Corporate Governance Update

AIG Corporate Governance Seminar 2017, London 26th April

AIG's 20th Corporate Governance seminar hosted in London was well-timed, coming soon after the UK government's proposed Green Paper on Corporate Governance was introduced. This and a combination of compelling content and quality speakers meant the event was a resounding success.

As keynote speaker, ITV Political Editor **Robert Peston** engaged delegates in a thought-provoking presentation entitled The Age of Uncertainty, which examined some of the current and future economic and political risks facing companies and their boards.

Top of the bill was a panel discussion: Are we at another watershed? Panellists explored the political and economic context for UK corporate governance reform and the resulting priority issues and opportunities for company boards.

Lord Tim Clement-Jones moderated the animated discussion with panellists **Josh Hardie**, CBI Deputy Director-General; **Lord Daniel Finkelstein**, Associate Editor of The Times; **Miles Celic**, CEO, TheCityUK; and **Anthony Hope**, Chairman and Non-Executive Director, AIG Europe Limited.

The second session featured a specialist panel of cyber security experts, including **Mark Camillo**, AIG Head of Cyber, EMEA; and moderated by UK Cyber leader **Christopher Burgess**, who provided an overview of the current exposures for companies and offered practical advice on building an effective risk man ment framework.

Later, delegates also heard from two more AIG speakers: **Noona Barlow** on emerging trends in D&O claims, and **Brian Botkin** on multinational programmes.

Corporate Governance Green Paper Presents Opportunity for Businesses to Rehabilitate Their Reputations

The headline panel at this year's recent annual AIG Corporate Governance conference in London posed the question: Are we at another watershed? Moderated by Lord Tim Clement-Jones, the panellists explored the political and economic context for UK corporate governance reform and the resulting priority issues and opportunities for company boards.

In the face of a rise in anti-globalisation and anti-business sentiment, as evidenced by the Brexit vote, the Government has demonstrated its commitment to address these concerns with the introduction of the Corporate Governance Green Paper. The panellists noted that this underswell of popular sentiment has been based on the reality of a widening gap between the rich and the poor in the UK. The share of national income going to workers has diminished while executive pay over the past two decades has grown much faster than general pay. This has also coincided with the reduced power of the unions.

With this background in mind, the panellists noted that the introduction of the Corporate Governance Green Paper sees the Government tackling these issues head-on from the Conservative ideological perspective. Rather than strengthening the power of the unions, the Government is looking to address the way that business conducts itself.

In terms of the components of the proposed reform, the panellists highlighted the provision to strengthen shareholder voting rights on executive pay with certain elements in the pay package subject to a binding vote. The proposed reforms would strengthen the role of the remuneration committee and improve the effectiveness of long term pay incentives, ensuring executive pay is seen to be more closely aligned to company performance.

The proposed reform also seeks to increase stakeholder voice (employees, customers and suppliers) in the Boardroom with the introduction of advisory panels which, according to the panellists, would be a relatively radical reform of current company law.

Board composition was another closely examined topic, with panellists agreeing that it was critical to have the correct balance of independent and non-executive directors to reflect and balance the interests of all the company's stakeholders. Diversity of background and expertise in Board composition, particularly cyber expertise, was also noted by panellists as increasingly essential for best practice corporate governance.

The third major area of reform noted by the panel was the proposed enhanced standards of corporate governance for larger privately owned companies, which would hold them accountable to the same level as publicly listed businesses. This reform can in part be seen as the Government responding to the public backlash that followed the collapse of BHS, which left many without jobs and facing an uncertain future.

In terms of the evolution of the Green Paper, the panel predicted it would be influenced by a strong debate during the election around the role and value of business and evolve into a White Paper in due course. Post the election, panellists believed it was likely, with an anticipated strong Conservative majority, that corporate governance would form a key component of the Government's agenda.

Looking at the implications of the Government's corporate governance reform agenda for UK businesses, panellists believed it was strongly in businesses' interest to genuinely engage in the reform process.

As one panellist noted, "The UK has some of the best corporate governance standards in the world which is a competitive advantage for the UK."

