A smarter way to corporate governance

The new reality is moving beyond regulations and towards a forward-thinking approach, heavy on ethics and culture

It is increasingly acknowledged that successful and sustainable businesses are not just good for the economy, they support the wider society by providing jobs and helping to create prosperity, too. Society wants evidence that companies exist for more than simply generating short-term profits and expectations are for corporate governance principles to enhance confidence that companies act in the public interest.

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This has been an emerging mood across global economies, in the belief that sound corporate governance significantly influences the perspectives of organisations and makes them catalysts for improved societies.

The future of corporate governance is clearly marked by several social trends that have been taking place globally. ESG (environment, social and governance) and technology are fast-growing topics and may be the ones most impacting corporate governance.

ESG The focus on ESG as a means to creating sustainable value is on the rise. Socially responsible investing has become an important consideration for a growing number of investors, while ESG issues become more thoroughly integrated with company business as a whole. The aspect that is still elusive and is currently on the agenda of companies and investors, is how we can all leverage capital markets to improve not just risk-adjusted returns, but our society as a whole. In other words, how can ESG integration help create sustainable value? An appropriate corporate governance surely holds answers to this.

Technology Today, innovation is all around us. The Internet of Things (IoT) is the driving force behind the latest digital trend of improving everything in our society, and so making our lives 'smarter'. Organisations whose leadership is able to understand the nature of these challenges and has the temperament to embrace it will have a meaningful advantage in the increasingly technological future.

Smart investors and smart companies

We seem to be living in the era of 'smart' – we have smart phones, we use smart cars and some of us are or will be soon living in smart cities. The smart part sits at the very core of economics and society – it empowers the community to make better choices for its future. Given these societal trends, it may be the time now in the corporate world to speak about 'smart corporate governance': smart investors, smart companies, smart boards of directors, smart principles.

The changing landscape of corporate governance is stimulated by increasingly more responsible, more powerful and vocal institutional investors. Responsible investing and stewardship has gathered momentum across the world in the past decade, as we as investors look for financial returns while helping to achieve a positive impact on the world around us.

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The rising voices of the investor community relates to the impact that investors have on company boards. Just by looking at the main takeaways from the 2017 AGM season, one can observe the evolving policies of voting and engagement of many institutional investors on ESG matters. Among all the shareholder proposals on the US AGM agendas, almost 60% are ESG-related proposals. Consequently, the newest and perhaps most important board risk oversight expectations are being elevated by investors, calling on executives and boards to spend more time and effort directing and overseeing long-term value creation for shareholders and stakeholders.

Companies, too, have new ways of doing things: the shift from a 'linear' to a 'circular' way of doing business will be one of the medium- and long-term goals of several companies, also through the development of new technologies. Companies are making more efforts to understand what part of their value chains are associated with the main environmental and social impacts, as well as the magnitude of such impacts.

From our investor perspective through monitoring and engagement, we can positively observe the fact that company boards are listening and are acting upon our suggestions and expectations. For example, many boards are adjusting their composition in response to investor requirements for specific skills, i.e. adding ESG skills, cyber skills, international experience or diverse members, refreshing the boards or, in some cases, even asking certain members who did not perform accordingly to step down.

Even traditional corporate governance issues, such as executive remuneration, are evolving to meet the alignment, not only with performance or shareholder interest, but also with stakeholder interest. As investors, we are encouraging companies to approach remuneration from a wider angle and many companies are responding or are proactive in this regard. Financial performance no longer makes up the only metric for setting executive pay; non-financial, discretionary metrics are starting to become part of the pay policies. Tying company integrity, ethics, diversity, employee or customer satisfaction and ESG conduct to executive pay is becoming best practice.

SMARTER WAY OF THINKING
Modern boards need to look forward and evolve their ideas and practices

Smart boards of directors

The fast pace of change raises major issues for company boards of directors – how to achieve a balance between oversight and accountability on the one hand, while ensuring innovation and dynamism on the other. The focus of a smart board will be on ensuring that the business creates value for the company, its shareholders and stakeholders, while achieving its goals under conditions of uncertainty and unpredictable competition.

