CFA Institute

# THE CORPORATE GOVERNANCE OF LISTED COMPANIES

A Manual for Investors

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# Introduction

This is the third edition of the CFA Institute *Corporate Governance Manual*, with the first having been published in 2005 and the second in 2009. Much has changed in the corporate governance landscape in that time. In 2005, when CFA Institute published the first edition of this manual, including corporate governance factors in investment analysis was a novel concept to many. Today, in most instances, it is an accepted part of investment analysis. Corporate governance readings entered the CFA® Program curriculum about the same time as our first *Corporate Governance Manual*. The inclusion of corporate governance training in business school curricula and the availability of governance have both increased substantially since that time.

An increased understanding of the importance of corporate governance has not meant the end of corporate governance scandals. When we first published the *Corporate Governance Manual*, governance failures at Enron Corporation, Worldcom, Parmalat SpA, and others were fresh in our minds. The second edition of the manual was published in the wake of the financial crisis and governance breakdowns at Bear Stearns Companies Inc., Lehman Brothers Holdings Inc., Northern Rock, and others. More recently, we have witnessed corporate governance breakdowns at Volkswagen, Petrobras (Petróleo Brasileiro S.A.), and Samsung, to highlight a few of the higher profile governance failures. Corporate governance problems clearly will remain a challenge that investors need to understand and evaluate to gain a fuller understanding of the companies in which they invest.[1]

Governance has continued to evolve, and a number of issues have come forward since the second edition of this manual in 2009 that have spurred us to update this resource for investors.

- *Adoption of Stewardship Codes*. Many markets have adopted investor stewardship codes to promote better governance among investors and to promote best practices in engagement with investors.[2]

[1] See these and other publications from CFA Institute related to corporate governance issues at www.cfainstitute.org: *The Compensation of Senior Executives at Listed Companies: A Manual for Investors* (Charlottesville, VA: CFA Institute, December 2007), https://www.cfainstitute.org/en/advocacy/policy-positions/compensation-of-senior-executives-at-listed-companies; *Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors* (Charlottesville, VA: CFA Institute, May 2008), https://www.cfainstitute.org/en/advocacy/policy-positions/environmental-social-and-governance-factors-at-listed-companies; and *Shareowner Rights across the Markets: Individual Reports for 28 Different Markets* (Charlottesville, VA: CFA Institute, 2013), https://www.arx.cfa/up/post/1129/1307-Shareowner-Rights-across-the-Markets-Individual-Reports-for-28-Different-Markets-Introduction.pdf.

[2] See a complete list of government-mandated corporate governance codes in Appendix A and stewardship codes in Appendix B.

- *Increased Engagement*. Levels of engagement have increased between institutional investors and investors on governance issues.

- *Proxy Access*. Proxy access was introduced in the United States in 2015 when investors began filing more shareowner proposals seeking access to the corporate proxy. This led to many companies engaging with investors to allow investors to nominate one or two directors to the proxy ballot if the investors owned 3% of the company's shares for three years.

- *Move toward Dual-Class Shares*. The number of markets allowing companies to deviate from the one-share-one-vote standard—considered a best practice in governance circles—has increased. France, Hong Kong, and Singapore have passed laws or changed listing standards that have introduced dual-class shares, and a growing number of tech companies in the United States have adopted dual-class structures. Index providers have taken a stand, however, saying that they will limit the ability of dual-class companies to be included in some of their indices.

- *Environmental, Social, and Governance (ESG) Integration*. What started with corporate governance has grown to include environmental and social factors as nonfinancial factors investors need to consider the whole story of the companies in which they invest. In 2015, CFA Institute published *Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals*, and so we will not delve deeply into ESG in this manual, but we will speak occasionally to this topic.

- *Stakeholder Model of Corporate Governance*. For decades, a shareowner-centric model dominated investment thinking, with the focus being on what duty boards and companies owe their shareowners. In recent years, the stakeholder model in which boards and management must consider their duty to other stakeholders, and to society at large, in their corporate decision making has begun to challenge shareowner primacy. This focus also feeds into the increased consideration of ESG issues, as many long-term nonfinancial issues that may fall under ESG factors now are being measured and managed by corporations due to investor interest.

This manual does not provide a set of best practices, nor does it take a position on the best corporate governance structures for investors. Instead, its purpose is to alert investors to the primary corporate governance issues and risks affecting companies and to highlight some of the factors investors should consider when making investment decisions.

Issuers of financial securities also may find this manual to be a useful reference tool for determining which corporate governance issues are important to investors. We hope that this manual will raise awareness of the governance standards within the investment community.

# The Importance of Corporate Governance to Investors

The most effective and productive corporate governance structures rely on active and prudent shareowner engagement. Benjamin Graham and David Dodd recognized the direct correlation between active ownership and strong governance as early as the 1930s, advising that

> *The choice of a common stock is a single act, its ownership is a continuing process. Certainly there is just as much reason to exercise care and judgment in being a shareholder as in becoming one.*[3]

The link between corporate governance and performance has been well established through the years. (Details for accessing some of these studies are in Appendix C.)

Investors in both developed and developing markets have historically placed corporate governance premiums on companies with low corporate governance–related risks and corporate governance discounts on companies with poor governance. Policies and practices like opaque or limited disclosure, unqualified boards, limited shareowner rights, poor executive pay practices, and other governance red flags are seen by investors and factored into their analysis.

Markets have shown that good corporate governance leads to better results for companies, stakeholders, and investors by avoiding companies with the most questionable corporate governance practices. Corporate governance, therefore, is a factor that investors cannot ignore and should consider when seeking the best possible results for themselves and their clients.

# Definitions

In this manual, we use the definitions provided below.

## *Corporate Governance*

Corporate governance is the system of internal controls and procedures by which individual companies are managed. It provides a framework that defines the rights, roles, and responsibilities of various groups—including management, the board, controlling shareowners, and minority or noncontrolling shareowners—within an organization.

[3] Benjamin Graham and David Dodd, *Security Analysis*, 6th ed. (New York: McGraw Hill, 2009):540.

At its core, corporate governance is the arrangement of checks, balances, and incentives a company needs to minimize and manage the conflicting interests between insiders and external shareowners and stakeholders. Its purpose is to prevent one group from expropriating the cash flows and assets of one or more other groups and to provide a structure that ensures the long-term viability of the organization.

In general, good corporate governance practices seek to ensure that

- board members act in the best interests of shareowners, although increasingly, good corporate governance is tied to the interests of a broader *stakeholder* group (e.g., labor groups, society at large); over the long-term, the interests of shareowners and stakeholders converge;
- the company acts in a lawful and ethical manner in its dealings with all stakeholders and their representatives;
- all shareowners have a right to participate in the governance of the company and receive fair treatment from the board and management, and all rights of shareowners and other stakeholders are clearly delineated and communicated;
- the board and its committees are structured to act independently from management and other influential groups, and to act in the best interest of the corporation;
- appropriate controls and procedures are in place to cover management's activities in running the day-to-day operations of the company; and
- the company's governance activities, as well as its operating and financial activities, are consistently reported to shareowners, market participants, and stakeholders in a fair, accurate, timely, reliable, relevant, complete, and verifiable manner.

How well a company achieves these goals depends in large part on (1) the adequacy of the company's corporate governance structure and (2) the strength of the shareowner's voice in corporate governance matters through shareowner voting rights. This manual focuses on these two areas as a means to evaluate the corporate governance practices of companies.

## *Independence*

A number of national corporate governance codes and stock exchange–based rules[4] prescribe factors to consider when determining the independence of board and board committee members. Each company, each code of corporate governance, and each

[4] See Appendix A for a list of national and stock exchange–based governance codes.

market should have its own definition of independence, so that investors can define independence and its importance for themselves. Investors should understand whether a local standard of independence is a high standard or whether it sets a low bar, as well as whether a director can meet a high standard for independence. Generally, to be considered independent, a board member must not have a material business or other relationship with

- the company or its subsidiaries or members of its group, including former employees and executives and their family members;
- individuals, groups, or other entities that can exert significant influence on the company's management, such as controlling individuals, controlling families, or governments;
- executive managers, including family members;
- company advisers (including external auditors) and their families; and
- any entity that has a cross-directorship relationship with the company.

*Length of service on the board*: In some jurisdictions, a board member is no longer considered independent of company management after many years of board service. Shareowners need to understand how other relationships a director may have with a company may compromise his or her independence. Shareowners should understand whether directors

- have recently had material business relationships with a company, or
- represent a company with substantial voting rights in the company in question.

## Board Members

The term "board member" (in some jurisdictions, "director" is used) in this manual refers to all individuals who sit on the board (see the following definitions), including executive board members, independent board members, and nonindependent board members.

### Executive Board Members

This term refers to the members of executive management. In a *unitary* board (or committee system), executive board members also may serve as members of the board. In a two-tiered board, these individuals are part of only the management board. These individuals are not considered independent.

### Independent Board Members

An independent board member is an individual who meets the qualifications listed under the definition provided earlier for *independence*.

### Nonindependent Board Members

Individuals in this category may represent interests that conflict with those of the majority of shareowners. This category may include board members affiliated with individuals or entities that have control over management, those who are part of a cross-directorship arrangement with another listed company, or those who are representatives of labor organizations.

Shareowners should be cognizant of any individual, government entity, or organization that may qualify as a "shadow director"—namely, any holder of a controlling share of the company who is not a named director but who has a great deal of influence over management and the board. These individuals may be large stakeholders, sovereign wealth funds, governments, or other interested parties who may have motivations that are different from those of shareowners or the company.

### Board

The term "board" in this manual refers to a "supervisory" type of board (or "board of corporate auditors" in Japan) in countries with a two-tiered board structure. In countries that use a unitary board, the term refers to the board of directors. In most jurisdictions, corporate structures take the form of one or the other of these types, but in some countries, such as France and Japan, companies have the option of choosing which of the two structures to use.

## *Two-Tiered (Dual) Board*

Common in some parts of Europe—including Germany, the Netherlands, Austria, and Denmark—the two-tiered board structure has two elements, the management board and the supervisory board.

### Management Board

The management board consists exclusively of executive managers. It is charged, in consultation with the supervisory board, with running the company on a daily basis and setting the corporate strategy for the company. Its members do *not* sit on the company's supervisory board.

### Supervisory Board

The supervisory board is charged with overseeing and advising the company's management board.

### Corporate Auditors System

In Japan, the two-tiered board structure is called the "corporate auditors system" and is used by most large Japanese companies. The system includes (1) directors who are elected by shareowners and are responsible for business decisions, and (2) a board composed of corporate auditors, including at least one full-time corporate auditor. At least half of the members of the board of corporate auditors must be outside auditors. These corporate auditors are elected separately by shareowners and are charged with auditing the performance of the board.

## *Unitary Board*

In a unitary board structure, the board may include executive, nonexecutive, and independent board members. The board oversees and advises management and helps set corporate strategy, although in many jurisdictions, it does not engage in corporate decision making except in such matters as mergers, acquisitions, divestitures, and sale of the company. Jurisdictions increasingly require independent board members to constitute at least a majority of the board.

## *Committee System*

The committee system is most often used to delegate specific tasks to committees of the board, such as audit, nominations, and compensation committees—all of which must have at least three members. A majority of the members must be either independent board members or nonexecutive board members. Committees are asked to look at particular matters in more detail than the whole board, but responsibility for decision making remains with the board as a whole.