In this sense, the proposed reforms could well help UK businesses to not only rehabilitate their reputation at home, but also bolster their global competitive advantage.

Panellists included: Josh Hardie, CBI Deputy Director-General; Lord Daniel Finklestein, Associate Editor of The Times; Miles Celic, CEO TheCityUK and Anthony Hope, Chairman and Non-Executive Director AIG Europe Ltd.

U.K. Corporate Governance Reform

Rather like London buses, a decade can pass without significant reform of corporate governance, then a plethora of proposals and consultations arrive at once. It is not a coincidence that this renewed focus on corporate governance has emerged at the same time as Theresa May's accession to the office of Prime Minister, with her stated aim of - in the Prime Minister's words - building "an economy that works for everyone, not just the privileged few".

Background

In November 2016 the UK Government published a Green Paper on corporate governance reform in order to stimulate debate on ways of improving the UK's corporate governance framework. This was followed in February 2017 by the Financial Reporting Council's ("FRC") announcement that it intends to review the UK Corporate Governance Code and in April 2017 by the Business, Energy and Industrial Strategy Committee's ("BEIS") report on its inquiry into corporate governance (the "BEIS Report").

The Green Paper addressed three areas of corporate governance: executive pay, stakeholder voice and corporate governance in large privately-owned businesses. The Government asked business and other stakeholders to comment on a range of options for strengthening the existing regulatory framework around executive compensation and the responsibility of management to identify and engage with stakeholders. In addition, it also asked for views in relation to the possibility of an extended corporate governance regime that could apply beyond the traditional limits of public quoted companies into the arena of large privately-owned businesses.

Similarly, the BEIS Report also separately considered whether the corporate governance framework in the UK is fit for purpose and looked at a range of options regarding the promotion of good governance, remuneration and board composition.

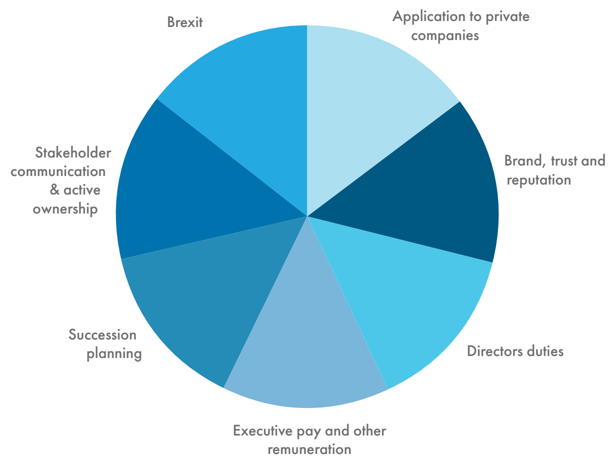
The fact sheet accompanying this article describes the issues on which the Government has sought views.

Commentary

It is clear that this is a watershed moment for debate on corporate governance, although it is not yet evident whether the proposals and consultations will translate into legislation and, if so, to what extent headline grabbing proposals will be watered down.

The Green Paper is largely a reaction to areas of contemporary public concern, perhaps in the light of the BHS pensions controversy. Despite its title (which suggests a reform of the entire UK corporate governance regime), its scope is quite narrow. It does not attempt to engage with the other strands of corporate governance - such as brand, trust & reputation and management succession planning - that also contribute to the success of a company and which together drive the creation and maintenance of long-term value within companies over the long term. Below is a chart that shows all of the facets of corporate governance. The areas addressed by the Green Paper are shown in green, highlighting its limited focus.

Components of corporate governance



In addition, the Green Paper only addresses the specific issues of executive pay and stakeholder representation through the prism of shareholder and public reaction, rather than taking the wider brief of identifying those changes that would increase the value of companies. In a similar vein, the BEIS Report, while set in a more general context. focuses particularly on pay and board composition. Both the Green Paper and the BEIS Report are, therefore, focussed on "input specifications" in the abstract. Whilst there is nothing wrong with this approach, it alone is unlikely to achieve grass root change and may risk engendering a tick box culture. If there is to be a genuine debate about governance being linked to national prosperity for the many and not just the few, then the Government ought to consider a more holistic approach to corporate governance, focussed on the "output specification" of long-term value creation in a risk adjusted environment. That will involve creating a balance of entrepreneurial flair and commercial prudence and is likely to be effective only with a culture of genuine transparency and accountability.

