of influence on the board and the management of the index constituents whose securities they hold. Engagement with the board and the management represents a material process by which passive investors can positively impact the corporate governance structures and practices of the individual companies they own, as they seek for the company to adopt policies and implement mechanisms which align more closely the interest of management with those of shareholders, by either expressing their views with the intention to encourage change (engagement), and/or ultimately forcing through the change (voting).

The value proposition inherited in engagement will largely depend on the investment mandate and the investment strategy pursued by the investor. Not all index tracking investors engage with their investee companies (the reasons vary), the same way not all fund managers running actively managed portfolios automatically sell out if they are concerned with the risk a company is running. Some active managers, especially those taking a long-term view, will prefer to engage with the board and the management to address the issues over the long term, weighting the potential benefits attached to such an engagement as opposed to selling. When engaging with a corporation's board, being a passive investor can arguably be an advantage, as participants on both sides of the engagement table are aware that a passive investor's investment is likely outlive both the board and the management, providing the shareholder not only influence, but a strong and genuine argument for long-term fundamental change. But just as was the case with corporate governance integration before the investment is made, the main challenge for governance specialists and fund managers is to precisely quantify the value created by their engagement efforts, a highly complex task, as it is impossible to quantify what may have happened if changes had not been implemented as a result of engagement efforts.

5.1 *Engagement Through Proxy Voting:* Speak Softly and Carry a Big Stick

Although engagement is a useful tool, it is often not enough in and by itself. The option of exercising voting rights in addition to engagement provides a more complete approach to active ownership. Furthermore, voting, in addition to engagement, provides a higher degree of leverage to ensure that the views of the investor, and by extension that of its clients whose interest they represent, are given appropriate consideration by the board and the management. What is often unappreciated by outsiders is that engagement and voting (the core of active ownership) requires constant efforts across the year, especially since many of the engagements undertaken will only yield results two to three years down the line. And often, the changes proposed by the company, as a result of engagement (revised incentive schemes, appointment of non-executive director etc.) will be slow and gradual.

Although shareholding sizes vary among institutional investors, some can amass relatively large positions (3–10%) which means that their voices at the engagement table, combined with their votes at the shareholder meeting carry considerable weight, especially since not all shareholders exercise their voting rights. Companies will try by all means to avoid large investors voting against management as it is an embarrassment for the board if a large vote turns out unsupportive, or worst case scenario risking one or more items on the shareholder meeting not begin voted through, which in essence means that investors send the Board back to the drawing board having to start all over again.

Exercising the right to vote, although a key element in an active ownership strategy, is not by itself enough as a vote on its own does not provide sufficient information to the recipient (the company) if there has been no interaction with the investor explaining the reason, either prior or after the vote has been casted. One often heard critique from the corporate world is the lack of feedback of a vote, in particular of a negative vote against management. Companies and their board depend on the feedback from the investor when they have voted against.

Specifically, they depend on exact information as to what led the investor to vote against. If the investor remains silent after a vote, that vote, although counted, can be labelled as semi-wasted.

Corporates and the board can, provided they take their time to read it, stay well informed in advance of a shareholder meeting on how investors might vote. Most of institutional investors have established a set of corporate governance policies and principles as well as proxy voting guidelines, which have been made publicly available. These corporate governance principles have often been formulated on the basis internationally recognized governance best practices, as well as empirical studies and observed experiences in other markets. Furthermore, the proxy voting guidelines usually cover items that are typically presented for shareholder votes at shareholder meetings, incl. director elections, executive remuneration, share issuances and/or buybacks etc. Whilst the corporate governance principles will usually provide a frame of reference for engagements, the proxy voting guidelines ensure that investors vote their holdings consistently across all portfolios and markets.

Although the widespread use of these guidelines is common, the content varies considerably from investor to investor. Some investors prepare very detailed guidelines, the key advantage being that it aids and speeds their voting, and provides clarity (for better or worse) to the company before the vote, but can often feel too prescriptive, leaving no room for deviation. Some investors on the other end tend to be less specific, often formulating vague statements on key issues, whilst being fully silent on others. Whilst not prescriptive at all, these guidelines provide little reference for boards, although are often an indication that the investor will provide a higher degree of deference to companies and allow deviations to best practice provided there is a proper rationale for doing so.