## *Company*

The term "company" as used here is the corporate organization in which the shareowners have an ownership position and in which investors are considering an investment.

## *Investors*

This term refers to all individuals or institutions considering investment opportunities in shares and other securities of the company.

### Shareowners

The term "shareowners," unlike the term "investors," refers only to those individuals, institutions, or entities that own shares of common or ordinary stock in the company in question.[5]

## Summary of Corporate Governance Considerations

### The Board

Investors and shareowners should

- determine whether a company's board has, at a minimum, a majority of independent board members;
- determine whether board members have the qualifications the company needs for the challenges it faces now and will face in the future;
- determine whether the board and its committees have budgetary authority to hire independent third-party consultants without having to receive approval from management;
- determine whether all board members are elected annually or whether the company has adopted an election process that staggers board member elections;
- investigate whether the company engages in outside business relationships (related-party transactions) with management, board members, or individuals associated with management or board members for goods and services on behalf of the company;
- determine whether the board has established an audit committee composed of independent board members, including those with recent and relevant experience in finance and accounting, to oversee the audit of the company's financial reports;
- determine whether the company has a committee of independent board members charged with setting executive remuneration and compensation;
- determine whether the company has a nominations committee of independent board members that is responsible for nominating board members;

[5] We do not include preferred shareholders here because, generally, preferred shareholders do not have voting rights. They often have greater dividend rights than normal shareowners.

- determine whether the board has other committees that are responsible for overseeing management's activities in select areas, such as corporate governance, mergers and acquisitions (M&A), legal matters, risk management, and environmental health and safety issues;
- evaluate the communications the board has with shareowners and the ability shareowners have to meet with the board; and
- determine whether the board has the diversity of background and experience that will bring beneficial points of view to the board.

## Management

Investors and shareowners should

- determine whether the company has adopted a code of ethics and whether the company's actions indicate a commitment to an appropriate ethical framework;
- determine whether the company permits insiders (management or board members) or their family members to use company assets for personal reasons;
- analyze both the amounts paid to key executives for managing the company's affairs and the manner in which compensation is provided to determine whether the compensation paid to the company's executives (1) is commensurate with the executives' responsibilities and performance, (2) provides appropriate incentives, and (3) is aligned with the company's corporate culture and strategy;
- inquire into the size, purpose, means of financing, and duration of share-repurchase programs and price-stabilization efforts;
- evaluate the level of communications that management has with shareowners and the ability shareowners have to meet with the management;
- determine whether management has adequately communicated its long-term strategic plans to investors, shareowners, and stakeholders;
- determine whether the incentive structures of management are aligned with the interests of the company and are tied to the execution of the long-term strategic plan, or whether they may encourage undue risk-taking that may be harmful to the interests of the company;

- determine whether management adequately understands and communicates how material nonfinancial key performance indicators and the environmental, social, and governance–related aspects, risks, and opportunities are being handled by the company; and
- determine whether the company communicates and discloses its financial and nonfinancial performance in a consistent and transparent manner.

## *Shareowner Rights*

Investors and shareowners should

- examine the company's ownership structure to determine whether it has different classes of shares that separate the voting rights of those shares from their economic value;
- determine whether the company permits shareowners to vote their shares before scheduled meetings of shareowners regardless of whether the shareowners are able to attend the meetings in person;
- determine whether shareowners are able to cast confidential votes;
- determine whether shareowners are allowed to cast the cumulative number of votes allotted to their shares for one or a limited number of board nominees ("cumulative voting");
- determine whether shareowners have the right to approve changes to corporate structures and policies that may alter the relationship between shareowners and the company;
- determine whether the board must receive shareowner approval for important decisions, such as adoption of a poison pill and some merger agreements, and whether a simple-majority or super-majority vote is required;
- determine whether shareowners are allowed to elect directors according to a "majority voting" standard;
- determine whether shareowners have either a binding or advisory "say on pay" concerning management remuneration;
- determine whether shareowners enjoy preemption rights that guard against dilutive instruments, such as new share issuances or convertible securities;

- determine whether and in what circumstances shareowners are permitted to recommend director nominees to the board or place their own nominees on the proxy ballot;
- determine whether and in what circumstances shareowners may submit proposals for consideration at the company's annual general meeting;
- determine whether the board and management are required to implement proposals that shareowners approve;
- determine whether the corporate governance code and other legal statutes of the jurisdiction in which the company is headquartered permit shareowners to take legal action or seek regulatory action to protect and enforce their ownership rights;
- carefully evaluate the structure of an existing or proposed takeover defense mechanism and analyze how it could affect the value of shares in a normal market environment and in the event of a takeover bid; and
- understand that the actions of other shareowners are governance issues they need to consider with the same degree of interest as they do the actions of the board and management.

# The Board

Board members have a duty to make decisions based on what ultimately is best for the long-term interests of the company and shareowners. Much discussion in recent years has focused on the need for boards and management to balance the short-term operations of a company with a long-term sustainable strategic outlook.[6] Although shareowners with a short holding period may indeed be interested in corporate governance, long-term shareowners (those who hold shares for years) are more likely to incorporate corporate governance factors into their investment analyses. The reason is that governance aspects often affect company value over a long timeframe. The board is responsible for the overall strategy of a company and should consider that the company's core purpose, risks and opportunities, strategy, business model, performance, and sustainable development are part of the value creation process. Many shareowners also are interested in whether the board ensures that the company promotes responsible corporate citizenship. To act in the best interests of the company and shareowners, board members need a combination of four things: independence, experience, resources, and accurate information about the company's financial and operating position.

1. *Independence*. A board should be composed of at least a majority of independent board members with the autonomy to act independently from the management and other special interests. Rather than simply voting with management, board members should bring with them a commitment to take an unbiased approach in making decisions that will benefit the company, shareowners, and stakeholders.

2. *Experience*. Board members who have appropriate experience, skills, and expertise relevant to the company's business are best able to evaluate what is in the best interests of the company and its shareowners. Depending on the nature of the business, specialized expertise by at least some board members may be required.

3. *Resources*. Internal mechanisms are needed to support the independent work of the board. Such mechanisms include the authority to hire the external auditor and other outside consultants without management's intervention or approval. This mechanism alone provides the board with the ability to obtain expert help in specialized areas; enables it to circumvent potential areas of conflict with management; and overall, preserves the integrity of the board's independent oversight function.

[6] See Dean Krehmeyer, Matt Orsagh, and Kurt Schacht, *Breaking the Short-Term Cycle* (Charlottesville, VA: CFA Institute, July 2006), https://www.cfainstitute.org/en/advocacy/policy-positions/breaking-the-short-term-cycle.

4. *Accurate Information*. Board members must have access to complete and accurate information about the financial position of the company and its underlying value drivers to enable them to steer the company toward its best long-term interests.

All of these points and how investors can evaluate them are discussed in more detail in the following sections.

# Board Independence

**Investors should determine whether the majority of a company's board is composed of independent board members.**

## *What Is Independence?*

Independence, as it relates to board members, refers to the degree to which they are not biased or otherwise controlled by company management, other groups who exert control over management, or the shareowners. Factors to consider in determining whether a board member meets this definition are provided in the section "Definitions."

## *Implications for Investors*

A board that is not predominantly independent, or a committee that is not completely independent, may be more likely than independent individuals to make decisions that unfairly or improperly benefit the interests of management, those who have influence over management, or groups of shareowners. These decisions also may be detrimental to the long-term interests of the company.

## *Things to Consider*

Investors should determine whether

- independent board members constitute, at a minimum, a majority of the board. A board with this makeup is more likely to limit undue influence of management and shareowners over the affairs of the board;

- independent board members are meeting regularly without management or executive board members present—ideally at least annually—and routinely reporting on their activities to shareowners. Such meetings permit board members to discuss issues facing the company without influence from executive board members;

- the board chair also holds the title of chief executive. Combining these two positions may give undue influence to executive board members and impair the ability and willingness of board members to exercise their independent judgment. Several national corporate governance codes require the separation of these two positions. Many jurisdictions consider the separation of the chair and CEO positions a best practice because it ensures that the board agenda is set by an independent voice uninfluenced by the CEO;

- independent board members have a lead member if the board chair is not independent. Some companies have kept the combined chair–CEO format but have named a "lead independent director" as a compromise. In such cases, shareowners must determine whether the lead director can set or influence the board agenda and is truly an independent spokesperson for shareowners;

- the board chair is a former chief executive of the company. If so, this arrangement could impair the board's ability to act independently of undue management influence and in the best interests of the company. Such a situation also increases the risk that the chair may hamper efforts to undo the mistakes made as chief executive; and

- members of the board are aligned with a company supplier or customer or are aligned with a manager or adviser to the company's share option or pension plan. In some cases, a company with a large number of suppliers, customers, and advisers may need to nominate individuals to the board who are aligned with these entities to ensure that it has the expertise it needs to make reasoned decisions. In such instance, investors should determine whether such board members must recuse themselves on issues that may create a conflict.

**Where to find information about the independence of the board and its committees:**

In most jurisdictions, companies disclose the names, credentials, and company affiliations of existing board members, either in their annual reports or in their annual proxy statements to shareowners. Companies often devote a special section in their annual reports to a discussion of the issues confronted by the board and board committees during the previous year. In addition, the websites of many listed companies provide information about board member independence.

Some specialty research providers focus exclusively on corporate governance issues and are good sources for such information as director independence and shareowner rights.

# Board Member Qualifications

**Investors should determine whether board members have the necessary qualifications to help the company face its challenges.**

## *Implications for Investors*

Investors should assess whether individual board members have the knowledge, skills, and experience required to advise management in light of the particularities of the company, its businesses, and the competitive environment. Board members who lack the skills, knowledge, or expertise to conduct a meaningful review of the company's activities are more likely to defer to management when making decisions. Such reliance on management threatens the duty of board members to consider the interests of the company and its shareowners. Moreover, having board members who are not capable of in-depth evaluation of the issues affecting the company's business could threaten the company's overall performance. Diversity among board members in terms of gender, educational background, and professional qualifications also may promote constructive debate in the boardroom (see the section "Nominations Committee").

The board is responsible for the company's strategy and should consider that the company's core purpose, risks and opportunities, strategy, business model, performance, and sustainable development are part of the value creation process.

## *Things to Consider*

Among the factors investors should consider when analyzing board members' qualifications[7] are whether the board members

- are able to make informed and independent decisions about the company's future with regard to finance, accounting, strategy, business, and law;
- are able to act with care and competence as a result of relevant expertise or understanding of
    - the principal technologies, products, or services offered in the company's business;
    - financial operations;

[7] The factors to consider are drawn from the CFA Institute textbook for the CFA® Program titled Corporate Finance.

  - legal matters;
  - accounting;
  - auditing;
  - strategic planning; and
  - the risks (financial risks, operational risks, and reputational risks) that the company assumes as part of its business operations;
- have made public statements that demonstrate their ethical perspectives;
- have experience serving on other boards, particularly with companies known for having good corporate governance practices;
- regularly attend board and committee meetings;
- have committed to the needs of the company—for example, by avoiding situations or businesses that could create a conflict of interest with the position as a board member; and
- have the background, expertise, skills, and knowledge in specific areas aligned with the company's mid-and long-term strategic objectives.

