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Characteristics of Effective Corporate Governance and Issues of Board Structure & Executive Compensation, Vietnamese Practice & International Experience

ESG & Sustainability Transformation

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ESG Transformation

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As we have illustrated in the previous article, the UK has been a model for modern governance for the world. The UK Corporate Governance Code was last revised in 2018. It comprises 18 principles under five themes:

- board leadership and corporate purpose;
- separation of responsibilities;
- composition, succession and evaluation;
- audit, risk and internal control; and
- remuneration.

These themes are consistent across most corporate governance codes around the world, as are (for the most part) the expectations and duties of the three main board committees that virtually all large companies have:

- the audit committee (sometimes the audit and risk committee);
- the nominating committee (sometimes the corporate governance committee or some combination of the two); and
- the remuneration committee (or compensation committee in the US; some companies now also incorporate it into the name to reflect its responsibility to cover a broader employee base).

The expectation is that audit and remuneration committees will be made up of only independent non-executive directors, and that such directors should form a majority of the nomination committee (the chairperson should not chair this committee). Some companies will establish other board committees to deal with special issues or on an ongoing basis, but they should take an appropriate approach to how these committees should best be structured. For example, most financial services companies now have a separate risk committee, usually made up of independent non-executive directors.

Other companies may have sustainability committees or committees that consider their key operational risks – such as a human resources committee in companies that rely heavily on their workforce or a health and safety committee. Such committees assist the board in monitoring key risks and handling the oversight workload. They are not mandatory, and clearly in smaller companies this workload will likely be handled by the audit committee or the board itself. The Code also identifies appropriate disclosures to make the board's operations transparent and demonstrate effectiveness to shareholders.

Issued alongside the 2018 Code is the Guide to Board Effectiveness, which follows a similar structure to the Code across the same five topics. It not only provides guidance but also provides questions to assist board members in considering whether they are being fully effective in their roles. The Guide also provides questions that board members can choose to ask management to gain a better understanding of the company's culture.

Almost half of the main body of the guide is devoted to the first topic, board leadership and corporate purpose – this topic essentially focuses on culture, strategy and maintaining appropriate relationships with key stakeholders. While this guide is clearly a UK document

aimed at assisting boards, the topics are useful to investors around the world in considering the effectiveness of corporate governance globally.

Board Structure, Diversity, Effectiveness and Independence:

Because governance is fundamentally about people, the key to effective governance is having the right people with the relevant skills and experience around the board table, as well as having the right board culture to enable each member to contribute effectively to boardroom debates.

This goal is easy to summarize but difficult to achieve. As we can see from many companies' annual reports on board skills and diversity, there are many more skills that boards look for internally, often more than there are members. If an issue is of high importance to the business, the usual expectation is that more than one person should have knowledge of the issue, because a board will rarely feel comfortable relying on a single perspective, especially when that person may not always be available. Plans need to be considered for the future to prepare for the departure of any members and to respond to unexpected changes (such as someone having an accident or having a conflict of interest).

Of course, a board can access specialist skills through advice from invited experts who present at meetings or provide input in other ways. One question to consider is which skills and experience are required on a regular basis and which are better accessed on an ad hoc, independent basis.

A skill set, or at least a depth of understanding, is increasingly required for every board involved in climate change. Not every board can afford to have a climate scientist, and indeed very few boards may actually want one. But all boards need to be competent in dealing with the business complexity of climate change issues, so that they can appropriately consider how to adjust their business models and investment approaches in response to the coming level of scrutiny on greenhouse gas emissions.

A company that fails to consider this is likely to underspend capital expenditure now or in the near future, investing in assets that will not have the same value in a carbon-restricted world—having a climate-competent board can help avoid these wastes. To achieve this goal, training will be necessary, for at least some directors on the board. There are increasingly courses available for them. Boards may also increasingly need to consider skills and training in other areas, such as environmental and social risk.

As well as training for directors, boards must consider the need to refresh skills and knowledge that have become outdated and have lost their practical value over time. Board needs will also change over time as its strategy evolves. The issue of board tenure and board independence is discussed below.

There are many types of diversity needed for a successful board, although the most important is diversity of thought. Other types include diversity of gender, race, age, culture, nationality, economic background and experience. Each of these can often help to bring diversity of thought. The aim is to avoid groupthink in the boardroom, which can lead to a lack of questions and challenges in meetings.

While diversity of thought is a broad concept, most diversity initiatives focus on the most visible issues: gender and race. Some markets now have quotas for female directors (notably Norway, a pioneer in this approach, and France), and most are moving towards an expectation that at least 30% of public company board members should be women. The issue of racial diversity has been actively debated in the US in recent years, and the UK's 2017 Parker Review called for at least one non-white director on every FTSE-100 board by 2021 and every FTSE-250 board by 2024.

