Incorporating Environmental, Social, and Corporate Governance Risks into Investment Decisions

Committee for Investor Responsibility

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Executive Summary

As a socially-minded institution committed to "practical idealism" and a "generosity of spirit," Wesleyan has long exhibited a concern for ethical considerations within its investment practices.[1] In a similar meeting last year, the Investment Committee demonstrated its active engagement with this issue by discussing and approving new language for the Investment Policy Statement. Through this language, the Board codified its commitment to ethical practices as an important component of investment decision-making.

Yet issues of environmental, social, and corporate governance (ESG) present far more than ethical quandaries: they also pose financial risks to institutional investors. With this report, the Committee for Investor Responsibility (CIR) aims to ensure that ESG principles are incorporated into investment decisions consistently and systematically. This serves two purposes: first, it establishes formal codification of the Committee's current practices so that future Committees will abide by the same principles; second, it allows for a more thorough consideration of risks in choosing external managers, affirming the Committee's fiduciary responsibility to maximize returns.

The following proposal summarizes ESG risk factors, with a more detailed account of empirical research included in the attached appendices. The CIR's recommendations can be found at the conclusion of this proposal. In brief, they are as follows: that the Investment Committee adopt a set of guidelines for considering ESG risks for the Investment Office to use in providing overviews of managers' portfolios, that the Committee express a preference for hiring managers who use ESG strategies, and that the Committee publicize its actions.

This proposal does not recommend any specific investment practices, nor does it seek to prescribe a categorical list of investments that should be prohibited. Rather, this proposal seeks to formalize existing ESG considerations and ensure that they are processed thoroughly and consistently. In making these recommendations, the CIR advocates for a qualitative yet standardized approach, through which a more transparent and comprehensive risk assessment procedure can be established.

Introduction

The Investment Committee has consistently demonstrated its commitment to ethical considerations in endowment decisions. Under current practices, ethical issues about managers' portfolios are brought up in Committee meetings at the request of an individual member. However, the CIR believes that addressing ethical issues in managers' portfolios should occur through a standardized and institutionalized process. In presenting this proposal, the CIR makes no specific recommendations about what corporate practices are especially injurious, or where to draw ethical "red lines"; this proposal is procedural and structural in scope.

The makeup of both the Investment Committee and the Investment Office will necessarily change over time, and formalizing ESG considerations will ensure that future trustees and staff will act according to the same rigorous standards practiced by current stakeholders. Last February, the Committee added language to the Investment Policy Statement formalizing its commitment to ESG concerns; enacting this proposal would provide a concrete vehicle to ensure that these considerations are available for Committee discussion.

In addition to procedural continuity, the enactment of this proposal would provide a thorough and easily accessible outline of managers to the Investment Committee. Furthermore, by conducting this research, the Investment Office would have a formal platform for understanding individual trustees' concerns, and in doing so will be better able to cater to the Committee's collective standards.

Expressing a written commitment to hiring ESG-focused managers who provide otherwise comparable returns would likewise institutionalize current practices. A preference for 'activist' managers would extend the CIR's proxy voting philosophy to the bulk of Wesleyan's endowment. Formalizing this preference would also publically communicate the Committee's stance to potential managers.

In addition to descriptions of portfolio assets, the Investment Office should provide the Committee with a qualitative summary of potential environmental, social, and corporate governance (ESG) issues within an asset manager's portfolio. In addition to listing a firm's relevant financial data, and the sector it belongs to, this summary might include information about pending litigation against a firm or publicized issues with its executive

compensation. A more detailed description of what these summaries might look like can be found below.

Sample ESG Summary Document

Relevant Assets:

- Include any assets that present substantial investment risk in each of the three ESG categories. A brief summary of which corporate practices may prove risky can be found in Appendices B-D.
- Additionally, include any assets that may be of particular concern to the Committee, based on historic precedent among Board members, temporal relevancy, or Wesleyan's institutional history.

Description:

- Summarize the assets in question.
- Note how much weight the asset in question holds within the fund.
- Note if this particular asset has been of previous or historic concern among the Board, is temporally significant, or relevant to Wesleyan's institutional history.

Associated Risks:

- Qualitatively assess the risks associated with these "particularly risky" assets.
- Characterize the type of risk that they pose (e.g., regulatory, consumer criticism, etc.).
- Include the temporal trajectory of the asset in question (i.e., whether the risk seems to be getting addressed or worsening over time).

