RBC Global Asset Management

Governance in the time of COVID-19

The effects of COVID-19 have upended societies, economies, and financial markets, and reminded us in a dramatic way that the only certainty in life is change. That is why we at RBC Global Asset Management (RBC GAM) use a range of risk management tools to ensure our portfolios remain resilient through all market conditions. One of these tools is responsible investment.

By incorporating environmental, social, and governance (ESG) factors in our investment decisions, we aim to create portfolios that succeed over the long term. One ESG issue material to all our investee companies is corporate governance. We believe that companies with good governance practices are better able to manage all material issues in their businesses, including financial, environmental, and social ones. This starts with the board of directors.

In this piece, we examine the importance of effective boards of directors in the time of COVID-19. Then, we highlight some of the specific board characteristics that our investment teams analyze to mitigate risk and improve the long-term outcomes of our clients' portfolios.

COVID-19 is testing boards in all areas of responsibility

COVID-19 has already dramatically changed the way we live and work. Companies are facing crucial decisions that can significantly impact the success of their businesses and the wellness of their stakeholders. Most often, it is the board of directors that oversees and approves these decisions. It is a tremendous responsibility, as directors must act quickly and thoughtfully to lead their companies both during the crisis and through the recovery that follows.

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Risk oversight is key as new and unforeseen issues emerge

One of the primary responsibilities of the board of directors is risk oversight. Boards must understand the risks facing the companies they oversee, and they must ensure that management has implemented appropriate measures to identify, monitor, and manage those risks. For example, as a result of COVID-19, companies have had to implement their pre-pandemic business continuity plans, as physical distancing and work-from-home policies have become the norm. Companies that had invested in more comprehensive business continuity planning and technology before the pandemic may have had an advantage in managing the crisis so far. That said, the effects of COVID-19 on businesses and regulations are ever-evolving, and boards and management teams must continually review and adapt their continuity plans to reflect this.

In particular, boards may find companies exposed to new risks related to supply chain disruptions, capital allocation, liquidity, cybersecurity, and key person risk. Not to mention risks to firms' reputations if they fail to meet emerging best practices on communication and treatment of employees. Over the long term, we expect boards to take a critical look at the effectiveness of their companies' risk policies to ensure they are prepared for a wide variety of potential risk events.

Strategic opportunities may arise

As the impact of COVID-19 evolves, boards must take swift, decisive action to support management in decisions related to capital allocation, employees, suppliers, regulators, and other factors. This means managing not only the risks of the current environment, but also the opportunities. One example is increased demand for delivery services. Some online delivery companies in Asia have introduced employee sharing programs with local businesses in order to capitalize on surges in demand for delivered goods. By temporarily hiring employees from businesses with demand shortages (e.g., cinemas and restaurants), these companies are able to drive revenue growth, while local businesses retain valuable human capital and employees earn supplemental income during difficult times.[1]

Other opportunistic activity could emerge in the form of mergers and acquisitions. Firms that are financially secure may seek to buy strategic stakes in public companies with depressed share prices or strategic assets from distressed firms. Indeed, some boards may find themselves facing unsolicited offers to acquire their companies. Whether seeking to acquire or contending with an offer, boards will have to consider the best interests of the corporation and its shareholders for the long term.

Incentives may shift toward long-term business and social imperatives

Another way that the board can influence strategic decision making is through its executive compensation program. Boards aim to structure management's goals and compensation in a way that incentivizes long-term value creation and success of the business. With COVID-19 causing drastic changes to business conditions, boards may choose to adjust short-term incentives to reflect potential new priorities amidst the crisis.

Some companies are already considering redirecting funds from executive compensation and towards other business and social imperatives instead. For example, executives and board members at public companies like Disney, Marriott, and Lyft have already volunteered to donate their salaries to help pay employees.[2] In the U.S., companies that apply for government aid will be required to limit funds paid to executives as one of the conditions of accepting the coronavirus relief package.[3]

No matter how the situation evolves, boards should aim to ensure that the structure of executive compensation incentivizes management towards long-term success.

Communication with shareholders must continue

Finally, even amidst a global pandemic, there are certain boardroom activities that must continue. Audit committees, responsible for ensuring accurate accounting and reporting of companies' financial performance, must ensure that financial filings are completed on time.