These wider themes were discussed by the panellists and speakers at the AIG Corporate Governance Conference held on 26 April 2017, both from the standpoint of what measures would work and also from a broader political and economic perspective. Lord Finkelstein observed that the Prime Minister's personal focus on corporate governance is a means of showing that the current Government is not just on the side of the wealthy. Josh Hardie, Deputy Director General of the CBI, noted that we are experiencing a time of significant change due to Brexit, technological developments and the debate on the functioning of the economic system. He noted that corporate governance will have an important role in facilitating trust between business, government and society during this time of change. Hardie went on to state that the financial crisis and other misdemeanours of the few have created a disconnect between business and society, but improvements would only occur by "getting to the heart of the problem", rather than mandating piecemeal measures. This view was echoed by Miles Celic, chief executive office of TheCityUK, who noted that whilst mechanistic measures could facilitate some change, more innovative and creative thinking would be required to foster cultural change, particularly around diversity.

As touched on by the panellists, corporate governance should be about the creation of sustainable value - not purely a short term reinforcement of share price or quarterly earnings. It must engender a culture of continual improvement, which was noted in particular by Anthony P. Hope, the chairman and a non-executive director of AIG Europe Limited. Although the considerations relating to remuneration and stakeholder engagement articulated in the Green Paper and the BEIS Report are relevant and important, the Government risks giving disproportionate emphasis to those aspects at the expense of other key components of a well governed organisation. The overriding objective for any for profit business must be to ensure that it is fit for the future and capable of generating long term value. In that regard we have only to look at the priority given to these issues by some of the world's largest commercial companies: see for example the comments made in March 2017 by the CEO of Shell regarding diminishing global appetite for fossil fuels over the next 10 years[1]. The thinking on the corporate governance of large private companies is more interesting and innovative: if we accept that proposition that there is such a thing as inherently "good" corporate governance there is no reason to suppose that it is "good" only for publicly traded businesses. It may well lead to a suitably adapted code of corporate governance for privately held companies, whether voluntary or not - and perhaps all the better for it.

A different approach would be for the debate on corporate governance to consider practical examples of good and bad output behaviour. An obvious example of bad outputs is BHS. Whilst BEIS has conducted an enquiry into the corporate governance failures that led to the collapse of BHS, this has not yet translated into wider practical guidance. It remains to be seen whether this will form part of any eventual corporate governance code applicable to larger privately-held businesses. In contrast, an example of good outputs that engender fundamental cultural change is illustrated by Siemens. Following a $1.6bn settlement with American and European authorities in 2008 for a bribery and corruption scandal, a new general counsel was brought in to clean up the corporate culture at Siemens. A full amnesty was offered to any employee who admitted engaging in corrupt practices. Those who

[1] The Independent, 10 March 2017.

rejected the amnesty but were subsequently found to have been involved were dismissed. This formed a key measure of turning around the culture at the business, which now operates on the principle that clean business is good business.

The Siemens example reminds us that corporate governance considerations are international: the importance of good corporate governance applies equally to all companies on a global basis. Although an appendix to the Green Paper does look at good examples of executive pay reform in Australia, Belgium, France, the Netherlands, Switzerland and the United States, the Government could also seek to broaden the scope of its review to consider instances of effective governance in other jurisdictions more generally.