The CIR recognizes that many managers already consider ESG factors because of the risks such investments entail and that the Investment Office clearly has an experienced and successful staff that effectively manages this balance. Without undermining the ESG work the Investment Office already does, this proposal seeks to facilitate clear communication between the Investment Office and the Committee through a new procedural framework. The CIR has confidence that collectively, the Investment Office and the Committee can define their own standards for review and ensure that they are adequately accounted for.

ESG Framework and Summary of Categories

Framing ethical issues in terms of ESG risks will strengthen Committee members' efforts to act as fiduciaries for the University. Investors have long recognized the importance of strong corporate governance in ensuring robust returns. The practice of incorporating environmental and social considerations into the investment process, however, remains relatively new. A growing body of empirical literature suggests that integrating ESG practices with more traditional investment practices may result in higher returns due to decreased risk. Additionally, shareholders are placing a greater importance on stewardship of the financial assets in light of the financial crisis.[2]

A firm's expected cash flows are dependent on a large number of considerations outside the firm. Factors such as resource availability, new government regulations, technological innovation, and changing social norms impact firms and sectors differently. The CIR contends that an ESG factor analysis would primarily serve as an indicator of investment performance and risk mitigation. The following sections provide brief overviews of the risk areas within an ESG framework; more detailed and empirical analyses of each category can be found in the appendices.

Environmental

Environmental considerations are increasingly recognized in risk assessment platforms because of the negative externalities and subsequent market inefficiencies that environmental issues generate.[3] Firms are at risk when these costs become internalized through government regulation, poor operational management, and changing consumer preferences.[4]

The availability of natural resources, infrastructure vulnerability, and energy reliability all present risks to firms.[5] Under a growing body of local, national, and international law, companies are subject to restrictions, regulations, and lawsuits relating to the impact of their activities on the environment. Furthermore, a strengthening environmental consciousness among the global populace may simultaneously prompt dissent and social unrest where business practices are harmful.[6] Additionally, environmental conditions may increase the threat of war, political, or social conflict, consequently affecting economic stability.[7] Through these mechanisms, environmental conditions present substantial investment risks and are of great consequence to fiduciaries seeking to maximize returns.

Economic production is dependent on the availability of material resources, which are increasingly strained on a global scale.[8] Shortage risks are exacerbated by contamination and pollution. Risks are even greater when concern over the user-viability of resources is coupled with over-consumption and resource depletion. Industries and companies that do not recognize these risks and adapt accordingly could face great financial risk or high production costs.

Environmental impacts are also shaped by climatic and ecological conditions. Certain corporate practices may be particularly risky considering resource distribution and localized vulnerabilities. Environmental context also impacts geopolitical conditions; environmental stress can affect social and political stress. From an investment perspective, these conflicts are difficult to manage because they are often unpredictable, constantly evolving, and driven by a variety of political and social factors. While it is impossible to fully predict geopolitical conditions, environmental conditions can be used as a partial proxy for assessing risk. Further information on these risks can be found in Appendix B.

Social

Social concerns likewise threaten returns; burdens that domestic or foreign governments may place on a firm's operations, for example, are definitive investment risk. Regulation and legislation have the potential to drastically alter the viability of a firm or its entire industry. When corporate practices are under regulatory scrutiny – such as those of coal-fired power plants – operational risk is passed on to investors. Firms are particularly risky when they rely on government contracts, face anti-trust or other litigation, or may be threatened by government tariffs or sanctions.

By the same token, poor corporate labor practices can face harsh government scrutiny, as can malfeasance on consumer issues. Both of these issues may also spark public outrage, often resulting in a temporary or long-term decline in a firm's value. Human rights abuses pose a similar risk to shareholders. Public campaigns that advocate divestment or boycott of a firm may negatively affect its corporate image, in turn harming its ability to do business. Further information on these risks can be found in Appendix C.

Corporate Governance

Actively monitoring the governance practices of firms is an important source of value to shareholders. Monitoring practices seek to ensure that management intentions align with

those of stakeholders. The value of active monitoring became increasingly apparent following a series of large corporate scandals at Enron, Tyco, and WorldCom in the 1990s and early 2000s. Active monitoring has also become additionally important as financial markets have opened up, free trade has become more normalized, and capital has become increasingly mobile.[9] Factors such as executive pay, insider ownership, board independence, minority and gender representation on boards, and co-mingling of board and management have historically influenced investment returns.