The 2022 review update (https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/diversity/ey-what-the-parker-review-tells-us-about-boardroom-diversity.pdf) noted that 89 of the FTSE-100 companies had achieved this target by the end of 2021, and around 55% of FTSE-250 companies had also achieved the target. These initiatives also gained new momentum from the Black Lives Matter movement in 2020, offering hope for more progress in the coming months.

An effective chair ensures that each member of the board contributes, which is less visible to outsiders but is critical to board effectiveness. Investors can gain some insight into how the chair operates in the boardroom from direct conversations with the chair and other members. Often the clearest indicator is the quality of the individual board members in general. Good directors tend not to join boards that do not allow them to contribute effectively, or if they do, they leave quickly. The unfortunate consequence of all this for investors with diversified portfolios is that weak boards tend to stay weak and are difficult to improve without significant change.

Board reviews (sometimes called board reviews or self-assessments) are required by many corporate governance codes and can help boards become more effective by bringing issues to the surface. Some investors are skeptical of these reviews, as it is relatively easy for a weak board and chair to limit the impact of the review. It is difficult to determine whether a board review is effective – although it has a better chance of success if it is an external process with an independent facilitator than if it is simply an internal review. In some markets, both the performance and results of a board review will need to be disclosed, which can help investors better understand a company.

Board independence is also a key concern. The aim should be to have a board that is independent of the executive team, and that is independent of thought and can challenge both the CEO and senior management at the company (including decisions made by previous board members).

The ICGN Global Governance Principles provide a view of independence criteria; this expands and clarifies some of the criteria embedded in standards in various Codes around the world. These criteria suggest that there will be questions about the independence of an individual who:

- has been an executive director of the company or its subsidiaries, or has been an advisor to the company, and there has not been a sufficient gap between those appointments and joining the board;
- receives or has received an incentive from the company or has received additional fees in addition to the director's salary;
- has a close family relationship with any adviser, director or senior manager of the company;
- holds a cross-directorship or has significant links with other directors through involvement in other companies or entities;
- is a significant shareholder in the company, or an officer of a major shareholder, or is related to a significant shareholder, or is a nominee or official representative of a shareholder or government; and
- has been a director of the company for a sufficiently long period that their independence may be compromised/impaired.

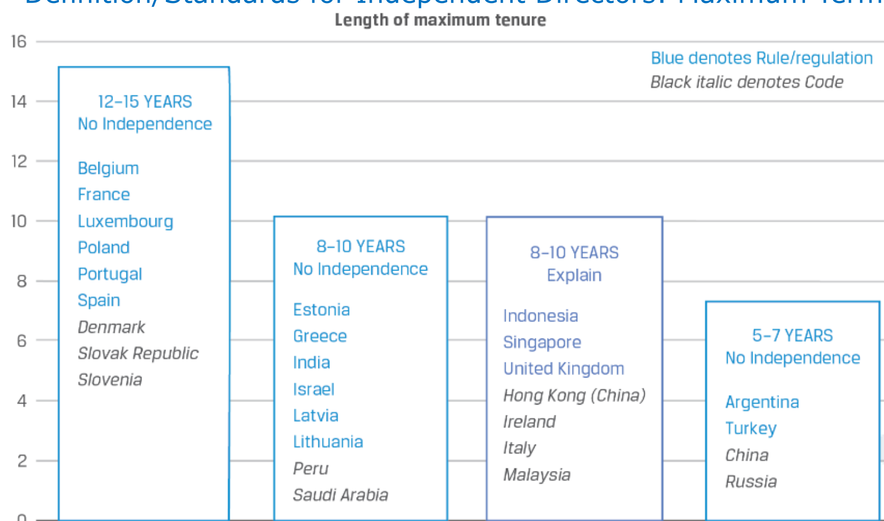
The intent here is not to suggest that boards should never include questionably independent directors. Indeed, such individuals can provide useful skills and perspectives. However, every board needs to have enough clearly independent individuals so that it can operate

independently and free from bias or undue influence. Investors recognize that independence is a state of mind and that some individuals may be completely independent despite some issues raised, and are not technically independent, while others, regardless of their appearance of independence (independent qualifications), will only support the CEO or the controlling shareholders. One of the challenges for investors is how to identify both types of individuals.

Most investors would prefer a company to acknowledge that an individual would not be considered independent (for one of the various reasons outlined above) but would still add real value to the business, rather than insisting that the individual would remain fully independent despite some obvious challenges. Similarly, how a board approaches an issue in its disclosures will determine how shareholders view it.

The issue of board tenure and independence is generally recognised globally (although it is not recognised as an issue in some major markets, most notably the United States), although different standards apply. As can be seen in the OECD Corporate Governance Factbook 2019, different markets have different expectations about how long it takes for independence to erode. Investors may often seek to adopt a single global standard, while companies may expect their local standards to be respected.

