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ESG ARTICLES

ESG Implications for Corporate Governance

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A trend has grown during the past few years in investors from the international financial sector, ranging from big investment funds and institutional investors to individual investors (retail investors). This trend is to invest not only in companies that have stable and competitive finances, but also in those that fulfill criteria of sustainable and responsible operations. These aspects have been focused mainly on three big matters: the Environmental, the Social and the Governance (ESG as an acronym). Thus, the investors choose companies that are considered as pillars of the ESG because these serve to value their legal, regulatory and reputational risk.[1]

Our main focus in this article is the governance criteria, which refers to the proper handling of the management and direction of the companies to ensure they are managed in the benefit of the shareholders and other stakeholders.

In Mexico, private business associations and public entities have undertaken important efforts to promote the implementation of sound governance practices. The Mexican Business Coordinating Board (*Consejo Coordinador Empresarial*) has published and repeatedly updated a *Better Practices in Corporate Governance Code*, which contains several principles and rules that can be adopted by companies and used as reference in this field. Such code had great influence in the Stock Market Law (*Ley del Mercado de Valores* in Spanish) (2005) (**LMV**), which provides obligatory guidelines in governance matters for stock market companies (*sociedades anónimas bursátiles* in Spanish) (**SAB**) and investment promotion companies (*sociedades anónimas promotoras de inversion* in Spanish) (**SAPI**) that decide to adopt the management regime of the SABs.

The Article 24 of the LMV is an example of the foregoing, which provides that the Board of Directors of the SABs must be comprised by at least 25% of independent directors. Another example is the creation of committees that help companies in audit matters, captured as an obligation in the LMV for the SABs. Both practices strengthen the governance of the companies seeking criteria of institutionalization and management.

The international governance standards of ESG provide very strict criteria under which the companies must rule their behavior in benefit of their shareholders and other stakeholders. Among the indexes that are used to determine the degree of fulfilment of companies with ESG criteria and that the investors evaluate are the following:

- Composition of the management bodies, taking several aspects into consideration, such as diversity and preparation, as well as independence of certain members;

1 Amel-Zadeh, Amir, and George Serafeim, *Why and How Investors Use ESG Information: Evidence from a Global Survey*, Harvard Business School Working Paper, No. 17-079, February 2017, http://nrs.harvard.edu/urn-3:HUL.InstRepos:30838135

- Clear and effective compensation parameters for the members of the management bodies;
- Implementation of codes of conduct for directors and suppliers;
- Use of proper risk management methods;
- Integration of sustainability and social responsibility policies in the supply chain;[2]
- Handling of clear and objective policies for the contracting of suppliers; and
- Use of external auditors to verify the financial information and significant specific risks for the company's activities (*i.e.*, money laundering prevention, IT security and data privacy).

Currently, the Mexican law allows companies (including the anonymous companies and the limited liability companies) to have *autoregulation*, that is, to adopt and incorporate into their bylaws and other internal regulations the governance criteria that they deem convenient, including the responsibilities, compensation for fulfilment and consequences for breach by their directors. Such parameters may be agreed by the shareholders at the time of their incorporation in their company bylaws, as well as later through shareholders' meeting resolutions.

The implementation of governance criteria under the ESG framework implies multiple benefits for the companies that do so. To name a few, it grants greater investment opportunities in certain financing schemes that consider following these policies a requirement; it impacts positively on their reputation, thus, it encourages a close and fruitful relationship with their shareholders, directors, and other stakeholders, who feel safe with the management; it generates greater competitive advantages considering the way the decisions are taken; and it helps reaching an institutionalization, through internal controls in the decision making, that allows a better and more efficient handling of their governmental bodies, conflicts of interest and risk management.

Due to the foregoing, even though the current regulation of the governance matter in Mexico is limited, a clear trend and genuine commitment exists in companies to adopt policies in such matter additional to the ones provided in the Mexican law.

2 K. Tang, *Exploring the G in ESG: Governance in Greater Detail – Part 1*, S&P Global, March 22, 2019, https://www.spglobal.com/en/research-insights/articles/exploring-the-g-in-esg-governance-in-greater-detail-part-i

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