In addition to prioritizing managers who participate in active governance monitoring, the Committee should consider how concentrating investment in industries known for strong business integrity may positively affect returns. Certain industries such as construction, extractive industries, and sectors which involve large public sector contracts are known to have had problems with corruption in the past, and may negatively affect returns.[10]

Recommendations

1. **Adopt a standard procedure for ESG-related risk review**.
    a. The Investment Committee should formulate a set of guidelines outlining the areas of ESG risks to be addressed when making investment decisions.
    b. When presenting potential managers to the Committee, the Investment Office should provide a qualitative report based on these guidelines detailing a manager's portfolio.
    c. Reports should be standardized across all potential managers.
    d. When reviewing risk areas for a given manager, the Investment Committee should collectively address each and "opt-in" to overlook a certain risk factor.
    e. The same procedure should be implemented when re-considering managers. Any significant change to a manager's portfolio relevant to the guidelines should be communicated to the Investment Committee.
    f. The above guidelines should be published and added to the Investment Policy Statement.
2. **Prioritize managers that use ESG investment strategies.**
    a. The Investment Committee should adopt a policy explicitly prioritizing managers who incorporate ESG considerations into their portfolio.
    b. In situations where managers present near-equal returns, and one manager exhibits more attentiveness to ESG considerations, that manager should be preferred.
    c. Managers who are 'activist' in voting corporate proxies – especially on issues of shareholder resolutions, executive compensation, and board diversity – are to be prioritized.
3. **Publicly communicate these new policies.**
    a. The adopted language should be published on the Investment Office's website, and in the Year End Letter for FY2016.
    b. Subsequent Year End Letters should include updates on implementation of the recommendations above.
    c. The Investment Office should present a summary of risk reviews for newly adopted managers, excluding information that would violate confidentiality, to the CIR.

Conclusion

Throughout this proposal, the CIR addresses the mechanisms through which the Investment Office communicates portfolio risks to the Committee. In doing so, we also aim to codify how risk is discussed among the Committee's members. Given frequent turnover in Board membership, the CIR believes the Committee would benefit by standardizing and institutionalizing a specific protocol for addressing ESG manager risk. The recommendations here achieve long-term continuity, and seek to ensure that ESG risks in managers' portfolios are explicitly communicated to the Committee.

Much like the recently added language to the Investment Policy Statement, this proposal seeks to formalize a system already occurring in practice. This proposal is procedural rather than prescriptive in scope; it is not suggesting that either the Investment Office or the Committee restrict its assessment of investment managers based on a specific set of ESG criteria. The CIR acknowledges that many managers that the Investment Office considers already employ ESG strategies. Likewise, we understand that the Committee already takes ESG considerations into account in assessing these managers. The CIR nevertheless believes that there is significant utility in codifying existing practices, for the benefit of current and future Committees.

Appendix A - History and Managerial Acceptance of ESG

Starting in the 1970s, new environmental legislation, including the Clean Air and Clean Water Acts, spurred discussion among investors about the new risks from increased regulatory standards.[11] Regulatory concerns of this decade set the stage for broader conversations about the relationship between investments and ESG considerations, prompting a reevaluated notion of investment risks.

A series of well-publicized environmental disasters throughout the 1980s, including the Bhopal gas leak in 1984, the Chernobyl nuclear explosion in 1986, and the Exxon Valdez oil spill in 1989, heightened investor concerns. Corporate governance issues also received additional attention from investors following the Enron and Tyco corruption scandals in the 1990s and early 2000s.

Figure 1: Sustainable and Responsible Investing in the United States (1995-2914)[12]

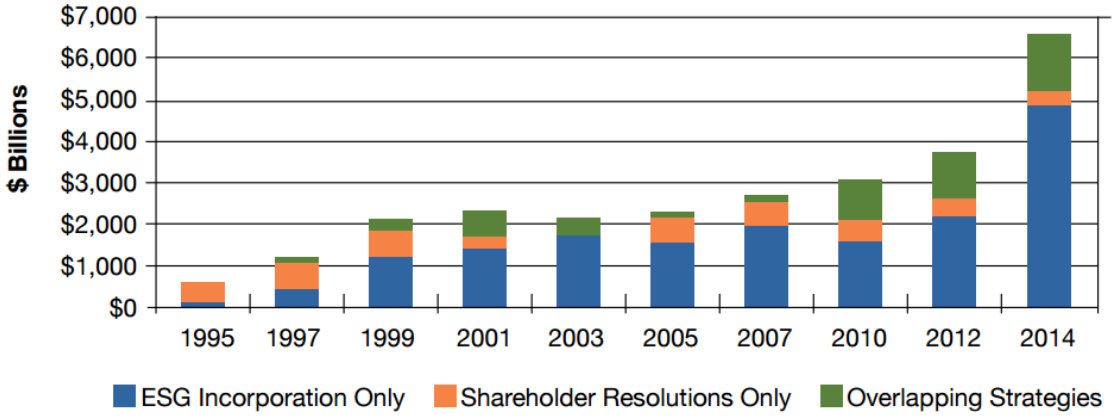


Figure 2: Investment Funds Incorporating ESG Factors (1995-2015)[13]