Definition/Standards for Independent Directors: Maximum Term



Green indicates Law or Regulation. Black italic indicates Code.. Source: OECD (2019).

In countries that apply the "Explain" standard, if a company wants to argue that the individual remains independent regardless of their tenure, an explanation is required, which shareholders may or may not accept.

Case Study:

Việt Nam:

According to the latest regulations in Vietnam, Circular 116/2020/TT-BTC Guiding a number of provisions on corporate governance applicable to public companies in Decree No. 155/2020/ND-CP dated December 31, 2020 of the Government detailing the implementation of a number of articles of the Securities Law:

The term of office of a member of the Board of Directors shall not exceed 05 years and may be re-elected for an unlimited number of terms. An individual may only be elected as an independent member of the Board of Directors of a company for no more than 02 consecutive terms.

A member of the Board of Directors does not necessarily have to be a shareholder of the Company [unless otherwise provided in the Company Charter.

A member of the Board of Directors of the Company may concurrently be a member of the Board of Directors of another company.

For state-owned enterprises as prescribed in Point b, Clause 1, Article 88 of the Law on Enterprises and subsidiaries of state-owned enterprises as prescribed in Clause 1, Article 88 of the Law on Enterprises, a member of the Board of Directors must not be a relative of the Director (General Director) and other managers of the company; of the manager, or the person with the authority to appoint the manager of the parent company.

The structure of the Board of Directors of a public company must ensure that at least 1/3 of the total number of members of the Board of Directors are non-executive members. The Company shall limit the number of members of the Board of Directors who concurrently hold executive positions of the Company to ensure the independence of the Board of Directors.

In the case of an unlisted public company operating under the model prescribed in Point b, Clause 1, Article 137 of the Law on Enterprises], the structure of the Board of Directors of the Company must ensure that at least 1/5 of the total number of members of the Board of Directors are independent members. In the case that the number of members of the Board of Directors of an unlisted public company operating under the above model is less than 05 people, the Company must ensure that 01 member of the Board of Directors is an independent member.

The company charter specifically stipulates the number, rights, obligations, organization and coordination of activities of independent members of the Board of Directors.

[For listed companies] The total number of independent members of the Board of Directors must ensure the following regulations:

• There must be at least 01 independent member in case the company has 03 to 05 members of the Board of Directors;

• There must be at least 02 independent members in case the company has 06 to 08 members of the Board of Directors;

• There must be at least 03 independent members in case the company has 09 to 11 members of the Board of Directors.

Independent members of the Board of Directors of a listed company must prepare an assessment report on the Board of Directors' activities.

Members of the Board of Directors as prescribed in Point b, Clause 1, Article 137 of the Law on Enterprises must meet the following standards and conditions:

• Not being a person currently working for the Company, the parent company or a subsidiary of the Company; not being a person who has worked for the Company, the parent company or a subsidiary of the Company for at least the previous 03 consecutive years;

• Not being a person who is receiving salary or remuneration from the Company, except for allowances that members of the Board of Directors are entitled to receive according to regulations;

• Not being a person whose wife or husband, biological father, adoptive father, biological mother, adoptive mother, biological child, adopted child, biological brother, biological sister,

biological sibling is a major shareholder of the Company; is a manager of the Company or a subsidiary of the Company;

• Not being a person who directly or indirectly owns at least 01% of the total number of voting shares of the Company;

• Not a person who has been a member of the Board of Directors or Supervisory Board of the Company for at least the previous 05 consecutive years, except in the case of being appointed for 02 consecutive terms;

• [Other standards and conditions according to the Company Charter].

The Chairman of the Board of Directors is elected, dismissed, or removed from among the members of the Board of Directors by the Board of Directors. The Chairman of the Board of Directors cannot concurrently be the Director (General Director).

The Board of Directors may establish a subcommittee to be in charge of development policies, personnel, salaries, internal audit, and risk management. The number of members of the subcommittee is decided by the Board of Directors, with a minimum of [03 people], including members of the Board of Directors and external members. [Independent members of the Board of Directors / non-executive members of the Board of Directors should make up the majority of the subcommittee and one of these members shall be appointed as Head of the subcommittee according to the decision of the Board of Directors.] The activities of the subcommittee must comply with the regulations of the Board of Directors. The resolution of the subcommittee shall only be effective when the majority of members attend and vote for it at the subcommittee meeting.

The Board of Directors shall appoint 01 member of the Board of Directors or hire another person to be the Director (General Director). The term of office of the Director (General Director) shall not exceed 05 years and may be reappointed for an unlimited number of terms. Regarding conflicts of interest, members of the Board of Directors of the Company must declare to the Company their related interests, including:

• Name, enterprise code, head office address, business lines of the enterprise in which they own capital contributions or shares; the ratio and time of ownership of such capital contributions or shares;

• Name, enterprise code, head office address, business lines of the enterprise in which their related persons jointly own or separately own capital contributions or shares of more than 10% of the charter capital.