One common element among investors, despite potentially different proxy voting guidelines, is a general agreement that any issue or proposal by the board that tries to limit shareholder rights, maintain or increase management entrenchment, decrease transparency, or decrease management accountability will usually receive a negative vote.

When Does Engagement Take Place, How Does It Take Place, With Whom and on What Topics?

Most of the votes take place between February and May when most companies hold their AGMs, which is to say that most votes casted are annual shareholder meeting related. As has been the case, most of the engagements have historically followed the shareholder meeting, meaning that companies mostly sought to engage their shareholders around the time of the shareholder meeting. Which for the most part meant that engagements were reactive and often initiated by the company on the back of a negative voting recommendation issued by a proxy advisor.

Although largely still the case, engagements have increasingly started to touch on much wider issues affecting the corporation outside their annual general meeting. Now investors are actively engaging with their portfolio companies on governance issues as part of their fiduciary duty and also with the objective to protect the long-term value of their assets by seeking changes to their policies and structures, ensuring that corporations are managed for the interest of all shareholders, making sure that the board and policies in place act against executive or board mismanagement. Furthermore, companies themselves have started to gradually approach investors well ahead of their annual general meetings to understand potential shareholder concerns over governance risks, as they seek to pre-empt potential points of disagreement.

Although engagement tactics may vary, the person to whom these engagements are directed to does not. A common desire among investors is to express their views and concerns to those who can do something to address them. Corporate governance matters are a board responsibility, hence why it is common for non-executives to lead the company's engagement efforts on behalf of the board. The usual person would the company chairman, or if it is a specific issue, it will be the chairman of one of the committees. And although the topics discuss during engagements will be varied, there are a number of topics that are often discussed, which include, but are not limited to (Table 2):

The wide range of topics that are usually discussed during engagements with the board and investors intends to shed light on how the corporation is being governed and for the interest of whom. However, the nature of any engagement undertaken will inevitably be influenced by the scope and urgency of the perceived problem and by the responsiveness of the board.

5.2 Differences in Approach to Ownership

Although the typical topics covered in engagements on corporate governance matters are relatively similar (executive pay, board composition, strategy, capital allocation etc.) the way in which engagement is undertaken is far from similar. Different approaches remain, however the two main camps, which are often confused by outsiders are shareholder activism on the one side vs active ownership on the other.

Shareholder activists, often led by smaller hedge funds, typically possess a small holding in the company they target, and can by themselves not do much. However, their main aim does not necessarily lie in trying to influence the board, but rather in trying to persuade other shareholders, preferably a majority of shareholders (Foley, 2016). The strategy is to convince other shareholders that the activist has worked out a better strategy for the company (whatever that may be) than the board. In such a pursuit, they will try every conceivable tactic, from direct public battle with the board, placing an agenda for vote at the shareholder meeting, speaking with other investors, using the press etc. This approach is arguably more confrontational in its aim, not shying away from a head collision with the board if deemed necessary. Activist shareholders will usually achieve their goal when the board believes that a majority of shareholders supports the activist.

Active ownership on the other hand plays a more discreet role, with behind the scenes discussions, with a more patient, yet an equally demanding approach. This

Table 2 Engagement topics

Ownership structure
• Potential negative efefcts on decision making
• Management/board entrenchment as a result of ownership
• Dual class shares
• Voting limitations and restrictions
• Shares with special rights
• Interference of shareholder(s) in the day to day operations
• Overall transparency, especiall concerning ultimate beneficary ownership
Board and board comittees
• Composition
• Independence
• Chairman/CEO separation
• Presence and role Senior Independent Director
• Appointment process and reasoning for recent appointments
• Board evaluation (internal or externally conducted)
• Remuneration of non-executives
Management
• Quality and experience
• Responsiveness to shareholder concerns
• General availability
Executive remuneration
• Design (complexity, split between fixed, short term and long term remuneration)
• Aligment with strategy
• Types of performance criteria , targets and their transparency and vesting periods
• Use of equity as a percentage of total pay
• Clawback mechanisms
• Accelerated vesting
• Maximum pay
Bylaws and strategy
• Bylaw protection against issuances without pre-emptive rights
• Anti-takeover devices
• Related Party Transactions
• Financial Tunneling
• Diversion into non-core and M&A decisions/track record
• Allocation of capital and returns
• Overall Strategy and performance
• Accouting and audit matters