	1995	1997	1999	2001	2003	2005	2007	2010	2012	2014
Number of Funds	55	144	168	181	200	201	260	493	720	925
Total Net Assets (In Billions)	$12	$96	$154	$136	$151	$179	$202	$569	$1,013	$4,306

Additionally, empirical evidence suggests that portfolios with greater concentrations of firms with high ESG ratings outperform benchmarks.[14] Companies with high ESG ratings also tend to have higher credit ratings and a lower cost of debt than their competitors.[15]

Figure 3 highlights the various reasons why fund managers choose to incorporate ESG considerations into their investment practices. A majority of fund managers surveyed

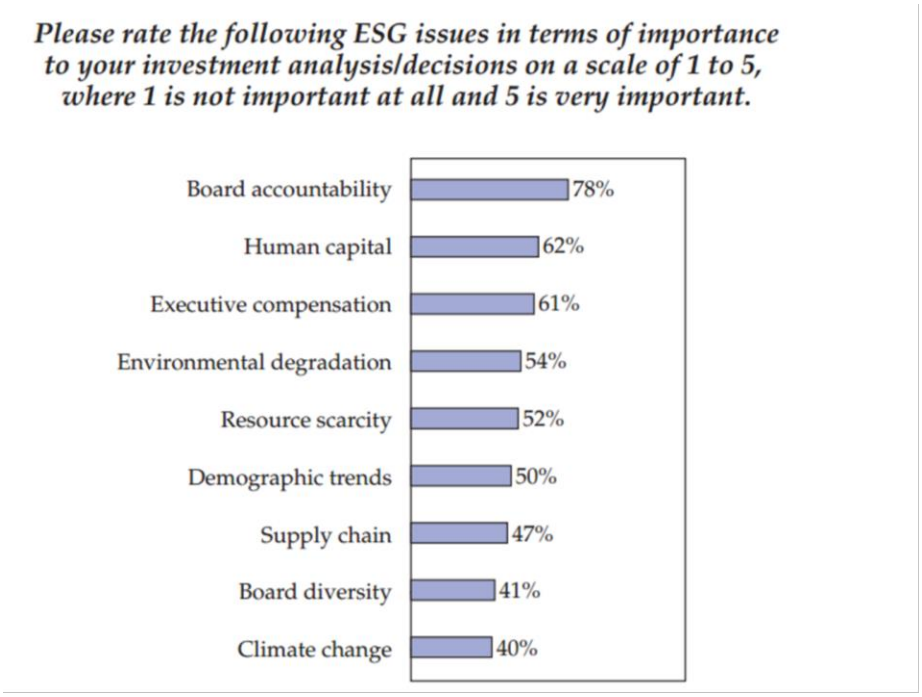
responded that considering ESG issues helps manage and lower risk. Consequently, ESG considerations provide a second measure of due diligence, contributing to a more robust and comprehensive analysis.

Figure 3: Why Fund Managers consider ESG issues[16]

Survey Response	Respondents (%)
To help manage investment risks	63
Clients/investors demand it	44
ESG performance is a proxy for management quality	38
It's my fiduciary duty	37
To help identify investment opportunities	37
My firm derives reputational benefit	30
Regulation requires it	7
Other	5

Figure 4 shows the response of fund managers to the question, *"Please rate the following ESG issues in terms of importance to your investment analysis/decisions on a scale of 1 to 5, where 1 is not important at all and 5 is very important."* Respondents ranked corporate governance issues as their first priority and environment considerations shortly behind.