The smart board is fit for the future, is forward-looking with regards to future commercial and industry contexts, seeking to understand the driving forces that are impacting on the business. Many companies are looking not only to long industry experience, but for first-time directors who demonstrate good judgement, intellectual agility, knowledge of technology or digital and the ability to deal with complexity and fast-changing marketplace challenges. And, as fresh faces enter the boardroom, more attention will be paid to director onboarding, an area of corporate governance that has been underserved for some time now.

For years we have been talking about tone at the top, but this is no longer sufficient for a lot of companies. New risks, such as disruption, reputation risks or conduct risks, are determining several boards to start asking questions about the company's tone at the bottom, about the company culture. These boards want to ensure that the tone that they set permeates through the entire organisation and that the tone of their company not only flows down but also flows up to the board, for example through organisational training, induction and through appropriate whistle-blowing procedures.

Things are also evolving with board committees. The traditional standing board committees – nomination, remuneration and audit – are no longer the only norm. Many boards are getting creative and setting up new special committees, as an increasing way for boards to be more efficient. These are generally a reflection of the environment and trends we are experiencing, such as technology, cybersecurity, climate change, social care. There are no limits to creating specialised committees and some are given unique nomenclature: from sustainability committee or technology & innovation committee, to environmental & safety committee to strategic planning or quality committees. In many circumstances these are not just special committees, but are chartered committees, which is an approach that we investors expect in order to understand the role and functioning of these new bodies. »

Traditional board committees have also evolved, particularly as to their role and composition. The criteria for committee chairs has become an important challenge for the overall board composition. We have already seen this approach with the audit committee requiring financial experts as members. For the remuneration committee, a unique skill-set focussed on remuneration or employee issues is now becoming desirable, as well as an expectation from the investor community who will look to discuss remuneration plans with committee members rather than with the company's human resources department. The risk committee in certain companies may also call for cyber or technology expertise because of these emerging corporate risks, placed high on board agendas.

Smart corporate governance principles

Corporate governance is indeed evolving to meet the changing needs of the society. The 'new' corporate governance seems to suggest that sustainability aspects (such as environmental matters, social and employee-related matters, human rights concerns, anticorruption and bribery) have a relevant impact on the business and should be considered in the definition of the risk profile and strategic objectives of a company. The definition of corporate governance is moving beyond 'rules' and 'processes' towards corporate culture, vision and responsibility, placing long-term value creation at centre stage.

Several corporate governance codes and principles have been updated across the globe in recent years and the main reason was to adjust them to the pace of the society. While keeping consideration for the context of the individual jurisdiction, society and culture have been firmly positioned as a common change agent in many of these reviews. The new codes also place more focus on transparency by the companies, to ensure there is no loophole and the preference – driven also by investors – is for simplicity rather than complexity of governance and its disclosure. The value of 'comply or explain' has been acknowledged and enhanced by most countries in the past years.

Looking at the principles that have marked the developments in corporate governance globally, one of the chapters of the recently revised OECD (Organisation for Economic Co-operation and Development) Corporate Governance Principles is actually dedicated to the role of stakeholders in corporate governance. This chapter outlines the benefit of active co-operation between corporations and stakeholders and underlines the importance of recognising the rights of stakeholders established by law or through mutual agreements. The chapter also supports stakeholders' access to information on a timely and regular basis the possibility to obtain redress for violations of their rights.

In Italy, the most recent amendments of the Italian corporate governance code (which has in time inspired also legislative reforms of the national corporate law) covers different areas, including sustainability, a board's approach to risk and the focussed role of the nomination committee. The code expands the role of the board of directors with reference to the sustainability of the business; the company risk profile is to consider also the risks that may be relevant for the sustainability of the business activities in the medium to long term. To further stress the importance of the sustainability matters for a good corporate governance, the code recommends relevant issuers (i.e. issuers included in the FTSE-MIB index) to consider setting up a committee having the task to supervise sustainability issues related to the relevant business and to its interactions with all the stakeholders. The Italian code also introduces the importance of a whistle-blowing system at relevant issuers within an adequate system of internal control and risk management.