Investors should be cautious of whether board members

- have faced legal or regulatory problems as a result of working for or serving on the board or management of other companies or organizations, in positions occupied as a public official or public authority, or in a political office;
- serve on an excessive or unreasonable number of boards for other companies, which may constrain the time needed to serve effectively on each board;[8] or
- have served individually on the board for more than 10 years. Such long-term participation may enhance the individual board member's knowledge of the company, but it also may cause the board member to develop a cooperative relationship with management that could impair his or her willingness to act independently.

[8] Some corporate governance codes put a limit on the number of company boards on which individuals may participate.

Investors also should consider whether

- the board and its committees have performed peer or self-assessments and, if available, any information relating to these assessments. This review will help investors determine whether the board has the competence and independence to respond to the competitive and financial challenges facing the company;
- the board requires ongoing training or continuing education for directors on particular committees so that those directors may properly execute their duties. An example would be training in enterprise risk management or valuing derivatives for the audit committee of a large financial firm;
- the board conducts performance self-evaluations or has the authority to hire independent third-parties to conduct such evaluations;
- the number of meetings held during the financial year is adequate;
- the board addresses material ESG issues in setting strategy;
- the board maintains a diverse constituency;
- directors who depart before the end of their term provide timely explanations to shareowners;
- board meetings are conducted with an appropriate quorum;
- the board has a policy on “corporate citizenship” commitments by the company;
- the board has historically taken a “stakeholder-inclusive” approach in which it balances the needs, interests, and expectations of material stakeholders in the best interest of the organization; and
- the board is involved in evaluating the company’s technological resources, including safeguards against cyberattacks.

**Where to find information about the qualifications of board members:**

Many listed companies post the names and qualifications of board members on their websites. In regions where this is not the practice, companies typically provide information about their board members in annual reports and, where applicable, in their annual proxy statements.

In many countries, companies report on the number of board and board committee meetings, as well as attendance by individual board members, in their annual reports, on their websites, or, where applicable, in their annual corporate governance reports.

Some corporate governance codes require listed companies to disclose in their annual reports whether they failed to comply with the codes' provisions and why they did not comply.

# Authority to Hire External Consultants

**Investors should determine whether the board and its committees have budgetary authority to hire independent third-party consultants without management approval.**

## *Implications for Investors*

Authority to hire external consultants ensures that the board will receive specialized advice on technical decisions that could affect shareowner value.

Independent board members typically have limited time to devote to their board duties. Consequently, board members need support in gathering and analyzing the large amount of information relevant to managing and overseeing the company.

The board and its committees often need specialized and independent advice as they consider various corporate issues and risks, such as compensation; proposed M&A; legal, regulatory, and financial matters; and reputational concerns. The ability to hire external consultants without first having to seek management's approval provides the board with an independent means of receiving advice that is not influenced by management's interests. Responsibilities for decisions taken on the advice of consultants, however, ultimately belong to the board.

## *Things to Consider*

Among other issues, investors should determine whether

- the board hired, at relevant periods in the past, external financial consultants to help it consider mergers, acquisitions, divestitures, or risk management issues;
- the nominations committee has used external advisers to recruit qualified nominees for management or for the board; and
- the remuneration committee has hired external advisers to help determine appropriate compensation for key executives.

**Where to find information about the authority of the board to hire external consultants:**

The three most likely places to find information relating to the board's authority to hire external consultants are the corporate governance section of the company's annual report, the annual corporate governance report to shareowners, and the corporate governance section of the company's website.

Other possible places to find this kind of information include the company's articles of organization (also known as the company charter) or bylaws, national corporate governance codes, stock exchange–mandated corporate governance requirements, and third-party corporate governance reports.

# Related-Party Transactions

Investors should investigate whether the company engages in outside business relationships (related-party transactions) with management, board members, or individuals associated with management or board members for goods and services on behalf of the company.[9]

## *Reasons for Reviewing the Company's Policies on Related-Party Transactions*

As they also relate to board members, policies that cover related-party transactions attempt to ensure the independence of board members by discouraging board members from engaging in the following practices, among others:

- receiving consultancy fees for work performed on behalf of the company;
- receiving finders' fees for bringing merger, acquisition, or corporate sale partners to the company's attention; and
- receiving fees from other sources, such as tunneling minority shareowners' profit to owner shareowners' profit via a related party transaction.

[9] For more on related-party transactions in Hong Kong, see Lee Kha Loon and Abe De Ramos, *Related-Party Transactions: Cautionary Tales for Investors in Asia* (Charlottesville, VA: CFA Institute, January 2009), www.cfapubs.org/loi/ccb.

## Implications for Investors

Receiving personal benefits from the company for which board members are supposed to make independent decisions poses an inherent conflict of interest if the benefits fall outside the role of a board member. Limitations on such transactions—through, for example, either the company's ethical code or its policies governing related-party transactions—reduce the likelihood that management can use company resources to sway board members away from the company's best interests.

## Things to Consider

When reviewing a company's policies regarding related-party transactions, investors should determine whether

- the company has a policy for reviewing and approving related-party transactions. If the company has such a policy, consider whether interested directors (directors with financial interests in the transaction) are allowed to approve such transactions;
- the company's ethical code or the board's policies and procedures limit the circumstances in which insiders, including board members and those associated with them, can accept remuneration or in-kind benefits from the company for consulting or other services outside the scope of their positions as board members. The intent of such provisions is not only to discourage actions that could compromise board members' independence but also to discourage the company from entering into contracts that may not provide the best value to the company and its shareowners;
- the company has disclosed any material related-party transactions or commercial relationships with existing board members or board nominees (for a discussion of this issue, see the section "Board Independence");
- board members or executive officers have lent, leased, or otherwise provided property or equipment to the company;
- the company has paid board members finders' fees for their roles in acquisitions or other significant company transactions; and
- the company has provided to board members in-kind benefits or perquisites (e.g., the personal use of company facilities or resources, or company donations to personal charities).

**Where to find information about related-party transactions:**

The annual reports of companies in many countries include a discussion of insider transactions and fees paid to board members and controlling shareowners, which often appears under the heading of "Related-Party Transactions."

In the United States and Canada, listed companies are required to provide information about their dealings with insiders in the annual proxy statement, which often appears under the heading of "Related-Party Transactions."

Investors also should look for any disclosures of related-party transactions in the prospectus of a company preceding a public offering of securities. This document should inform investors about transactions that permit insiders to purchase shares at a discount before an offering at a higher price.

## Board Member Terms and Board Composition

**Investors should determine (1) whether board members are elected annually or (2) whether the company has adopted an election process that staggers board member elections.**

### *Reasons for Reviewing Board Member Terms*

Investors need to understand the mechanisms that provide, limit, or eliminate their ability to exercise their rights to vote on individual board members.

### *Implications for Investors*

Companies that prevent shareowners from approving or rejecting board members on an annual basis limit shareowners' ability to change the board's composition when, for example, board members fail to act on an issue of importance to shareowners and also limit shareowners' ability to elect individuals with needed expertise in response to a change in company strategy.

### *Things to Consider*

When reviewing a company's policy for the election of board members, investors should consider whether

- shareowners elect board members every year or for staggered multiple-year terms (producing what is known as a "staggered" or "classified" board). An annually elected board may provide more flexibility to nominate new board members to meet changes in the marketplace, if needed, than a staggered board. Staggered boards also may be used as antitakeover devices. Conversely, staggered boards or long-term boards may provide better continuity of board expertise. In Japan, shareowners of a company that uses a corporate auditors system elect board members for two-year terms and elect members of the corporate auditors board for four-year terms. Shareowners of a company using a committees system elect board members every year;
- the board has filled a vacancy for the remainder of a board member's term without receiving shareowner approval at the next annual general meeting;
- the board is the appropriate size for the circumstances of the company. A large board may have difficulty coordinating its members' views, be slow to act, and defer more frequently to the chief executive. A small board may lack depth of experience and counsel and may not be able to adequately spread the workload among its members to operate effectively; and
- the board's composition reflects attention to diversity issues.

**Where to find information about board member terms and board composition:**

In most cases, the best place to find information about the election of board members is in the notice and supporting documents of the company's annual general meeting. In the United States and Canada, this information is typically part of the annual proxy statement to shareowners. Investors should check the company's bylaws and articles of organization to determine whether management and the board are permitted to fill vacancies without shareowner approval.

# Board Committees

This section considers separately the audit committee, the remuneration or compensation committee, the nominations committee, and other board committees.

## Audit Committee

**Investors should determine whether the board has established a committee of independent board members, including those with recent and relevant experience in finance and accounting, to oversee the audit of the company's financial reports.**

## The Purpose of the Audit Committee

The audit committee's primary objective is to ensure that the financial information reported by the company is complete, accurate, reliable, relevant, and timely. To this end, the audit committee is responsible for hiring and supervising the independent external auditors and ensuring that

- the external auditors' priorities are aligned with the best interests of the company;
- the auditor is independent of management influences;
- the information included in the financial reports is complete, accurate, reliable, relevant, verifiable, and timely;
- the financial statements are prepared in accordance with generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS) and regulatory disclosure requirements in the company's jurisdiction;
- the audit is conducted in accordance with generally accepted auditing standards;
- all conflicts of interest between the external auditor and the company are resolved in favor of the company; and
- the independent auditors have authority over the audit of the entire group, including foreign subsidiaries and affiliated companies.

## Implications for Investors

If the independence of the audit committee is compromised, it could raise doubts about the integrity of the financial reporting process and about the credibility of the company's financial statements. Misrepresentations of, or other distortions about, the company's performance and financial condition ultimately could have a detrimental effect on the company's share valuation.

## Things to Consider

Investors should determine whether

- all of the board members serving on the audit committee are independent;
- any of the board members serving on the audit committee are considered financial experts;

- the board submits the appointment of the external auditors to a vote of shareowners;
- the board, supported by the audit committee, has the authority to approve or reject other proposed nonaudit engagements with the external audit firm. This conclusion should be based on a review of the committee's report on the services received from and fees paid to the external audit firm;
- the audit committee has policies relating to any fees paid by the company to the external auditor for nonaudit consulting services and for resolving these types of potential conflicts of interest. Such nonaudit fees may influence the auditors in a way that leads them to resolve conflicts regarding financial reporting issues in favor of management rather than for the benefit of shareowners;
- the company has procedures and provisions ensuring that the internal auditor reports directly to the audit committee in the case of concerns regarding the accuracy or integrity of the financial reports or accounting practices. Similarly, the audit committee should have unimpeded access to the internal auditor;
- any discussions between the committee and the external auditors have resulted in a change in the financial reports as a result of questionable interpretations of accounting rules, fraud, or other accounting problems, and whether the company has fired its external auditors as a result of such issues;
- the committee controls the audit budget to enable it to address unanticipated or complex issues;
- the company has signed any agreement with the auditor limiting the auditor's liability in the event of negligence, breach of duty, or breach of trust;
- the committee undergoes or is required to undergo periodic training to keep abreast of current financial issues;
- the company has a policy concerning audit firm tenure to address concerns that, after a long audit relationship with a company, the audit firm may be less inclined to remain impartial; and
- the company has used a number of different auditors in recent years, which may indicate that the company is shopping for a more pliant audit firm.

**Where to find information about the audit committee:**

## Australia

Companies listed on the Australian Securities Exchange (ASX) are required to disclose in their annual reports whether they have *not* complied with the exchange's recommendations pertaining to the audit committee, along with an explanation of why they did not comply.