Figure 4: Relative Importance of ESG Issues; chart shows the percent selecting 4 or 5[17]



Appendix B - Environmental Risks

There is an extensive body of research which has recognized the connections between environmental challenges and economic conditions, particularly with regard to climate change. In late 2015 Time Magazine declared that "Climate Change Could Wreck the Global Economy,"[18] citing recent research published in *Nature*.[19] This study projected that global GDP in 2100 will be 23 percent lower than it would be without the effects climate change.[20] Other research has demonstrated that the U.S. economy is not immune to environmentally-induced economic burdens.[21]

1. Availability of Resources

Countries are starting to recognize and correct for externalities through measures that will likely raise costs for firms that contribute to the externality in question. According to PRI (Principles for Responsible Investment) and UNEP FI (United Nations Environmental Program Finance Initiative), the cost of environmental damage induced by the world's largest corporations through 2008 is estimated to be $2.15 trillion USD.[22] The Investment Leaders Group laid out three mechanisms by which these costs may be internalized: government regulation, poor operational management, and changing consumer preferences.

Environmental sustainability is broadly acknowledged in the corporate world as fundamental to sustaining and growing future financial returns. A survey by Accenture and the UN Global Compact found that 63 percent of CEOs expect sustainability to "transform their industry within 5 years."[23] Additionally, sourcing materials for products is becoming increasingly difficult, dangerous, and expensive. Due to a recent 10 percent increase in natural resource prices, India's current trade surplus is projected to decline to 0.6 percent of its GDP.[24] Although technological development is vital to the efficient usage of resources or adoption of alternative processes, it is questionable whether many companies are incorporating these innovations fast enough to keep pace with resource depletion.

Additionally, climate change-induced changes in precipitation patterns and glacier melt are shifting water access globally, while changing weather patterns and drought have impacted crop yields and food access.[25] Disruption of macro-level environmental conditions such as

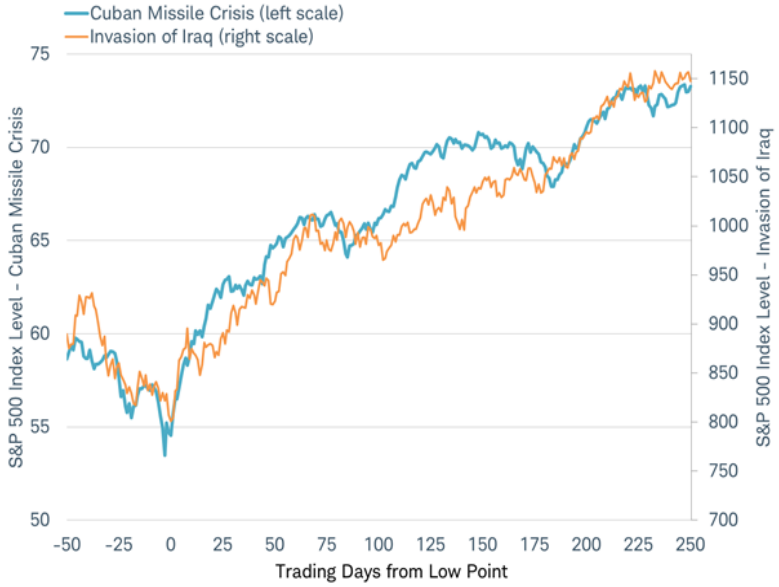
clean air and water, soil fertility, pollination, and flood control can put industrial operations at risk, and throw investment returns into jeopardy.[26]

2. Geopolitical Conflict and Socio-Political Instability

Geographic considerations are also worthy of scrutiny because of unequal planetary resource distribution. For example, water-intensive industries that operate in water scarce regions are more risk-prone than those that use the same production methods in a relatively water rich location. Additionally, environmental conditions matter because of localized vulnerabilities. A natural gas corporation employing fracking methods in an already earthquake-prone location or near significant freshwater resources poses greater external risks.

Because of increasingly interconnected global financial markets, managing geographic risks has become more difficult. The relationship between geopolitical instability and economic threat can be seen in Figure 5. This figure shows the relationship between the S&P 500 Index and geopolitical instability by examining crisis timelines in Cuba and the Middle East. More recently, unstable conditions in the Middle East and North Korea were cited as contributors to global stock market declines in the beginning of this calendar year.[27] Locations facing heightened political instability, or those that are particularly prone to such conditions, thus prove risky to investors.

Figure 5: Stock Market Performance after International Incidents[28]



Appendix C - Social Risks

1. Regulatory and Governmental Risks

Government regulation and legislation often penalize corporate practices or force significant operational changes, passing on serious financial risks to investors. Last year, for example, the Obama Administration implemented new limits on carbon dioxide emissions from coal-fired power plants, and as of January 2016, it announced that it would no longer grant coal mining leases on federal lands.[29] These new rules have substantially affected most coal firms' ability to operate, resulting in a 95 percent decline in coal stocks' value during the second half of the Obama administration.[30]

Figure 6: Dow Jones U.S. Coal Index, January 2012-January 2016[31]

Just as with any other risk, there is no way to be certain to what extent regulatory actions will adversely affect investment returns. But there are numerous signals that may prove useful to the Committee when examining the portfolios of external managers.