The declaration specified in Clause 1 of this Article must be made within 07 working days from the date of arising of the related interests; any amendment or supplement must be notified to the Company within 07 working days from the date of the corresponding amendment or supplement.

A member of the Board of Directors who, on his/her own behalf or on behalf of another person, performs work in any form within the scope of the Company's business activities must explain the nature and content of such work to the Board of Directors and may only do so with the approval of the majority of the remaining members of the Board of Directors; if such work is performed without declaration or without the approval of the Board of Directors, all income derived from such activities shall belong to the Company.

Executive Compensation:

Pay is where the most obvious conflict of interest between boards and shareholders arises. Since (at least in public companies) investors cannot negotiate pay directly with management, shareholders need to rely on remuneration committees to do so effectively on

their behalf, and they need to trust that the non-executive directors on those committees will negotiate well and keep the interests of shareholders in mind.

However, there is a larger challenge: Directors are obligated to ensure the success of individual companies, while shareholders are, in most cases, concerned with the broader market. Therefore, while shareholders may be more concerned with the effect of rising salaries on the market as a whole (often driven by companies seeking to meet pay standards and remain competitive in terms of compensation and benefits), directors will want to ensure that the best possible candidate is appointed to their company, which may lead them to overpay certain individuals. Often, many debates about executive pay arise directly from this difference in thinking between the board and shareholders.

While salaries vary across markets, the pay structures for top executives are very similar. In summary, executive pay structures in many parts of the world fall into four categories:

- fixed salaries, typically increasing annually;
- benefits, including retirement savings (usually calculated as a percentage of salary, often at more generous levels than for regular employees);
- annual bonuses; and
- stock-based incentives (often in the form of long-term incentive plans or LTIPs).

While the size of fixed salaries and how they increase (often ahead of overall salary inflation) can be controversial, most attention has focused on the incentive variables: Bonuses and equity-related components. Bonuses are typically calculated on the basis of annual performance against metrics (often referred to as key performance indicators or KPIs) set at the beginning of the year; They are paid in cash at the end of the year – although increasingly bonuses are deferred for two or three years, often in shares that are only issued at the end of the deferral period.

KPIs for bonuses will be primarily financial metrics (usually related to profits), but typically around 20% of KPIs relate to individual performance or non-financial measures, including ESG factors. Investor expectations on this issue have changed significantly over the past few years and the prevailing view is now that at least part of compensation should be driven by such ESG metrics – typically factors that clearly align with the strategic objectives of the business.

Long-term equity-related awards typically measure performance over at least three years and are often paid in shares that must be held for a further period of time (currently the overall minimum period is five years or more). Performance for these programs is typically measured using broad financial metrics, often a combination of total shareholder return (TSR) and earnings per share (EPS).

While this may sound complicated, it is actually a significant oversimplification, as we can see by reading the many pages devoted to compensation in an annual report.

Trust, or lack thereof, has fueled debates about executive compensation. Investors see large payouts for poor performance, and corporations see shareholders voting against programs they have supported for years or have indicated they would support in the past. Companies face a variety of views from investors. Fear of a vote against board compensation proposals has led many companies to create a compromise structure, rather than one that directors are fully confident will drive value in the business. Because a compromise structure means that executives lack confidence that they can deliver what is needed to unlock the company's full potential. The conflict is likely to attract media and investor attention, and tensions between the company and its shareholders are likely to escalate.

Disputes also arise from other differences in thinking. Investors tend to seek pay outcomes that are consistent with the performance of the company they are entitled to as shareholders. They are unlikely to object to even the most generous compensation packages when share price performance is strong (although there is growing evidence that US companies in particular are testing the boundaries of shareholder indifference). Companies tend to look at performance within the business itself (viewing share price as a function of market sentiment as business performance), and boards believe they need to honor contractual obligations, paying according to the terms of incentives agreed to with executives. This situation can sometimes lead to a disconnect in expectations: rewards due under contractual incentives may seem excessive to shareholders because they do not reflect the market performance of the stock.

Overcoming these differing views is necessary, but to date no proposed alternative structure has gained enough traction among both investors and companies to become a universal solution to the problem.

Discussions about executive pay are also complicated by concerns about fairness and the extent to which CEO pay outcomes are out of step with what the average person knows, as illustrated by the disclosure of pay ratios now mandatory in some markets (notably the UK and the US). These reports compare the remuneration of a corporate CEO with that of the company’s median paid employee and reveal huge discrepancies, often in the hundreds to one. While investors will typically be sympathetic to companies that want the best leadership, growing tensions over income and wealth inequality make the question of fairness, as illustrated by pay ratios, increasingly difficult to ignore. These considerations are part of what is now driving the debate over executive pay.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!