Some of these more internationally applicable facets of corporate governance were considered at the AIG Corporate Governance Conference, with a particular focus on the potential risks associated with failures of corporate governance: Noona Barlow, Head of Liabilities and Financial Lines Claims for AIG, noted the changing landscape of collective shareholder action, which has changed from once being a largely US phenomenon to the position now where 60% of claims occur outside of the US. Ms. Barlow also talked about the global trend towards litigation funding, which is encouraging claims from claimants who would not otherwise have been able to pursue proceedings. Another global risk that has the potential to affect all companies is cyber risk, which was considered both by Ms. Barlow in the context of directors & officers insurance claims and also by a separate panel that discussed how boards and companies can develop cyber perils resistance. Several members of the panel noted that they are often surprised by the number of companies they encounter who do not have a specific cyber resilience strategy: this is clearly an issue which needs to be put at the forefront of the board agenda. Finally, Brian Botkin, Global Head of Multinational Financial Lines at AIG, focussed on the importance for directors of groups that operate in multiple jurisdictions to identify gaps in insurance coverage, which may be affected by local laws (such as non-admitted insurance) and coverage issues, as well as local tax considerations.

Next steps

Given the current political uncertainty in the UK following the general election on 8 June, it remains to be seen how the main political parties intend to address corporate governance issues in the near to medium future. At the AIG Corporate Governance Conference, Lord Finkelstein noted that he did not expect a significant amount of further detail on corporate governance in the Conservative party's manifesto, so it is likely that we will need to await a White Paper later in the year for the new Government's proposals. We can also expect the FRC's proposed amendments to the UK Corporate Governance Code, which will likely take into account the Green Paper and BEIS Report proposals in some measure. This, coupled with the developing issue of Brexit planning impacting on directors' duties, will ensure that corporate governance reform is likely to stay on the political agenda for the foreseeable future.

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Cyber Resilience – a Key Priority for Boards

At the recent annual AIG Corporate Governance conference in London, a specialist panel of cyber security experts provided an overview of the current exposures for companies and offered practical advice on an effective risk management framework. Christopher Burgess, UK Cyber Leader at AIG, led the panel discussion.

While the digital revolution brings exciting opportunities for business, it also brings new risks. Boards are under growing pressure to develop and implement cyber resilience strategies that embed the right governance and processes into their business to understand and minimise cyber risk.

In light of the global increase in cyber crime and the growing likelihood of class actions against company directors for cyber breaches in the UK, along with the pending implementation of the General Data Protection Regulation in May 2018 (making it mandatory for companies to disclose data breaches), the panellists emphasised the importance of Boards taking a robust approach to cyber security management and risk assessment.

Rather than a box ticking exercise at Board level, companies should set up cyber risk working groups. The Board would have responsibility for actively overseeing and assessing whether the business is actively engaging with those groups. All potential cyber risk exposures should be mapped out and catalogued against all aspects of operations, to ensure that the Board has sufficient information to make an informed decision about the company's exposure.

Once this has been completed, Boards need to consistently question whether their risk policies are up to date and to closely examine whether they conflict with other aspects of the business to ensure they are workable. As part of this process, company culture and behaviours should be taken into account to ensure that risk practices are realistic and effective. Panellists highlighted that the majority of successful cyber attacks occur because employees did not identify the early warning signs, demonstrating that effective risk management practices need to be regularly monitored and enforced.

Cross-functional cyber teams with cross-functional reporting lines were also recommended as essential to ensuring that cyber security risk management was active within the company culture. As cyber risks continue to evolve, beyond those that can be considered purely operational to those whose severity can threaten the very existence of a company, this has never been more important. Historically, businesses have tended to focus on the financial risks of cyber crime, from both a first and third party perspective. However, cyber events are shifting to pose a physical threat too. Companies need to be aware of the threat from a cyber breach with the potential to cause physical injury to people or damage to property.

However, with a robust cyber security framework embedded in the business and with effective oversight of the Board, the panel experts agreed that cyber security risks could be anticipated, identified and avoided with more certainty and effectiveness.

Panellists included: Mark Camillo, Head of Cyber EMEA AIG; Jonathan Ball, Partner Norton Rose Fulbright; Oisin Fouere, Managing Director London K2 Intelligence; John Ludlow, Non-Executive Director at IRM and AIRMIC.

Emerging trends in D&O

Noona Barlow was a keynote speaker at AIG's recent Corporate Governance Seminar in London where she shared her insights on developments in the Directors and Officers (D&O) market.