First, firms carry additional investment risk if the long-term viability of the firm depends on continued government support. This is particularly true of defense contractors such as Northrop Grumman, General Dynamics, and Lockheed Martin; the latter, for instance, received 79 percent of its 2014 revenues from the U.S. government.[32] This is far from a specialized issue: nearly all of the nation's largest corporations provide some contractual services for the government. If the government were to drastically reduce or even cease

procurement, these firms could become a significant investment liability. Similarly, firms that operate under a special agreement with the government (like utility companies with exclusivity contracts that limit revenues) may encounter regulatory burdens that threaten future returns.

Due diligence requires consideration of whether the government has proposed rulemaking that impacts a firm's core business practices. Even if the government has not initiated the standards process, items on the semiannual Regulatory Agenda may signal an intention to alter practices. Investors should also be mindful of whether the overall political climate has shifted so as to elect officials antithetic (or alternatively, sympathetic) to a firm's operations. Not only may this result in legislation that threatens returns, it also may accelerate Executive Branch rulemaking.

Next, there is cause for investor concern if the government has threatened or initiated litigation against firms in a manager's portfolio. Antitrust proceedings against a firm – or one of its competitors – are particularly worthy of concern. The Committee should consider whether the firm in question is subject to a class action suit; civil litigation presents an immediate threat to investor returns. The Justice Department is currently suing Volkswagen for a sum that could total $19 billion following its diesel emissions test scandal,[33] and 48 state attorneys general have jointly filed an additional suit.[34] Volkswagen's potential legal liability will dramatically impact its ability to pay dividends to its shareholders. Litigation brought by labor regulators such as the Equal Employment Opportunity Commission (EEOC) and U.S. Wage and Hour Division poses similar investment risk, as does suits from consumer regulators such as the Federal Trade Commission.

For firms that market products subject to sin taxes (such as alcohol, tobacco, and casino revenues), investors should be mindful of any state intentions to raise revenues, which could negatively impact demand. Tariff schedules on products manufactured by firms in an investment portfolio also merit consideration. Future free trade deals may alter tariffs and render products more or less favorable to foreign competitors. Political violence, regime change, and U.S. travel warnings may also adversely impact firms' ability to conduct business abroad.[35] Firms with operations in countries facing U.S. financial sanctions (such as Belarus and Sudan) are not suitable investment targets.[36]

The overview above has focused on regulatory risks to firms within the portfolios of external managers, yet we recommend the Committee also seriously consider the

regulatory risk to investment vehicles themselves. When contemplating an investment that requires a long-term commitment to a manager, the Committee is urged to be mindful of whether regulation might force investment practices to change – even significantly – during the duration of the commitment. Private equity managers currently face an unprecedented surge of litigation,[37] and the SEC is pursuing more aggressive enforcement of fee allocation and conflict of interest rules.[38] Violations of these rules negatively impact investors on their face, but government enforcement may further disadvantage investors by forcing firms to pay high settlements. Burdens on investment managers threaten returns on a systemic level.

2. Labor, Consumer, and Human Rights Issues

A firm's reputation is integral to its value. Product quality and safety can greatly influence public perception of a firm. Unsolved issues can lead to costly recalls, suspended sales and production, decreased revenues, damaged reputation, cut backs, loss of jobs, drop in share price, or lawsuits. Additionally, a large upswing in damaging litigation around consumer protection poses additional risk to companies non-compliant with consumer protection laws.[39] Heightened risk to investors stems from insufficient brand or product loyalty, lower sales based on product quality and safety, and increased reputational and litigation risks.

Human rights concerns increasingly pose social, political, and legal hurdles for companies. Labor issues, including slave labor, child labor, and minimum wage expectations are increasingly important to investors due to their material financial implications.[40] The experience of Nike Corporation aptly demonstrates how human rights allegations can significantly impact a company, both financially and reputationally. In the early 1990s, a report released by human rights activist Jeff Ballinger exposed Nike's poor working conditions and minimal pay in Indonesian factories.[41] Protests at the 1992 Barcelona Olympics and interviews with Nike factory workers provoked massive media attention and reputational damage. Recognizing the importance of human rights to its shareholders, Nike established the Fair Labor Association in 1999 to establish a code of conduct for its contractors.[42] Human rights concerns can impose litigation and reputational risk, in turn passing that risk financially onto investors.