## Canada

Companies listed on the Toronto Stock Exchange (TSE) are required to disclose in their annual reports whether

- they have an audit committee,
- the audit committee members are nonexecutive,
- the board has defined its roles and responsibilities,
- the audit committee communicates directly with internal and external auditors, and
- the audit committee is responsible for overseeing management reporting and internal control systems.

## European Union

All listed companies in the EU must have an audit committee or "body carrying out equivalent functions." The committee must have at least one independent member—although most national codes set a higher standard—and at least one member must have "competence in accounting or auditing." The audit committee is required to report on the company's system of internal controls in the annual director's report.

## United States

Companies must disclose whether they have at least one financial expert on their audit committee and the name of at least one of the committee's financial experts. They also must disclose whether the named board members are independent. If they disclose that they do not have at least one financial expert on their audit committee, they must explain why.

Companies also must disclose in their annual proxy statements

- whether they have a standing audit committee and, if so, the name of each committee member, the number of meetings held, and a description of the functions performed by the committee;
- whether the board has adopted a written charter for the audit committee. If so, the company must include a copy of the charter as an appendix to the proxy statement at least once every three years. If this information is available, investors will most likely find it on the company's website;
- if the company's shares are quoted on the NASDAQ or the American or New York stock exchanges, whether the audit committee members are independent as defined in the applicable listing standards (together with certain information regarding any audit committee member who is not independent);
- whether the audit committee has reviewed and discussed the audited financial reports with management and the independent auditors and whether the auditors made appropriate disclosures regarding their independence; and
- a statement by the audit committee specifying whether it recommended to the board that the audited financial statements be included in the annual report.

In some US jurisdictions, the audit committee holds the primary responsibility for assessing and mitigating the risks a company faces. If the audit committee is charged with such a responsibility, shareowners need to determine whether the committee reviews all of the risks a company faces, including credit, market, fiduciary, liquidity, reputation, operational, strategic, and technology risks.

## Remuneration and Compensation Committee

**Investors should determine whether the company has a committee of independent board members charged with setting board and management remuneration and compensation.**[10]

### *The Purpose of the Remuneration and Compensation Committee*

The remuneration committee is responsible for ensuring that compensation and other awards encourage the board and management to act in ways that enhance the company's

[10] For more on executive compensation in Asia, see Lee Kha Loon and Abe De Ramos, *It Pays to Disclose: Bridging the Information Gap in Executive-Compensation Disclosures in Asia* (Charlottesville, VA: CFA Institute, March 2008), and *The Compensation of Senior Executives at Listed Companies*.

long-term profitability and value. It is also responsible for ensuring that the remuneration packages offered to management are commensurate with the level of responsibilities of the executives and appropriate in light of the company's performance, and for determining whether compensation drivers are fostering excessive risk taking, entrenchment of mangers, or abusive or unethical behaviors. The committee can further these goals by

- including only independent board members on the committee;
- linking executive compensation to the long-term profitability of the company and long-term increases in share value relative to competitors and other comparably situated companies;
- ensuring that remuneration policies are aligned with a company's strategy, risk appetite, and corporate culture;
- eliminating any potential conflicts of interests between the compensation committee and the company by using, for instance, only independent compensation consultants who report solely to the committee;
- communicating regularly with the company's shareowners about compensation philosophy and how it aligns with the company's strategic goals;
- establishing clear mechanisms in compensation packages for recouping incentive pay from management if the money was earned through fraud;
- developing clear (i.e., "plain language") explanations of compensation philosophy and policies that are periodically communicated to all shareowners and other stakeholders; and
- ensuring that compensation committee members (or the board if the board sets compensation) understand all components of executive pay packages and are aware of what final payments may be made to executives in both best-case and worst-case scenarios.

## Implications for Investors

The existence of the committee and its independence from executive management bias helps ensure that the rewards and incentives offered to management are consistent with the best long-term interests of the company. Committees that lack independence may be overly pressured by management to award compensation that is excessive when compared with other comparably situated companies or to provide incentives for actions that boost short-term share prices at the expense of long-term profitability and value.

## *Things to Consider*

As part of their analyses relating to the remuneration and compensation committee, investors should determine whether

- the overall composition of the compensation packages offered to senior management is appropriate;
- the committee adequately articulates its compensation philosophy, policies, and procedures to shareowners;
- executive compensation is linked to the long-term profitability of the company and long-term increases in share value relative to competitors and comparable companies. Shareowners should determine whether incentive structures encourage management to take excessive risks in the short term that may prove detrimental to the company's long-term viability;
- compensation packages contain clear mechanisms, if allowed by local laws and regulations, for recouping incentive pay from management if it was earned through fraud or other activities deemed detrimental to the company's sustainable performance or viability;
- committee members understand all components of executive pay packages and are aware of what final payment may be made to executives in best-case and worst-case scenarios;
- committee members regularly attended meetings during the previous year;
- the company has provided detailed information to shareowners in public documents relating to the compensation paid during the previous year to the company's five highest paid executives and to its board members;
- the company has issued any disclosures about the major components and amounts paid to these individuals. Some jurisdictions require companies to provide only summary information about the compensation of senior managers and the board;
- the terms and conditions of options granted to management and employees are disclosed and whether the terms are reasonable;
- the company intends to issue newly registered shares to fulfill its share-based remuneration obligations or intends to settle those options with shares repurchased in the open market;

- the company and the board are required to receive shareowner approval for any share-based remuneration plans. Such plans affect the number of shares outstanding and, consequently, current shareowners' ownership interests, as well as the basis on which earnings per share are reported and the market valuations of the company's securities;
- the board receives variable remuneration instruments, such as stock options or restricted stock, and whether such awards adequately align the interests of the board with those of the company;
- senior executives from other companies who have cross-directorship links with the company are members of the committee. Executive remuneration is often based on compensation of similarly positioned individuals at other companies, and if the committee has individuals who could benefit directly from reciprocal decisions on remuneration, those decisions may not be in the best interests of the subject company (see the section titled "Board Independence"); and
- whether potential conflicts of interest exist between the compensation committee and the company. One way to avoid such conflicts is to use only independent compensation consultants who report solely to the committee.[11]

**Where to find information about the remuneration and compensation committee:**

## Australia

Companies that list on the ASX are required to disclose in their annual reports whether they failed to comply with the exchange's recommendations for remuneration committees and to provide an explanation of why they did not comply.

## Brazil

The major sources for compensation information in Brazil are the Reference Form and the annual general meeting proxy statements required by the regulation.

## Canada

The TSE requires TSE-listed companies to report in their annual reports or their management information and proxy circulars whether they have a compensation committee

[11] For more discussion on this topic, see *The Compensation of Senior Executives at Listed Companies*.

and, if so, whether it is composed of independent or nonexecutive board members and whether a majority of the board is independent. New rules that came into force for annual reports after 31 December 2008, not unlike the SEC rules, require disclosure of total compensation in a "compensation disclosure and analysis" section.

### *United Kingdom*

Listed UK companies are required to report in their annual reports on the frequency of and attendance by members at remuneration committee meetings. These companies also must disclose the responsibilities delegated to the committee.

### *United States*

Listed US companies report in their annual proxy statements on whether they have a standing compensation committee. These reports also include the names of committee members, summaries of compensation strategies, and the policies and procedures of the committee.

## Nominations Committee

**Investors should determine whether the company has a nominations committee composed of independent board members that is responsible for recruiting board members.**

### *The Purpose of the Nominations Committee*

The nominations committee is responsible for

- identifying new board members with appropriate qualities and experience in light of the company's business needs;
- regularly examining the performance, independence, skills, and expertise of existing board members to determine whether they meet the current and future needs of the company and the board;
- creating nominations policies and procedures; and
- preparing for the succession of executive management and the board.

## Implications for Investors

The slate of candidates offered by the nominations committee will determine whether the board ultimately works for the benefit of the company. This committee must remain independent to ensure that it identifies individuals who can and will work on behalf of the company and to ensure that the performance assessment of current board members is fair and appropriate (see the section "Board Member Qualifications").

## Things to Consider

Investors may have to review company reports over several years to adequately assess whether the nominations committee has recruited board members who act in the interests of the company. They also should review

- the criteria for nominating new board members;
- the composition, background, and areas of expertise of existing board members and whether new nominees complement the board's current portfolio of talents, including an attempt to bring diverse talent and backgrounds to the board;
- how the committee finds potential new board members, including whether the committee engages in a search for candidates, such as by using an executive search firm, or whether its members rely on the advice of management or other board members;
- the attendance records of board members at regular and special meetings;
- the company's succession plan for executive management in the event of unforeseen circumstances, such as the sudden incapacitation of the chief operating or finance officers, as well as information provided by the company about the plan and who is expected to lead and implement it; and
- the report of the committee, including any discussion of its actions and decisions during the previous year, including the number of meetings held, attendance by committee members, and the committee's policies and procedures.

**Where to find information about the nominations committee:**

The annual reports of companies in many countries include a general discussion of the actions taken by the committee during the previous year. Moreover, the websites of many listed companies describe the activities and members of the committee and, in some countries, provide information about the committee's charter.

The annual reports of companies listed in some countries, such as Australia and the United Kingdom, are required to disclose and explain when a company fails to comply with applicable nominations committee rules.

The corporate governance report, if available, often includes an explanation of the company's nominations process and whether the company has a specially designated nominations committee.

In some jurisdictions, such as the United States, investors should look in the annual proxy statement to shareowners for indications about the work of this committee, including the name of each committee member and the number of meetings held.

# Other Board Committees

**Investors should determine whether the board has other committees that oversee management's activities in certain areas, such as corporate governance, M&A, legal matters, risk management, and environmental health and safety issues.**

## *The Purpose of the Other Board Committees*

A board may have other specialized committees designed to deal with issues pertinent to their industry, line of business, or current circumstances that are not standard committees that most companies have.

## *Implications for Investors*

Because other board committees usually are not covered by national corporate governance codes or exchange-mandated guidelines in the manner that audit, remuneration, or nominations committees are, they are more likely to include members who are part of executive management. Consequently, these committees may not, and possibly need not, achieve the levels of independence expected of the audit, nominations, and remuneration committees. Although an Executive Committee may serve as a vehicle for taking actions quickly (without the need to call a special meeting of the entire board), it also may be used to circumvent scrutiny by the full board. In cases in which Executive Committees exist, investors are advised to carefully review the company's bylaws, number of meetings, and actions taken.

Depending on each committee's purpose, other committees created by the board can provide additional insight into the goals, focus, and strategies of the company. For example, a committee dedicated to risk management may consider the identification and quantification of financial and operational risks faced by the company and determine its optimal risk exposure. In the wake of the 2007–2009 global financial crisis, risk management committees—especially those at financial institutions—have heightened profiles and have taken on responsibilities now seen as important as those of more traditional board committees (e.g., audit and compensation committees). Risk management committees around the globe are now charged with a thorough review of the company's financial risks, including leverage, counterparty risks, and exposure concentrations.

### *Things to Consider*

Investors should understand the amount of risk management and risk measurement expertise present on a committee charged with managing and measuring a company's risk profile.

**Where to find information about other board committees:**

As in the case with the audit, compensation, and nominations committees, investors may look for information about special-purpose committees in the following four places: the annual reports to shareowners; the annual corporate governance report, if available; the websites of listed companies; and, in jurisdictions such as the United States and Canada, the annual proxy statement to shareowners.