Scrutiny of company boards is getting more intense. Last year AIG Europe's D&O claims were up against a backdrop of increasing defence costs and a rise in regulatory investigations. In addition, we have started to see claims increasingly being brought in multiple jurisdictions; in recent years, more than a third of large claims were brought outside the company's home country, illustrating the continuing impact of greater global connectedness.

Regional differences

However, boards are dealing with a different set of issues depending onwhere they sit. For example, in a recent study we did of our large losses, the EU saw a third of claims resulting from bankruptcy, compared to the UK, where the key drivers were regulatory and investor action.

In addition, in the US, the level of class actions is at its highest level ever, with companies in the pharmaceutical industry particularly in the firing lineas are foreign-owned companies, which accounted for 22% of class actions in the US last year, a significant number when you consider that only 13% of companies listed in the US are foreign-owned.

However, in another interesting development, a recent AIG study revealed that 60% of the class actions we have dealt with in our European offices were actually brought outside of the US. The number of cases being brought in Europe is rising steadily and there are a number of reasons for this shift. For example, the Morrison decision has made the US unless viable option for class actions while the RBS settlement is an example of a successful class action settlement in the EU, highlighting the maturing of class-action frameworks within Europe.

Changing regulation

Regulatory developments may serve to further widen the disconnection between the EU and the US in the next few years. Since the global financial crisis, there's been a big focus on corporate governance, pay and board composition in the EU. We have seen the publication of the UK Government's Green Paper on Corporate Governance Reform while the European Shareholders' Rights Directive is expected to come into force in 2018.

In contrast, in the US, the Trump administration seems to be moving in the opposite direction, towards less stringent corporate governance. President Trump recently described the Foreign Corrupt Practices Act – a key weapon America's fight against international business bribes and corporate favours – as "a horrible law". (is this correct? I have only seen references to him calling it stupid) Meanwhile, Trump has repeatedly promised to dismantle the Dodd-Frank Act, a set of financial industry regulations Congress enacted after the 2008 financial crisis, claiming it is holding back lending and tying up business in red tape.

Cyber risk

Irrespective of where a company is located, the cyber threat is a common issue that has moved rapidly up the boardroom agenda. Rightly so – cyber claims were up to 212 in 2016 from just two in 2013. The majority of these incidents – around 70% – are driven by 'bad actors' rather than employee negligence. However, in many cases these bad actors gain access to a company's systems via human frailty, such as people clicking on a phishing email. This means that raising awareness of the different types of threat and cyber training across the company is an imperative.

However, there is a difference between being aware and actually being ready to do something about it. Somewhat worryingly, according to AIG research, 73% of executives believe that the arrival of the 4th Industrial Revolution is increasing the level of cyber risk but only 40% have changed the cyber protection in the last two years.

The good news is that we are seeing a real difference between what happens to those clients who are ready for a cyber event and those who are not. Those who are prepared can move very quickly, drawing on IT forensics and legal services to resolve the issue, notify their clients and get back to business-as-usual as soon as possible. Most cyber claims we deal with are now resolved within 48 to 72 hours.

Crystal ball gazing

Looking forward, cyber will continue to be a key threat. In the last few years there have been a several cases brought against directors following cyber breaches that have been dismissed for a number of reasons, including the ability of companies to prove that their directors and officers had done enough to prepare and defend against cyber threats. However, this may not be always the case. Yahoo! for example is under investigation due to the non-disclosure of two significant cyber breaches in 2014 and many observers will be watching the outcome of this case with interest as it may signal more to come.

Elsewhere, climate change is moving up the agenda. In the US, Exxon Mobil is under investigation for violating consumer protection and securities laws by downplaying the risks of manmade climate change. Meanwhile, the Securities and Exchange Commission is looking at disclosure in the oil and gas industry.

Finally, Brexit is probably the biggest 'known-unknown' for company boards. Nobody clearly knows what the final agreement will look like, but companies should prepare for all scenarios. This will be costly and time-consuming and is a huge distraction for both government and businesses. But, at the end of the day, there is a very real risk that at some point in the future, directors and officers may be held accountable for not doing enough – or, indeed, potentially for doing too much – to prepare for life outside the EU.