Investors are quickly realizing the importance of corporate inclusion in a company's recruitment policies. Initially prompted by equal pay and women's rights, globalization of the workplace has expanded the relevance of these concerns to investors. Good wages and

benefits, as well as workplaces free of hazards and harassment, ultimately increase corporate efficiency.

3. Social Movements

Social risk, defined as challenges to companies' business practices due to both real and perceived environmental or social impacts, are incurred through stigmatization of a company or an industry.[43] Stigmatization can be rooted in issues of internal misconduct, public exposure or a release of new information, or externally changing social norms. All of these challenges pose risks to investor returns, especially when highlighted by public campaigns. One study on stigmatization and fossil fuel assets found that stigmatization affects the reliability of future cash flows.[44] Additionally, public actions can clearly impact corporate revenue: a 2015 mass protest in Seattle temporarily halted Royal Dutch Shell ships from leaving the harbor to begin drilling in the Arctic. This cost Shell $7 billion dollars in unused Arctic infrastructure, and an addition $4.1 billion in lost earnings.[45] While often indirect, social stigmatization poses financial risks to investors, and therefore should be included in the due diligence process.

An example that is pertinent to investors today is the stigmatization of the fossil fuel industry. A study by the Smith School at Oxford compiled 27 different empirical studies of current divestment campaigns targeting the fossil fuel industry. Nine of the studies found that divestment campaigns had a direct impact on firm's market capitalization, and. fourteen of the studies found indirect impacts posed by campaigns.[46] Although this literature review was inconclusive as to the mechanisms and scope of impact, it suggests that effects from stigmatizations have the potential to impact returns.

Divestment campaigns have had an appreciable impact on investment returns in the last several years. Public outrage at TransCanada's proposed Keystone XL pipeline has coincided with a significant devaluation of its stock. If this effect is largely due to public dissatisfaction with the fossil fuel industry, other fossil fuel infrastructure projects may face similar financial risks. Increasing dissatisfaction with the state of the private prison industry may have a similar effect, or may influence state legislators to reduce their reliance on such firms. In this manner, divestment campaigns present a tangible investment risk to fiduciaries.

FIGURE 7: TransCanada (TRP) Stock Prices, March 2015 - Present[47]

Boycotts have also been used as a tactic by social movements to target specific firms and industries. Although the implementation of this tactic has changed over time, it remains a powerful force that investors ought to consider. In a study examining the impact of consumer boycotts on target firms' stock prices from 1962-1986, White and Kare found that boycott announcements had a clear adverse effect on stock prices on the date the boycott was announced and in the next 10 days.[48] The aggregate decline in stockholder wealth in the immediate period was $27.44 million, and over ten days, $80.60 million.[49] The study mentions that "these results are primarily negative in nature and provide at least a general hint of the equity damage that a corporation is likely to suffer in the face of a well-organized boycott effort." Though the literature is somewhat divided on the subject, the possibility that boycotts may impact investment presents a risk to investors. While the questions provoked by social movements are often of concern to ethically-minded investors, their impacts on stock prices and revenue also presents financial risk.

Appendix D - Corporate Governance Risks

Although there are many factors that affect a firm's value and would be beneficial to monitor, here the CIR seeks to highlight executive pay, business integrity, and board diversity and insider ownership. These factors have historically influenced investment returns.

1. Board Diversity and Insider Ownership

As corporate boards are responsible for electing, retaining, and compensating a firm's executive management, the makeup of the board is acknowledged as an important source of value to shareholders. Board diversity encompasses gender diversity, industry diversity, and diversity in relationship to the company (independents versus insiders).

Distribution of shareholders is also related to insider ownership and board diversity. Firm ownership that is highly concentrated in the hands of a few majority stockholders can be problematic, especially if these stockholders hold disproportionate board seats. Information regarding the distribution of shareholder voting power may be a means to reducing agency costs and asymmetries between management and shareholders.

One example where a lack of board diversity has had significant repercussions is the recent Volkswagen emissions scandal. Prior to the scandal, Volkswagen's stock traded at a discount compared to other companies in its industry because of prior governance and board concerns.[50] One key weakness in the company is lack of diversity on its advisory board. Of the 20 executives that serve on the board, only one executive is an independent director. Additionally, 17 out of 20 of its executives are from either Austria or Germany. External voters only control 12 percent of the company, making it impossible for any shareholders, even a block shareholder, to address corporate issues or concerns.[51] Volkswagen exemplifies how the lack of board diversity, past problems with management, and lack of shareholder influence makes firms risky from a corporate governance perspective.