## Board Communications with Shareowners

**Investors should evaluate the communications the board has with shareowners and the ability shareowners have to meet with the board.**

Board communication is important, but many boards do not conduct proper investor relations services, or provide non-board-level communications with shareowners in emerging markets.

### *Implications for Investors*

A corporate board does not have the time or resources to meet with all shareowners, but it should establish ways for shareowners to communicate their concerns to the board. This practice enables the board to understand legitimate concerns raised by shareowners that it may not have identified or addressed. A board should not breach its fiduciary duty to the company by acting in the interests of any specific shareowner to the detriment of the company as a whole or by disclosing material information to one group of shareowners while withholding it from others and the market.

## *Things to Consider*

Most jurisdictions do not establish formal rules governing the interaction of boards and shareowners; therefore, the culture of board–shareowner interaction and collegiality will vary from market to market. Also, because of a lack of time and resources, a board is likely to meet only with institutional shareowners who have significant holdings in the company. Information technology not available in past decades may provide ways for shareowners to communicate their concerns, as some companies have designated an e-mail address for the board, or some other form of electronic communications. Shareowners should consider whether they have easy and effective ways to communicate their concerns to the board, the chair, or the lead independent director.

In recent years, many institutional shareowners have greatly increased their commitment to engagement, including a sizable growth in engagement staff. Therefore, many shareowners have the expectation that they should be engaging more often and on more issues with their portfolio companies. In turn, companies and boards should develop a strategy and the staffing power necessary to deal with increased shareowner engagement. This engagement should focus on building relationships with investors beyond basic investor relations interactions. By fostering better communications and trust with investors through engagement, companies, their management, and boards may be better able to protect themselves against corporate raiders and investors who do not share their long-term strategic plan.

**Where to find information about board communications:**

A company's corporate governance documents and websites will likely detail ways in which shareowners may communicate with the board, if such means of communications are available. Institutional investors and analysts who meet with boards are likely to reach a board through the company's investor relations contact, its corporate secretary, or an existing personal relationship with a member of the board.

# Management

Although the board, in consultation with management, helps set the strategic, ethical, and financial course for a company, investors ultimately rely on management to implement that course. Management has the responsibility to communicate to directors, investors, and the public information about the company's performance, financial and nonfinancial condition, and any changes in strategy or corporate initiatives in a complete, effective, and timely manner.

Investors are generally familiar with management reports about a company's financial performance and condition. However, they may not be aware of other sources of information that may provide insight into the corporate culture, governance practices, and ESG issues. The company's code of ethics, corporate governance principles, compensation policies, share-repurchase and price-stabilization programs, takeover defenses, sustainability reports, and approach to shareowner communication all provide valuable insight into whether management is focused on maximizing company value.

To help investors understand management's role and responsibilities in corporate governance matters, the following section discusses company codes of ethics and corporate culture and reviews aspects of corporate transparency.

## Implementation of Code of Ethics

**Investors should determine whether the company has adopted a code of ethics and whether the company's actions indicate a commitment to an appropriate ethical framework.**

### *The Purpose of a Code of Ethics*

A company's code of ethics sets standards for ethical conduct that are based on the company's purpose, vision, mission and values, as well as on basic principles of integrity, trust, and honesty. This code provides personnel with a framework for behavior while conducting the company's business, and guidance for addressing ethical dilemmas and conflicts of interest personnel may face in the workplace. In effect, the code of ethics represents a part of the company's risk management, integrity, and compliance policies, which are intended to prevent company representatives from engaging in practices that could harm the company, its products, and the shareowners or stakeholders.

## Implications for Investors

Reported breaches of ethics in a company often result in regulatory sanctions, fines, management turnover, and unwanted negative media coverage, all of which can adversely affect a company's performance and value. Adoption of and adherence to an appropriate corporate code of ethics indicates a commitment on the part of management to establish and maintain ethical practices. The existence of such a code and policies may be a mitigating factor in regulatory actions in cases in which a breach occurs.

## Things to Consider

As part of their analyses of the company's ethical climate, investors should determine whether the company

- gives the board access to relevant corporate information in a timely and comprehensive manner;
- has an ethical code and whether that code prohibits any practice that would provide advantages to company insiders that are not also offered to shareowners. For example, a code might prohibit the company from offering shares at discounted prices to management, board members, and other insiders before a public offering of securities to prevent dilution of the value and interests of those who buy at the public offering price;
- has an ethical code that the company promotes internally and requires training for employees on compliance with the code;
- has designated someone who is responsible for corporate ethics;
- has an ethical code that provides waivers from its prohibitions to certain levels of management, the reasons why, and proposed action plans to eliminate those waivers;
- has waived any of its code's provisions during recent periods, has explained why it did so, and has proposed action plans to avoid those waivers from happening again;
- is in compliance with the corporate governance code of the country where it is located or the governance requirements of the stock exchange that lists its securities. Typically, companies must disclose whether they have failed to adhere to such codes and, if so, give reasons for the failure. In some cases, noncompliance may result in fines or sanctions by regulators. The company also may face informal sanctions, such as product boycotting by customers or political groups; and
- regularly performs an audit of its ethical or governance policies and procedures to make improvements.

**Where to find information about a company's code of ethics and other ethical matters:**

Companies with ethical codes typically post them on their public websites, include them in annual reports to shareowners, or, in countries that require them, include them in annual corporate governance reports.

The annual reports of companies listed in some countries, such as Australia, disclose when and why a company failed to meet applicable governance standards regarding the creation and implementation of a code of conduct.

Investors may check on the requirements of a country's national corporate governance code (see Appendix A) or exchange-mandated governance requirements.

# Personal Use of Company Assets

**Investors should determine whether the company permits management, board members, or their family members (insiders) to use company assets for personal reasons.**

## *Reasons for Reviewing the Company's Policies on the Personal Use of Company Assets*

Policies that limit or prohibit the use of company assets by insiders attempt to ensure that resources are used in the most efficient and productive manner for the purpose of generating returns for the company and all of its shareowners and stakeholders. Such policies and procedures also seek to preserve the independence of board members by attempting to prevent the conflicts of interest that may result when board members or their families use company assets.

## *Implications for Investors*

When insiders, including management, board members, or their families, use company assets for personal reasons, those resources are not available for investment in productive and income-generating activities. Such use also creates conflicts of interest for board members.

## *Things to Consider*

When reviewing a company's policies regarding the personal use of company assets, investors should determine whether the company

- has an ethical code or policies and procedures that place limits on the ability of insiders to use company assets for personal benefit;
- has lent or donated cash or other resources to insiders (including family members and other related parties), has explained why it did so, and has proposed action plans to avoid repeating those actions;
- has purchased property or other assets, such as houses or airplanes, for the personal use of management, board members, or their family members; has explained why it did so; and has proposed action plans to avoid making such purchases again; and
- has leased assets, such as dwellings or transportation vehicles, to management, board members, or their family members, and whether the terms of such contracts are appropriate in light of market conditions.

**Where to find information about insider transactions:**

Investors may find information about loans to company executives, board members, or their families on its website or in the "Related-Party Transactions" section of a company's annual report, its annual corporate governance report, and its annual proxy statement to shareowners. Investors also should review the prospectus of a company before a public offering of securities for any related-party transactions. This document should inform investors about transactions that permit insiders to purchase shares at a discount prior to an offering at a higher price.

# Corporate Transparency

This section reviews aspects of executive compensation; share-repurchase and price-stabilization plans; management communications with shareowners; financial, corporate governance, and ESG reporting; and auditing practices.

## Executive Compensation

**Investors should analyze both the amounts paid to key executives for managing the company's affairs and the manner in which compensation is provided to determine whether compensation paid to the company's executives (1) is commensurate with the executives' responsibilities and performance, and (2) provides appropriate incentives without fostering excessive risk taking, manager entrenchment, or abusive or unethical behaviors.**

## Reasons for Reviewing Executive Compensation Disclosures

Disclosures of how much, in what manner, and on what basis executive management is paid shed light on a board's stewardship of company assets. Furthermore, these disclosures allow investors to evaluate whether the compensation is reasonable in light of the apparent return to the company in terms of performance.

## Implications for Shareowners

The purpose of compensation is to reward managers for gains that are attributed directly to superior and sustainable performance. An appropriately designed program should create incentives for company executives to generate sustainable value for shareowners.

A flawed compensation program may encourage executives to make decisions that generate additional compensation for themselves through short-term gains rather than decisions that implement an appropriate strategy focused on long-term growth. A flawed program may reward managers for excessive risk taking or following broad sector- or industry-wide trends and could dilute the ownership positions of existing shareowners.

Compensation is often split between a basic salary and some form of bonus. Although no single model prevails, best practice has moved toward bonuses that reflect (1) recent business performance against targeted indicators, such as key performance indicators linked to the company's strategy; and (2) a bonus based on a long-term incentive plan (LTIP), which uses forward-looking indicators of success. The LTIP is designed to capture how well the management has positioned the company for long-term growth. In general, salary is not performance dependent but the bonus and LTIP are.

## Things to Consider

When reviewing a company's executive compensation disclosures, investors should examine the following:

- *Remuneration or Compensation Program*. An examination of the terms and conditions of the company's executive compensation program, along with an analysis of summaries of agreements with executives, will help investors determine whether the program rewards long-term growth or short-term increases in company value. This review should include a plain-language explanation of whether the remuneration and compensation committee uses consultants to set pay for company executives or relies on internal sources, which may be biased. Investors should focus on whether the rewards offered to management are based on the performance of the company relative to its competitors or on some other metric.

- *Past Executive Compensation*. Analysis of the actual compensation paid to the company's top executives during recent years and the elements of the compensation packages offered to key employees can help shareowners determine whether the company is receiving adequate returns for the investment it has made in management and whether remuneration is aligned with company and shareowner interests. For example, the proportion of fixed versus variable compensation can indicate management's risk appetite.

- *Whether Compensation is Variable or Performance Based*. Investors should determine whether the compensation package is linked (throughout a normal business cycle) to the long-term profitability and share-price performance of the company relative to its competitors and peers. Best practices include disclosure of the targets and actual award thresholds that the board uses to determine incentive-based compensation (both the bonus and LTIP). Investors should ask the following key questions:

    - ☐ Is the remuneration plan relatively simple to understand or overly opaque?
    - ☐ Is performance measured relative to peers, and are these peers the right comparison group?
    - ☐ Do targets require adequate stretching by executives in the current economic climate?
    - ☐ Are remuneration goals appropriate for the specific business and efficient and cost-effective in delivering its long-term strategy?
    - ☐ Are targets clearly linked to the company's long-term strategy or positively correlated with financial performance, such as return on capital or total shareholder return?
    - ☐ Is the remuneration somehow linked to nonfinancial criteria (e.g., ESG) and if yes, to which?
    - ☐ Is the incentive scheme compatible with the risk policy of the company?
    - ☐ Is performance measured over a reasonable timeframe, ideally through a complete business cycle?
    - ☐ Does performance measurement take account of risk taken?
    - ☐ Does the compensation plan include clawback provisions to recoup pay earned through fraud?
    - ☐ Do restrictions on shares require management to hold shares for a certain timeframe?

- *Use of External Consultants*. Investors should determine whether the remuneration and compensation committee uses consultants to set pay for company executives or whether it relies on internal sources, which may be biased.