The most important change introduced by the revised Dutch corporate governance code is placing long-term value creation centre stage, requiring executive and supervisory directors of Dutch companies to act in a sustainable manner by making deliberate choices on the sustainability of the strategy in the long term. Even more than previously, the code is predicated on personal responsibility on the part of management board and supervisory board members, the provisions being formulated in a principle-based way as much as possible, so that executives and directors are encouraged to find an appropriate way to fulfil their responsibilities. Notable, one of the principles in the code specifically states that the board is responsible for shaping a culture that is aimed at long-term value creation.

The most recent South African King IV report on Corporate Governance has advanced from the 'apply *or* explain' principle of the earlier King III report to 'apply *and* explain'. Practically this means that companies are required to take measures to achieve the principles, but also to explain measures and their results. With the drafting of King IV, changes were effected to the code in order to present very clearly its contribution to organisational value, advocating that an organisation defines its role and purpose to create value not only for itself and its shareholders but also for all stakeholders. Clearly, the code in its revision has considered the realities of the South African landscape at country level, including socio-economic inequality, economic and political instability, and skills shortage.

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The US Commonsense Corporate Governance Principles published in 2016 were actually drawn up by large investors (not by market authorities or industry associations as in other countries). The aim was to create a logical reference piece and baseline principles that companies should follow in order to meet investor expectations. The most important message coming out of these principles is for the boards to think long term, as many international institutional investors are also committing their investment in companies long term.

Looking at Brazil, because of the strong legal framework and the force of the public prosecutors, it is not uncommon for companies in the country to face public civil actions in the case of ESG-related violations; and we've seen several recent cases. The new Brazilian Code issued in 2015 accommodates these issues and sees the role of directors evolving: becoming more proactive rather than reactive, focussing on the long term rather than on the short term, considering intangibles rather than tangibles, having a broad vision about the role of the company in the society and consider stakeholders rather than just shareholders.

Asia is also aligning, albeit slowly, to the global pace of corporate governance reforms. In Japan, a corporate governance code that took effect in 2015 seeks to make companies more transparent and responsive to shareholders, also giving consideration to the increase in foreign investments in the country. According to the Council of Experts Concerning the Corporate Governance Code of the Japanese FSA, 'the code seeks growth-oriented governance (and) promotes timely and decisive decision-making based upon transparent and fair choices through the fulfilment of companies' accountability in relation to responsibilities to shareholders and stakeholders'.

GLOBAL CORPORATE GOVERNANCE REFORMS
Many international codes and processes have been revamped in recent times

Most recently the reforms revealed by the UK government in 2017, which will impact the UK Corporate Governance Code, aim to create 'efffective system of corporate governance which incentivises business to take the right long-term decisions' through greater stakeholder participation, fairer executive pay and superior governance in private companies. The emphasis is on strengthening stakeholder voices in corporate decisions.

Interestingly, too, other countries that do not have a corporate governance history have put forward certain principles that are quite unique and that we may expect to find within future revisions of other countries' codes. For example, in Pakistan the State Bank of Pakistan (SBP) has been developing a framework on 'enterprise technology governance and risk management in financial institutions' with a vision to provide baseline technology governance and risk management principles to the financial institutions. As part of the governance framework, SBP has mandated financial institutions to have a board IT committee with a minimum of three directors as its members, one of whom shall be an independent director and at least one member shall have relevant qualification or experience of IT.

All these approaches are marking a forward-looking corporate governance, an effective way to implement it for the future of our society: a smart corporate governance.

Smart approach

What is relevant for the recent global corporate governance codes and principles is that the new reforms are timely, addressing two crucial audiences: shareholders and stakeholders. They will respond to investor long-term interests, being complemented by the stakeholder interest, approaching the issues of governance with a view to companies' broader role – as being responsible towards investors, employers, customers and as a force in society. Culture and ethics are also key aspects of the 'new' corporate governance principles and standards.

Nevertheless, while development of new frameworks for corporate governance are centred around the delivery of purpose and long-term value, companies do not need to wait for legislation or redrafted codes to act. Companies now have wide stimulus, from both investors and from society, to evolve governance reforms.

The challenge should not be underestimated but opportunities should not be underestimated either. Evidence shows that focussing on long-term value creation and treating stakeholders responsibly leads to superior long-term shareholder returns. So, across the world, it is in a company's interest to outclass and be the driver in sustainable wealth creation.