Source: Own compilation

method is often employed by larger asset managers who wish to keep their conversations confidential. The main advantage of this approach is that it yields a higher level of trust between the investor and the board, especially on sensitive matters (of which corporate governance tends to be), and therefore increases ability of the investor to influence fundamental change over time. Furthermore, corporates will often approach these investors when planning to make changes, providing the investors with an ideal opportunity to shape the outcome of the discussion. A proactive approach to consistent engagement with its shareholders behind the scenes and over time not only allows the board to understand shareholder concerns over governance risks, but allows building relationships that may help fend-off potential activists, should such one arise. The main disadvantage is that asset managers do not get the credit they deserve for their efforts as no information is being provided to the public.

Even within active ownership, there are different camps with different approaches to engagement. There are those that allow the board to manage the corporation without excessive interference, as they do not attempt to impose highly prescriptive actions, providing a higher degree of deference to the board. This approach rests on the belief that the board is best positioned to make decisions and should retain a considerable degree of flexibility. On the other side, there are those that engage and vote out of set of rigid policies, allowing no deviation to the board to explain how the board's own approach to corporate governance may address some of the shareholder concerns over governance risks.

Two forms for engagement that are often overlooked by the market are collective engagements and engagement between shareholders. Often, and especially in companies with a widely held ownership, some investors will promote collective engagements, which takes the form of a group of shareholders coming together under one roof to engage with the company. Although a conceptually interesting idea, where most shareholders will agree on the problem, the main challenge is to agree on a solution. Furthermore, the level of intimacy and the willingness of discussing more confidential information during such collective meetings will inevitably decrease. However, a key advantage is that it allows smaller investors to have a direct say through such forums, which might not otherwise be possible in a one-to-one meeting given their size. Engagement among shareholders is a relatively new phenomenon, which in some markets is widely used to discuss issues of concerns among companies. Ensuring that no laws on concert parties are being trespassed, investors regularly use this tool to share concerns, whilst ensuring that boards (knowing that such communication between shareholders exists) do not attempt at divide and conquer shareholders by giving different messages.

5.3 A Rising Tide Lifts All Boats

Finally, because index tracking investors are by definition invested across the entire market, they have a logical interest in raising standards across the entire market, not just in individual corporations. As a result, institutional investors spend a considerable amount of time and resources devoted to addressing concerns at a market level by entering into dialogue with any institution, private or public, that yields any sort of influence over corporate governance standards and shareholder rights in any given market. Institutional investors are keen participators in and contributors to the debate on how to raise governance standards. Speaking to regulators, listing authorities, institute of directors and stock exchanges offers the investor the advantage of narrowing (or expanding it, depending on how it is viewed) its engagement efforts to a smaller set of market players seeking to ensure a wider raise in governance standards across the entire market. Engagement with the objective of raising governance standards at individual companies and the market as a whole are not mutually exclusive, and are more of a complement to each other, in that both activities ultimately seek to enhance governance standards for the benefit of all shareholders, thereby reducing risk and enhancing the value of their investments over time.

6 Conclusion

Driven by experience, client pressure and increasing social expectations, investors are increasingly seeking to understand how corporate governance (agency risk) can affect their investments, and what actions can be taken to mitigate these risks. And although far from complete, and although far from mainstream, the increasing attention and commitment of resources into the integration of corporate governance both before and after the investment is made is a positive development in the continued improvement of fundamental analysis. Furthermore, a more active ownership approach among investors seeking to ensure that boards work in the interest of all shareholders is likewise a positive development.

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