- *Share-Based Compensation Terms*. Examination of the terms of this type of remuneration program, including the total shares offered to key executives and other employees, should alert investors to how the program can affect shares outstanding, dilution of shareowner interests, and share values. Investors should determine whether the company seeks shareowner approval for creation or amendments to such plans (for other issues that may require a vote of shareowners, see the section "Shareowner Rights").

- *Stock Option Expensing*. Compensation, regardless of whether it is paid in cash, shares, or share options, involves payment for services received and should appear as an expense on the income statement. IFRS and GAAP both require companies to expense stock option grants. Investors should be aware of a potentially excessive leverage offered by stock options and excessive risk-taking incentives.

- *Option Repricing*. Investors should remain aware of efforts by the company to reprice downward the strike prices of stock options previously granted. Changes in the strike price remove the incentives the original options created for management and thus reduce the link between long-term profitability and company performance with management remuneration.

- *Equity-Award Vesting Schedules*. Shareowners need to determine whether options, restricted stock, and other equity-based awards vest immediately, which may engender a short-term mind-set, or vest over a series of years, which may better align the interests of management with those of the company and shareowners.

- *Supplemental Executive Retirement Plans (SERPs)*. Many companies have established SERPs or other retirement plans for their executives that provide benefits above and beyond those covered in the company's ordinary retirement plans. Investors should understand the details of these supplemental plans to determine which company resources are or will be devoted to these plans over the life of an executive's contract.

- *Perquisites*. Shareowners should understand the nonfinancial benefits given to executives and the outlays of company resources that are behind such benefits. Perquisites include automobiles and personal use of corporate aircraft; security systems; executive dining rooms; legal, tax, and financial consulting services; and low-interest-rate loans.

- *Share Ownership by Management*. Investors should determine whether members of management have share holdings other than those related to stock option grants. Such holdings should align the interests of executives with those of the company and shareowners. Shareowners should look to see whether management is required to hold shares for any time after they might leave the company, which in theory makes management more inclined to weigh the long-term impact of their decisions.

- *The Company's Peer Group*. Shareowners should note whether the company discloses the peer group that is used to benchmark its performance. If so, shareowners need to determine whether this peer group is appropriate and whether it has been relatively stable over the years. A compensation red flag may be raised if a peer group is not appropriate for comparison or is frequently changing.[12]
- *Clawback Provisions*. Investors need to understand whether the company has provisions for the return of money by managers in clear cases of fraud.

**Where to find information about executive compensation:**

In many jurisdictions, companies report information about executive compensation in their annual reports. In some cases, disclosures about amounts paid to individual executives is voluntary, although accounting standards setters and securities regulators are increasingly making such disclosures compulsory.

In the United States and Canada, executive compensation strategies and reports of actual compensation paid to key executives are included in the company's annual proxy statement to shareowners. Investors also may find such information posted on company websites.

# Share-Repurchase and Price-Stabilization Programs

**Shareowners should inquire into the size, purpose, means of financing, and duration of share-repurchase programs and price-stabilization efforts.**

## *Reasons for Reviewing Disclosures of Share-Repurchase and Price-Stabilization Programs*

A company may use a share-repurchase program to buy its own shares that are already trading on a public stock exchange. In a stabilization program, the company has its investment bankers buy and sell shares following a public offering of shares to reduce the price volatility of the shares.

[12] See also *The Compensation of Senior Executives at Listed Companies*.

## Implications for Investors

Buying shares on the open market can have a positive effect on share values by reducing the number of shares available and increasing the value for the remaining shares outstanding. Price-stabilization programs may reduce the volatility of a security's price following a public offering and permit the market to achieve balance between buyers and sellers. Such programs, however, also may provide insiders with an opportunity to trade at a higher price in anticipation that the share price will decline or buy at a lower price in anticipation of future price gains.

## Things to Consider

When reviewing share-repurchase and price-stabilization programs, investors should determine the following:

- *The Intention of the Program*. Investors should determine whether the board intends to use repurchased shares (1) to reduce the number of shares outstanding to increase long-term valuations, (2) to fund the future exercise of management share options, or (3) to prevent a hostile takeover. Depending on the perspective of the investor, the program may enhance or hurt long-term share value. Fixed-income investors, for example, may view the use of cash to repurchase shares as detrimental to the ability of the company to repay its outstanding debts.[13] Equity investors, in contrast, may see such actions as beneficial to their valuations.

- *The Size and Financing of the Program*. This information, together with disclosures about whether the company plans to use internally generated cash from operations or issue debt to finance the purchases, can help equity investors determine how the program will affect the value of the company's shares.

**In addition, investors should review the following:**

- *Regular Updates on the Program's Progress*. In particular, investors should review the prices at which open-market purchases of shares were made, the number of shares purchased, cumulative amounts of shares repurchased to date, and the average price paid to date. This information should help investors anticipate completion of the program and how that may affect share value. It also should help investors determine whether the program is proceeding as planned or exceeding original intentions for scope and cost.

[13] Bond indentures may require that the company repay outstanding debt securities or receive a waiver from bondholders before launching a share-repurchase program.

 

- *Disclosures Relating to Stabilization Activities*. Before investing in a public offering of securities, investors should determine whether the company intends to use such stabilization services and should subsequently review updates about the number of shares purchased and sold under the program, the average price paid and received, and when the activities concluded. This information will indicate whether the company and its advisers acted as proposed or whether they engaged in unintended or undisclosed activities.

**Where to find information about share-repurchase and price-stabilization programs:**

The annual and interim reports of a company, in most cases, will provide the information relating to a share-repurchase program. The prospectus for an offering should include initial information relating to stabilization activities. Annual and interim financial reports should provide the results of stabilization programs.

Investors should look to the prospectus for an offering to determine whether at the time of the offering the company intended to use agents to perform price-stabilization services following the issuance of the securities.

Of particular interest are post-stabilization disclosures. In the EU, companies are required by the Market Abuse Directive to disclose (1) whether stabilization activities were undertaken and, if so, (2) the dates the program began and ended, and (3) the range of prices at which such activities were conducted. The ultimate disclosures will come from either the issuer or the lead underwriter.

The SEC currently does not require post-stabilization disclosures like those of the EU, although it is considering implementation of such a policy. Currently, NASDAQ requires market makers to attach a special symbol to an order for this purpose; other exchanges require underwriters to notify the exchange and provide disclosure to the recipient of the bid that such bids are part of a stabilization program. In many other jurisdictions, post-stabilization disclosures must be made only to the company and the exchange.

## Management Communications with Shareowners

**Investors should evaluate the level of communications that management has with shareowners and the ability shareowners have to speak with management.**

## Reasons for Reviewing Management Communications with Shareowners

The level of engagement with shareowners signals how open a management team and its board are with outside input. Shareowners should also evaluate the quality of management communications with shareowners to better assess the quality of the information provided.

## Implications for Investors

As was the case when discussing board–shareowner communications, investors need to understand that corporate management does not have the time or resources to meet with all shareowners. Management, however, should take care to establish ways for shareowners to communicate their concerns to management so they may understand legitimate concerns raised by shareowners that may not have been identified or addressed.

Management must not give information to certain shareowners that is not given to all shareowners, but management should be open to shareowner suggestions and concerns.

## Things to Consider

Most large companies employ in-house investor relations teams or outsourced investor relations professionals to handle communications between management and individual shareowners. These avenues are probably the best way for investors to communicate with management. Individual shareowners rarely have a direct avenue to contact management outside of an annual meeting.

To engender the kind of communications they want from management, shareowners should

- encourage companies to provide frequent and meaningful communications about strategy and long-term vision, including transparent financial and nonfinancial reporting that reflects a company's progress toward its strategic goals;
- encourage the inclusion of statements concerning long-term corporate strategy in all company communications; and
- encourage companies to disclose and comment on significant changes to their operating metrics (e.g., debt-to-equity ratio, inventory turnover, current ratio, sales growth).

**Where to find information about management communications:**

Much of the communication management has with shareowners comes through prescribed avenues, such as the company's annual report, annual meetings, earnings press releases, earnings conference calls, and conference presentations.

Institutional investors and analysts who meet with management are more likely than individual investors to reach management through a company's investor relations contact, corporate secretary, or existing personal relationship with a member of the board management. Shareowners may want to determine whether companies are required to disclose information not only to the analyst community but also to the general investing public.

# Financial Reporting, Corporate Governance, and ESG Reporting

**Investors should evaluate the level and quality of reporting around corporate governance and ESG issues as well as that of financial reporting to determine if a company offers timely and transparent information.**

## *Reasons for Reviewing Financial Reporting, Corporate Governance, and ESG Reporting*

Many investors use the level and depth of reporting on corporate governance and ESG issues, in addition to analysis of financial reports, as a proxy for the quality of management and the board. The rationale for this reliance is that management teams and boards who are managing these issues well are managing the long-term sustainability of the company.

## *Implications for Investors*

Traditional reporting about a company's financial position (balance sheet, income statement, statement of cash flows) is the main lens with which investors judge the health of a company. This analysis, coupled with proper scrutiny of a company's governance and ESG policies, gives a fuller view of the risks and opportunities facing a company.

## *Things to Consider*

When evaluating financial, corporate governance, and ESG reporting, shareowners should consider

- whether financial reporting practices are in keeping with international best practices;
- whether nonfinancial reporting standards for corporate governance disclosure are in keeping with international best practices;
- whether the company has a formal policy relating to ESG and sustainability issues;
- whether nonfinancial reporting disclosures for ESG and sustainability disclosure are in keeping with international best practices (e.g., annual report contains an ESG or sustainability section, or company produces a separate global reporting initiative or sustainability report);
- whether quarterly reporting is mandatory;
- whether financial reports are clear and informative;
- whether the company discloses when shareowners own 5% or more of company stock;
- whether the company discloses share transactions by directors and controlling shareowners within three working days; and
- whether the company uses an easy to understand electronic format (like XBRL) to disclose information.

**Where to find information about financial report and corporate governance:**

Financial information should be found in the standard places in a company's annual report. Governance and ESG information may be found in many different places, such as a company's website, in a separate sustainability or ESG report, or even in the annual report itself if the company has adopted an integrated reporting framework.

# Auditing Practices

**Investors should evaluate the quality of the audit performed on a company's financials to determine if the financial information provided is accurate and a true reflection of the company's health.**

## *Reasons for Reviewing Auditing Practices*

Any audit irregularities or red flags raised by an auditor should result in further and careful examination by investors to determine whether such issues may have an adverse impact on a company going forward.

## *Things to Consider*

When evaluating a company's auditing practices, shareowners should consider

- whether the company has an effective and independent audit committee;
- whether the company has been involved in any transactions during the past five years that cast doubt on the independence of the external auditors;
- whether auditing practices are in keeping with international standards;
- whether external auditors adequately question and explain audit findings in their report; and
- whether the market in which the company operates has an independent audit regulator, and if not, whether audit standards follow international best practices.

**Where to find information about auditing:**

This information can be found in an audit report, typically located prior to a company's financial statements in its annual report.

# Shareowner Rights

The value of a financial security is determined not only by its claim on the company's future earnings but also by the rights associated with that security. Among the rights associated with shares of common stock are the right to elect board members and the right to vote on matters that may affect the value of shareowner holdings, such as mergers or acquisitions. Other rights may include the right to apply the cumulative votes of one's shares to one or a limited number of board nominees, the ability to nominate people to the board, and the right to propose changes to company operations.