2. Executive Pay

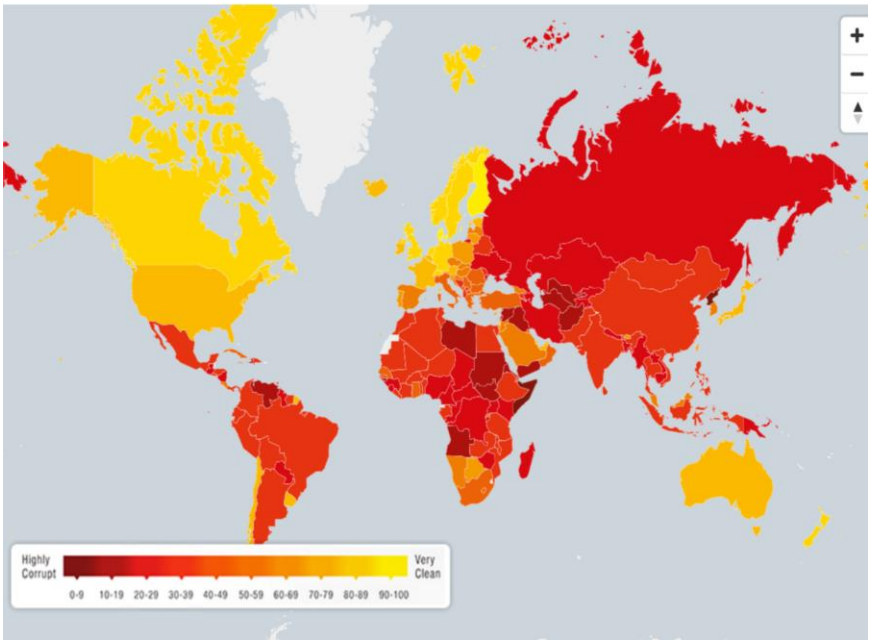
The financial compensation awarded to a firm's executives is largely designed by corporate management.[52] Since the 1990s, a dramatic rise in executive compensation has garnered attention among academics and the broader public.[53] As compensation packages are intended to attract, retain, and incentivize executives, it is important to question whether increasing compensation is consistent with shareholder interests.[54]

While compensation of executives is theoretically linked to a firm's performance, executive pay may constitute an agency problem, and consequently a risk management problem. The impact of executive compensation on firm performance poses complex and controversial questions, on which the empirical research is varied. When the deviation between a firm's CEO pay arrangements and shareholders' interests is considerable, researchers Core et al. (1999) found that firms had worse financial performance.[55] Cooper et al. (2009) found that firms that pay their CEOs in the top ten percent of pay earn negative abnormal returns over the next five years of approximately -13 percent.[56]

3. Business Integrity

Figure 8 shows a map of corruption perception produced by Transparency International. Most countries outside of the United States, Canada, Australia, New Zealand, Great Britain and Western Europe have fairly low corruption scores, indicating high business integrity in these countries. Countries outside of this group often have much lower scores, indicating higher risk from corruption. Additionally, sectors such as construction, real estate and property development, oil and gas, and mining industries have historically had problems with corruption in the past.[57]

Figure 8: Corruption Perceptions Index 2015[58]



The impact of corruption scandals can impact entire industries or economies. As discussed above, one of the most recent corruption scandals involved German-owned car manufacturer, Volkswagen. In September 2015, the U.S. Environmental Protection Agency (EPA) revealed that Volkswagen was selling cars with defective emissions software. Volkswagen faces fines of up to 18 billion dollars, in addition to replacing 11 million vehicles.[59] The scandal has cost the company millions in revenue in addition to significant damage to its reputation. The European Union reported that Volkswagen's market share slipped from 12.6 percent to 11.5 in December of 2015 alone.[60]

Another recent corruption scandal involved Brazil's largest oil company, Petrobras. The firm and a number of small oil producers were caught colluding to form an oil cartel, driving the price of oil up. In the end, five politicians were arrested, 117 indictments were made, and 13 criminal cases were charged against companies.[61] Petrobras is a huge contributor to the Brazilian economy, at one time making up 10 percent of the nation's GDP, thus the damage extended much further than the company itself.[62] Within the last year, Petrobras has lost half its market share in Brazil. Analysts expect that this the Brazilian economy will contract by one percent this year due to Petrobras' impact alone.[63]
Respectfully submitted,

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