This is complicated in the short term, as auditors may be limited in their ability to conduct site visits amidst physical distancing protocols. As a result, we have already seen the

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U.S. Securities and Exchange Commission (SEC) and the Canadian Securities Administrators (CSA) relax their filing deadlines by 45 days for struggling companies in the U.S. and Canada.[4] However, SEC Chairman Jay Clayton noted another key responsibility for public companies during this time: to "provide investors with insight regarding [companies'] assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable."[5]

Indeed, boards must continue to communicate with shareholders throughout the crisis. They must continue to host annual general meetings – likely through virtual channels. And they must be ready to remove any obstacles that could impede their ability to act when it matters most. Some companies, for example, may have found themselves impacted by strict travel restrictions that made it impossible to hold in-person board meetings. These boards first had to ensure that quorum could be met and decisions could be approved virtually under the legal structures of the corporation, before they could even begin to react to the effects of the pandemic itself.[6]

How boards are structured can foster better decision making

So how do investors ensure that boards can execute all of these responsibilities effectively before a crisis ever occurs? At RBC GAM, we evaluate several characteristics of board structure that we believe can foster better environments for better decision making. These are among the governance factors that our teams assess when making investment decisions and when engaging with companies, both directly and through proxy voting.

Independence. Directors have a fiduciary duty to reflect the best interests of the corporation in all decisions. To complete this duty effectively, they must not hold interests that conflict with this obligation. This includes relationships with the company's stakeholders, like major suppliers or customers, and relationships with the management team itself. We believe that a significant majority of the board should comprise independent directors and that key board committees should be 100% independent. This can foster an environment of integrity and challenge, which promotes better overall decision making for the firm.

Diversity. We believe that diversity of backgrounds and experience can help boards of directors consider more perspectives regarding potential problems and more options for potential solutions in making critical decisions. To get the most benefit, we encourage boards to reflect the characteristics of communities in which their companies operate. This includes gender, ethnicity, and cultural factors, among others. The aim is for boards to possess a range of relevant skillsets and perspectives that enable them to oversee the business in an effective manner and understand fully the risks and opportunities facing the business. A thoughtful approach to board renewal can also improve both independence and diversity of the board, as new directors can add new perspectives and skillsets while retaining the right mix of experienced directors overall.

Commitment. Serving as a director requires a significant commitment of time and effort to fulfill all the duties outlined above. While it may seem feasible for directors to serve on many boards during regular business conditions, this may not be the case during high-risk environments. Situations like COVID-19 are when directors' focus and attention are needed most. For this reason, we consider director attendance at board meetings and the number of boards on which individual directors serve in our evaluations of overall board effectiveness and when we cast our votes at annual general meetings.

Responsiveness. Finally, we examine previous decisions that companies have made to assess boards' and management's responsiveness to material risks and opportunities. As shareholders, for example, we expect boards to enact the requests of successful proxy voting proposals in a timely manner. As bondholders, we value boards and management teams that consider debtholders' interests alongside shareholders' when making decisions related to the capital structure. Ultimately, we aim to identify leadership teams that successfully execute company strategy, act with a high level of integrity and transparency, and act in the best interests of the company over the long term.

Our commitment to responsible investment is as important as ever

As the impacts of COVID-19 unfold, we continue to integrate corporate governance considerations alongside all material factors in our investment decisions. By assessing board effectiveness and encouraging investee companies to continue to improve their corporate governance practices, we strive to create portfolios that meet and exceed our clients' investment goals for the long term.

[1] Toh, M., JD.com is hiring 20,000 people who can't work because of the coronavirus, CNN Business, February 12, 2020. Retrieved from https://www.cnn.com/2020/02/12/tech/alibaba-jd-workers-china-coronavirus/index.html

[2] Brandt, L., 13 business leaders who have cut their salaries to $0 to help struggling workers as the coronavirus wreaks havoc on their industries, Business Insider, April 1, 2020. Retrieved from https://www.businessinsider.com/list-of-business-leaders-giving-up-salaries-during-the-pandemic-2020-3

[3] Tankersley, J. et al, The coronavirus economy: when Washington takes over business, New York Times, March 26, 2020. Retrieved from https://www.nytimes.com/2020/03/26/business/economy/coronavirus-relief-bill.html

[4] Canadian securities regulators to provide blanket relief for market participants due to COVID-19, Ontario Securities Commission, March 18, 2020. Retrieved from https://www.osc.gov.on.ca/en/NewsEvents_nr_20200318_csa-provide-blanket-relief-for-market-participants-covid-19.htm

[5] SEC provides conditional regulatory relief and assistance for companies affected by the coronavirus disease 2019 (COVID-19), U.S. Securities and Exchange Commission, March 4, 2020. Retrieved from https://www.sec.gov/news/press-release/2020-53

[6] COVID-19: Taking board decisions without meeting, McCann Fitzgerald, March 13, 2020. Retrieved from https://www.mccannfitzgerald.com/knowledge/corporate-advisory-and-governance/covid-19-taking-board-decisions-without-meeting

For more information, see our Approach to Responsible Investment.

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