Shareowners may not have all these rights in all cases, nor will they always find it easy to exercise those rights that *are* accessible. For example, companies in some regions can restrict voting to only those owners who are present at scheduled meetings of shareowners. Companies also may be able to prevent shareowners—in return for exercising their vote—from trading for a designated period before the annual general meeting. In other cases, individuals and institutions cannot confidentially cast their votes. In still other cases, founding-family members or government shareowners may exercise disproportionate influence over a company's affairs through the ownership of special classes of shares or pyramid controlling structures that grant them super-voting rights.

Shareowners may have the power to remedy situations in certain cases, but such remedies are not universal. Local laws and regulations also may provide legal or regulatory redress.

Such issues are of interest not only to equity investors but also to investors interested in fixed-income investments—for example, companies that grant super-voting rights to a certain class of stock and shareowners historically use debt financing more than equity financing to fund investments in new business opportunities.[14] Such a strategy may raise the financial risk of a company and, ultimately, increase the possibility of default.

Investors should recognize what specific rights are attached to the securities they are considering and factor that information into any investment decisions. Doing so may avoid situations that result in reduced valuations and poor investment performance. Shareowner-rights standards and the legal and regulatory environments that underpin those rights

[14] A December 2003 study by Paul A. Gompers, Joy L. Ishii, and Andrew Metrick found that companies with two classes of common shares that separated the voting rights from the cash flow rights resulted in underinvestment and lower valuations. See Gompers, Ishii, and Metrick, "Incentives vs. Control: An Analysis of U.S. Dual-Class Companies," *NBER Working Paper No. w10240*, National Bureau of Economic Research (January 2004), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=492353.

vary from market to market. Therefore, shareowners must seek out information to understand their rights in each market. For this reason, we have included a comprehensive list of corporate governance codes in Appendix A and stewardship codes in Appendix B.[15]

Following is a discussion of issues that investors should consider when evaluating the shareowner rights of various companies.

# Shareowner Voting

Companies have several kinds of rules governing the way shareowners may vote their shares. This section reviews aspects of shareowner voting about which investors should be aware, including ownership structure and voting rights, proxy voting, confidential voting and vote tabulation, cumulative voting, voting for other corporate changes, and shareowner proposals.

## Ownership Structure and Voting Rights

**Investors should examine the company's ownership structure to determine whether it has different classes of common shares that separate the voting rights of those shares from their economic value.**

### *Reasons for Examining the Ownership Structure of the Company*

A company that assigns one vote to each share is more likely to have a board that considers and acts in the best interests of an alignment among all shareowners, and the one-share, one-vote standard is considered to be a best practice by most international corporate governance codes and standards. Conversely, a company with different classes of shares in which the majority, or all, of the voting rights are given to one class of shareowners may create a situation in which the management and board are disproportionately focused on the interests of those favored shareowners and not on the company's interests. It is usually in the shareowners' best interests for cash flow rights and voting rights to be equivalent. Companies with dual classes or multiple classes of shares often have a disconnect between cash flow rights (to all shareowners) and voting rights (in favor of certain shareowners with higher voting rights).

### *Implications for Investors*

Since the publishing of the second edition of this manual, dual-class share structures have gained acceptance and increased in use in the United States, France, Hong Kong, and

[15] See also *Shareowner Rights across the Markets*.

Singapore. It therefore is of paramount importance that shareowners understand what voting rights they do and do not have. In response to this increase in dual-class structures, some index providers have stated that they may restrict access to their indices to those companies that stray too far from the best practice one-share, one-vote principle. Another development concerning the issue of dual-class shares is the adoption by some companies of "sunset provisions" that either phase out a dual-class structure or abruptly end the dual-class structure at some company milestone or date in the future.

## Things to Consider

When analyzing the ownership structure of a company, investors should consider whether

- the company has different classes of shares and how voting rights differ among them;
- the company has safeguards in its articles of organization or bylaws that protect the rights and interests of those shareowners whose shares have inferior voting rights;
- the company was recently privatized by a government or government entity and whether the selling government has retained voting rights that could veto certain decisions of management and the board. If so, a government could prevent shareowners from receiving full value for their shares;
- the super-voting rights granted to certain classes of shareowners have impaired the company's ability to raise equity capital for future investment. Investors may find the inferior class of shares unattractive, which could harm the company's ability to finance future growth by means other than raising debt capital and increasing leverage;[16] and
- the shareowners have a limited ability to change multiple class structures and other governance practices affecting management accountability.

**Where to find information about whether the company has more than one class of shares:**

In certain jurisdictions and in certain companies, investors may find information about the different classes of shares in the annual proxy statement to shareowners. The company's website also is likely to describe the differences between shares of common stock and may provide hyperlinks to the company's articles of organization, annual and interim financial reports, prospectuses, and proxy statements.

The prospectus relating to the initial or follow-on offerings of common shares to the public is likely to include a discussion about different classes of common shares, including

[16] See *Shareowner Rights across the Markets*.

whether any entity or group of investors retains sufficient voting power to overrule certain management or board decisions.

The notes to the financial statements, particularly in the annual report, will likely disclose the existence of different classes of common shares.

# Proxy Voting

**Investors should determine whether the company permits shareowners to vote their shares before scheduled meetings of shareowners regardless of whether they are able to attend the meetings in person.**

*Reasons for Evaluating a Company's Voting Rules*

The ability to vote one's shares is a fundamental right of share ownership. In some jurisdictions, shareowners may find it difficult to vote their shares, however, because the company accepts only those votes cast at its annual general meeting and does not allow shareowners the right to vote by proxy or electronically.

## *Implications for Investors*

By making it difficult for shareowners to vote their common shares, a company limits a shareowners' ability to choose board members or otherwise express their views on initiatives that could alter the company's course.

## *Things to Consider*

In examining whether a company permits proxy voting, investors should consider whether the company

- limits shareowners' ability to cast votes by conditioning the exercise of their right to vote on their presence at the annual general meeting;
- coordinates the timing of its annual general meeting with other companies in its region to ensure that all of them hold their meetings on the same day but in different locations. In some regions that require shareowners to attend such meetings to vote, such actions seek to prevent shareowners from attending all the meetings and, therefore, from exercising their voting rights. In Pakistan, to avoid companies bunching their annual meeting dates together and disenfranchising shareowners, companies must submit meeting dates to the securities regulator for approval;

- permits proxy voting by means of paper ballot, electronic voting, proxy voting services, or some other remote mechanism;
- is permitted under its national governance code to use share blocking, whereby the company prevents investors who wish to exercise their voting rights from trading their shares during a period before the annual general meeting to permit the company and various financial institutions to certify who owns the shares; and
- gives shareowners enough time between the release of the proxy and the actual annual meeting to thoughtfully review any voting decisions and vote their shares. In some markets, shareowners are given only days or weeks to make such voting decisions, which renders voting especially difficult for foreign investors who may not be able to vote their shares as quickly as those investors in the local market.

**Where to find information about the company's proxy voting rules:**

Investors can look to the company's articles of organization and bylaws to determine the mechanisms shareowners can use to vote their shares. Investors also can examine the company's corporate governance statement for information about whether proxy voting is permitted.

In the United States and Canada, the proxy statement describes the mechanisms by which shareowners can cast their votes by proxy. Also, state corporation law in the United States and provincial securities legislation in Canada regulate issues relating to proxies. Consequently, investors may have to determine the locality in which a company is incorporated—typically found in the articles of incorporation—to review the proxy regulations governing the company.

# Confidential Voting and Vote Tabulation

**Investors should determine whether shareowners are able to cast confidential votes.**

## *Reasons for Determining Whether Shareowners Are Able to Cast Confidential Votes*

Shareowners are more likely to vote and to do so conscientiously if they are assured that board members and management will not find out how they voted.

## *Implications for Investors*

Confidentiality of voting ensures that all votes are counted equally and that the board members and management cannot resolicit the votes of individuals and institutions who voted against the positions of these insiders until the votes are officially recorded.[17]

## *Things to Consider*

In examining whether shareowners can vote anonymously, investors should consider whether

- the company uses a third-party entity to tabulate shareowner votes;
- the company or its third-party agent retains voting records;
- the company provides "timely disclosure" (immediate or a day or two after the vote) of annual meeting voting results;
- the vote tabulation performed by the company or its third-party agent is subject to an audit to ensure accuracy;
- shareowners are permitted to vote only if they are present at a scheduled company meeting (for a discussion of this issue, see the section "Proxy Voting").

**Where to find information concerning confidentiality of voting rights:**

Investors should look to the company's bylaws or articles of organization to determine the procedures for counting and tabulating shareowner votes.

A voting practice that was recently discontinued in South Korea, but may still be in place in other jurisdictions, is "shadow voting" or "mirror voting." Under shadow voting, the result of a vote at the annual general meeting is extrapolated across all shareowners to meet minimum voting requirements.

[17] In the case of pooled investment funds, CFA Institute has taken the position that the funds should disclose to investors how they voted the shares of each company on behalf of the fund's beneficiaries. Such disclosures are different from disclosing those votes to management and the board, in that the investment fund is disclosing its voting record to the *beneficiaries* on whose behalf it is acting.

# Cumulative Voting

**Investors should determine whether shareowners are allowed to cast the cumulative number of votes allotted to their shares for one or a limited number of board nominees (which is cumulative voting).**

## *Reasons for Determining How a Company Handles Cumulative Voting*

Cumulative voting allows shareholders to concentrate their voting power behind one board candidate, and is seen as a shareowner-friendly voting structure to enhance the voting power of minority shareowners.

## *Implications for Investors*

The ability to use cumulative voting enables shareowners to vote in a manner that enhances the likelihood that their preferred candidates are elected to the board.

## *Things to Consider*

In evaluating how a company handles cumulative voting, investors should consider whether the company has a significant minority shareowner group, such as a founding family, that might be able to use cumulative voting to elect board members who represent its specific interests at the expense of the interests of other shareowners.

**Where to find information about whether a company permits cumulative voting:**

The articles of organization and bylaws frequently provide information about how a company regards shareowner initiatives and rights. The prospectus that a listed company must file with the local regulator typically will describe the circumstances under which shareowners can exercise their voting rights.

In the United States, investors also may look to Form 8-A, which listed companies must file with the SEC, for a description of the rights afforded a company's common shares.

# Voting for Other Corporate Changes

**Investors should determine whether shareowners have the right to approve changes to corporate structures and policies that may alter the relationship between shareowners and the company.**

## Reasons for Considering Shareowner Input on Corporate Changes

Changes to certain corporate structures have the ability to affect the value, ownership percentage, and rights associated with the company's securities. Among the issues shareowners should review is the ability of shareowners to effect changes to the following company aspects:

- articles of organization,
- bylaws,
- governance structures,
- voting rights and mechanisms,
- poison pills,
- change-in-control provisions,
- board membership (by contesting board elections or recommending directors), and
- M&As and liquidation of assets.

## Implications for Investors

Certain changes to the company's bylaws or articles of organization can affect the shareowner's interests in the company. For example, the introduction or modification of an antitakeover mechanism might make a takeover too expensive for potential acquirers to consider, thereby denying shareowners full market value for their shares. Similarly, providing large quantities of stock options to management and employees may dilute the value of shares held by existing shareowners while redistributing company resources to insiders without shareowner approval. Shareowners should consider whether such option grants place too much emphasis on short-term goals without regard for long-term risks.

## Things to Consider

In reviewing which issues require shareowner approval, investors should determine whether shareowners

- have an opportunity to vote on the sale of their company or a substantial portion of their company to a third-party buyer. Investors may wish to consider whether shareowners have an opportunity to vote on significant acquisitions and divestitures that could increase or reduce annual revenues by 10% or more;
- have the right to vote on certain aspects of executive compensation (see the section "Executive Compensation");
- have the right to vote against directors in director elections;
- have the right to approve a new antitakeover measure, or to remove or waive existing ones, and determine whether such measures are subject to periodic review and retention by shareowners (see the section "Takeover Defenses");[18]
- have the ability to periodically reconsider and revote on rules that require super-majority voting to revise the company's bylaws, articles of organization, or other governance documents. Although these super-majority requirements may have been useful in making unwanted changes more difficult at a particular time in the company's development, they may not serve the same purpose in light of the company's evolution. Such provisions can make even changes overwhelmingly supported by shareowners difficult to enact;
- have the ability to vote for changes to the following company elements:
    - articles of organization,
    - bylaws,
    - governance structures, and
    - voting rights and mechanisms;
- Investors should review the following issues to determine whether, and under what conditions, shareowners may vote on
    - share-repurchase programs, particularly if their purpose is to fund share-based compensation grants (see the section "Share-Repurchase and Price-Stabilization Programs");
    - amendments, additions to, or revocation of corporate charters and bylaws; and
    - issuance of new capital stock, including common shares and instruments that convert into common shares.

[18] Antitakeover measures have the potential to benefit shareowners as well as entrench management, so investors should know the details of any antitakeover measures

**Where to find information about whether certain corporate changes require shareowner approval:**

Companies often provide information to shareowners about specific issues requiring a vote as part of their disclosures related to the annual general meeting or as part of disclosures related to a special meeting of shareowners.

A company typically will provide information about which issues require shareowner approval in the company's bylaws and articles of organization. These documents also provide information about whether management and the board can fill any vacancies without shareowner approval.

# Shareowner Proposals

Shareowner proposals are generally of two types: board nominations and resolutions. In all cases of shareowner proposals, one issue is whether the proposal is binding or advisory only.

## Shareowner-Sponsored Board Nominations

**Investors should determine whether and in what circumstances shareowners are permitted to recommend director nominees to the board or place their own nominees on the proxy ballot.**

### *Reasons for Determining Whether Shareowners Can Propose Board Nominees*

The ability to nominate one or more individuals to the board is a right that shareowners have in some markets but not in others. This "proxy access" allows shareowners who meet certain ownership thresholds to propose one or two directors on the annual general meeting ballot. When a board and management fail to remedy existing problems and improve the company's performance, shareowners may use this power to nominate their own candidate to the board to ensure that at least one nominee is independent of the existing board.

### *Implications for Investors*

If shareowners have the right to nominate board members, they have the ability to force the board or management to take steps to address shareowner concerns.

### Things to Consider

In evaluating whether shareowners can propose nominees to the board, investors should determine

- in what circumstances shareowners have the right to nominate board members; and
- how the company handles contested board elections. At some companies, particularly in the United States and Canada, a single vote cast in favor of a nominee is sufficient for an uncontested nominee to get elected to the board. In cases in which the nominations are contested by shareowners, different rules for determining winners may apply.

**Where to find information about the ability of shareowners to nominate individuals for the board:**

The notice of the annual general meeting will provide information related to the election of board members. Also, the articles of organization and bylaws frequently provide information about how a company regards shareowner initiatives and rights. In the United States, investors may look to the company's annual proxy statement.

## Shareowner-Sponsored Resolutions

**Investors should determine whether and in what circumstances shareowners may submit proposals for consideration at the company's annual general meeting.**

### Reasons for Determining Whether Shareowners Can Propose Corporate Initiatives

Investors need to understand what they can do if the board and management fail to remedy existing problems or improve the company's performance. Investors also need to understand the extent to which outside institutions or individuals with specific interests or biases are able to influence company activity. The ability to propose needed changes can prevent erosion of shareowner value.

### Implications for Investors

The right to propose initiatives for consideration at the company's annual general meeting is one way for shareowners to send a message that they do not like the way the board or management is handling one or more company matters. If the proposal receives an overwhelming number of votes, it could pressure the board and management either to make the changes called for or, if they fail to do so, to justify their decision.

### *Things to Consider*

In evaluating the ability of shareowners to propose changes for the company, investors should determine whether

- the company requires a simple majority, a two-thirds majority, or some other super-majority vote to pass a shareowner resolution. The company may require a simple majority vote to pass board- or management-sponsored initiatives;
- initiatives proposed by shareowners benefit the long-term interests of all shareowners or whether they represent the narrow interests of those making the proposals; and
- any "advance notice provision" exists in the jurisdiction that would require a shareowner to give notice of a proposal a certain amount of time before an annual meeting. Often such advance notice has to do with the nomination of directors, and such notice requirements call on a shareowner to give notice of such proposals to the company months before the annual meeting.

**Where to find information about shareowner authority to propose voting initiatives:**

A company's articles of organization and bylaws frequently provide information about how a company regards shareowner-sponsored proposals. In the United States, shareowners may look to the annual proxy statement for information about how to submit proxy initiatives.

## Advisory or Binding Shareowner Proposals

**Investors should determine whether the board and management are required to implement proposals that shareowners approve.**

### *Reasons for Determining Whether Shareowner Proposals Are Binding*

Unless the company is required to implement an initiative that shareowners have approved, the board and management may ignore those and other shareowner concerns.

### *Implications for Investors*

Requirements that the board and management implement approved shareowner-sponsored initiatives could pressure the board and management to act as approved by the general meeting.

### *Things to Consider*

When reviewing the company's rules regarding shareowner initiatives, investors should determine whether

- the company has implemented or ignored approved shareowner-sponsored proposals in the past;
- the company requires a super-majority vote to approve changes to its bylaws and articles of organization; and
- national regulatory agencies have pressured companies to act on the terms of approved shareowner initiatives.

**Where to find information about the enforceability of shareowner-sponsored proposals:**

The articles of organization and bylaws typically provide information about whether shareowner initiatives are binding and, if so, the size of the majority vote needed to enforce the measure. Investors also may look to the regulatory agency in the jurisdiction where the company is headquartered to determine whether the agency has taken steps to enforce shareowner initiatives in other cases.

# Other Shareowner-Rights Issues

Issues discussed here include shareowner legal rights, takeover defenses, and the actions of other shareowners.

## Shareowner Legal Rights

**Investors should determine whether the corporate governance code and other legal statutes of the jurisdiction in which the company is headquartered permit shareowners to take legal action or seek regulatory action to protect and enforce their ownership rights.**

### *Reasons for Determining the Legal Remedies Available to Shareowners*

In situations in which the company has failed to fully recognize shareowner rights, shareowners may have to turn to the courts or national regulators to enforce their rights of ownership.

### Implications for Investors

The legal rights of shareowners in a given jurisdiction determine whether or not they have legal redress if their rights as shareowners are compromised.

### Things to Consider

When reviewing the local governance code and statutes regarding legal and regulatory actions, investors should determine whether

- local legal statutes permit shareowners to take derivative legal actions, which permit shareowners to initiate legal actions against management or board members on behalf of the company and, if so, what conditions must be met for them to take such actions;
- the regulator in the local jurisdiction where the company is headquartered has taken action in other cases to enforce shareowner rights or to prevent the denial of shareowner rights; and
- shareowners, either individually or as a class, are permitted to take legal action or seek regulatory action to enforce fraud charges against management or the board.

**Where to find information about legal and regulatory relief for shareowners:**

The regulator in the local market of the company's headquarters may provide information about the remedies available to shareowners in a variety of legal and regulatory matters.

## Takeover Defenses

**Shareowners should carefully evaluate the structure of an existing or proposed takeover defense and analyze how it could affect the value of shares in a normal market environment and in the event of a takeover bid.**

### Reasons for Reviewing Disclosures Relating to Takeover Defenses

Such disclosures should provide shareowners with information about the situations in which takeover defenses could be used to counter a hostile bid. Examples of takeover defenses include golden parachutes, cross-shareholdings, caps on voting rights, poison pills, and greenmail.[19]

[19] Greenmail is a premium paid by the object of a hostile takeover bid to the entity making that bid in return for an agreement that the bidding entity will halt its takeover bid for a certain period.

## Implications for Investors

By forcing an acquiring entity to deal directly with management and the board, takeover defenses may reduce the potential for the acquirer to succeed, even in situations that would benefit shareowners. Defenses against takeovers also may cause investors to discount the value of the company's shares in normal trading because of the conditions and barriers they create.

## Things to Consider

When reviewing a company's antitakeover measures, investors should

- inquire whether the company is required to receive shareowner approval for such measures before implementation. Each company is likely to structure antitakeover measures differently. In some cases, investors may find that the board is permitted to implement an antitakeover measure subject to approval by shareowners within a set period of time. Others may not require shareowner approval at all;
- inquire whether the company has received any formal acquisition overtures during the past two years and whether takeover defenses were used;
- inquire as to all the details regarding those mechanisms and whether they can vote for their removal, amendment, or waiver;
- consider the possibility that the board and management will use the company's cash and available credit lines to pay a hostile bidder to forgo a takeover. In general, shareowners should take steps to prevent the board from carrying out such actions. If the company agrees to such payments, shareowners should review any publicly available information about the terms of such greenmail payments;
- consider whether, in some cases, change-in-control issues are likely to invoke the interest of a national or local government, which might then pressure the seller to change the terms of a proposed acquisition or merger. In such cases, the investor is unlikely to find specific government directives decreeing such defenses, although investors may find indications about the likelihood of such actions by examining the government's past actions relating to the company or relating to other companies in similar situations;

- consider whether change-in-control provisions will trigger large severance packages and other payments to company executives; and
- understand whether the company is involved in any cross-shareholding arrangements with other companies that may function as a defense against hostile takeover bids from unwanted third parties.

**Where to find information about takeover provisions:**

A company's articles of organization are the most likely places to find information about existing takeover defenses. Newly created antitakeover provisions may or may not require shareowner approval. The company may have to provide information to its shareowners about amendments to existing defenses.

# Actions of Other Shareowners

**Investors should understand that the actions of other shareowners are governance issues they need to consider with the same degree of interest as they do the actions of the board and management.**

## *Reasons for Reviewing Disclosures Relating to Other Shareowner Actions*

The actions of other shareowners may have a great deal of influence on the value of a company's shares. Activist investors or investor groups with significant stakes in companies often have the power to influence corporate decisions and sometimes to replace board members and even management. Shareowners should pay attention to the actions of the owners of significant company's shares to determine whether their actions are consistent with the creation of long-term shareowner value.

## *Implications for Investors*

Investors may see their shareholdings diluted, may see a shareowner push for changes they do not agree would be in the best interests of the company, or may get ideas from activists about strategies that investors may want to apply at other companies in which they are invested.

## *Things to Consider*

When reviewing the activities of other shareowners, investors should understand the motivations behind the actions of any activist investor: Are the motivations short term in nature or intended to enhance the creation of long-term value?

**Where to find information about the actions of other shareowners:**

Investors can often find this information in the required filings by both a company and its investors, but will likely have to keep track of financial media in order to obtain "real-time" information about the activities of other shareowners.

# Appendix A. Existing Corporate Governance Codes

**Australia**

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**Greece**

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**Hong Kong**

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