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FOREWORD

Corporate governance is about achieving long-term sustainable value while being accountable to the owners and other key stakeholders. For a corporate governance framework to be effective, the organization’s leadership values and principles must be reflected in day-to-day activities and executive behavior. This is where the new governance focus on corporate culture comes in.

While “corporate culture” or “organizational culture” can be defined in a number of different ways, it is essentially about behavior. Culture is less about what an organization does but more about how it does it. Important drivers include the tone from the top, incentive structures, corporate codes of behavior, recruitment policies, and promotion practices.

In the wake of the banking crisis and other corporate scandals, it is increasingly recognized that learning to understand and shape the drivers of behavior is a key issue for companies, boards, owners and regulators. Corporate culture is closely linked with all aspects of a company, ranging from risk to strategy, from compliance to sustainability. Yet, culture is a not an easy topic to discuss and it does not often receive the emphasis it requires inside board rooms.

Thus this issue of the Hawkamah Journal is focused on the theme of corporate culture. We are pleased to feature an interview with Sir David Walker on topic as well as a number of authors exploring culture from various angles, from the regulatory perspective to the role of the internal audit. It is clear that corporate culture is a key ingredient in good corporate governance.

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WE ACCELERATE

At Dubai Chamber, we cut through all the red tape by making importing and exporting goods a more streamlined operation. With ATA Carnet goods can be imported duty-free and tax-free for up to a year. And all applications for Certificates of Origin can now be completed quickly and efficiently through our online service. It’s not rocket science, simply the business of making business simple. To find out more about all our services, visit dubalchamber.com
Sir David Walker is a global leader in corporate governance. Currently Chairman of Winton Capital, he has been Chairman of Barclays, Chairman of Morgan Stanley international and an executive Director of the Bank of England. In 2009, he undertook a review of corporate governance for the British Government as part of its response to the global financial crisis. This led him to place greater emphasis on the question of corporate culture. He talks to Peter Montagnon.

What did you learn most from your review into banks?

If you go back ten years, if you talked about behaviour in companies, I thought that was all psychological soft stuff. I just wanted to focus on the business. When I did the governance exercise on banks, it was a tremendous learning process. What I learned most in doing my bank governance review – and a lot of this is the same for other major corporates – was about the importance of behavioural patterns. It’s the job of the chairman to provide space for, time for challenge and to expect challenge in the boardroom and to get rid of non-executives who are not capable of it. The behavioural stuff is absolutely critical.
So this is different from compliance with rules.

It’s the hard-soft paradox. If you are a financial institution - or if you’re a pharmaceutical company - you are obliged to conform to what they call black letter legislation or regulation. You are required to have cert 12% capital, 5% leverage, so much liquidity; you are required to subject your new drug to trials. The same goes for energy companies or anybody else.

Those regulatory requirements are black letter. You can tick a box at a point in time and say “yes” we have got this ratio, we have done this test, this pre-clinical trial. So you tick a box. You have to put resource into it, or you may have to build up your capital and sell subsidiaries to do so. But you get there. These hard requirements, the black letter stuff, are easy. It’s a soft task.

The soft expectations which are behavioural are hard to deliver. I find that paradox quite helpful because you can have a finance director ticking the boxes on capital and liquidity but the behavioural stuff is not tractable in that way at all. One of the early problems is measurement. How do you calibrate? How do you know what you yourself are doing?

Is the ability of people to speak up a good indicator?

I do think it’s important to note the difference between whistle-blowing and speak-up. One is much more important than the other. One is more relevant as an indicator of the state of health of the company than the other. Speak up is more important. Whistle blowing is what you have to resort to when someone is apprehensive and isn’t ready to speak up. Speak up is something that happens openly. That actually is really the thing to commend.

So you need an atmosphere where people aren’t afraid to speak their mind, and the board has to stand behind that?

Absolutely. The board’s responsibility to identify, recruit and mentor the chief executive is a sacred trust. If you get it wrong, you damage the company for several years. If you get it right it can be magical. If a chief executive is autocratic and controlling, you won’t get the atmosphere in which there is openness. A chief executive who is successful probably should not be there for more than a finite period, say four to six years. The proposition is that openness and the ability to speak up becomes much more difficult, the more successful the chief executive is. However concerned he is to have an atmosphere of openness.

So that’s very important part of getting the culture right.

Absolutely. I mean the ability to challenge, and I think there are three layers to this. It’s very hard for people to challenge from below, if you’ve got a very successful boss, if he’s created a track record of achievement, quarter after quarter. Secondly, it’s very hard for his “peer group”, I mean the executive committee, to challenge for the same reason, and ditto for the board. Why should the board worry, if they’ve got someone who’s producing good profits each quarter? The most serious risk in a good CEO is they cease to challenge themselves and start to believe in their own capacity. There is a loss of self doubt.

On the other hand the key requirement in a chief executive is to have the confidence to make decisions.

By definition, a successful chief executive, for precisely those reasons, has got to have a thick hide, has got to be able to sleep at night. Now that sleeping at night means you don’t worry about someone you’re controlling or who daren’t speak up. As time goes on you get more and more confident. The skin gets thicker and you become a liability.

So succession planning is vital to culture?

I’m very clear that the chairman’s responsibility is to ensure that there is a choice and that we’ve got internal as well as external candidates.
Isn’t this different in family-owned businesses such as you often find in the Gulf region?

The key thing even for a family business is that they have to think about succession planning.

Maybe chief executives in family business stay for longer, say about eight or ten or 12 years rather than five or six or seven years in other companies. But succession planning is still very important. The more successful the business, the less people think about succession planning. People say: things are going well, what are you worrying about that for?

Isn’t this a problem also with institutional shareholders? They don’t worry when the business is performing?

That’s just myopia. They need to remember sustainability, but the board is responsible.

How does this fit into regulation and supervision?

The bottom line from the regulators is that they know how important this is and how little they can contribute to it. They’re very enthusiastic that others like the Banking Standards Board (a UK organisation founded and paid for by the banks to promote high standards of behaviour in the sector) should do as much as possible.

Yet don’t they need to find out about the culture and use that as a risk measurement?

I’d go a bit further and say they are privy to the cultures of all the banks they regulate. And they’ll be aware of different methods of calibration, different frequencies of measurement, so they are channels for communicating best practice and should work closely with organisations like the Banking Standards Board, which I think they are now starting to do.

Can regulators or shareholders do much about culture from outside?

If you’re the regulator, you might become unhappy about behaviours in a particular bank. Yet you’re not sure. You have no evidence that this involves breaches of unambiguous black letter rules. So there’s no criminality, no evidence of the rules being breached, but you just think that the culture is a bit “high, wide and handsome” and there are a lot of complaints. Then you are absolutely empowered to talk to the chairman or chief executive about it and draw it to the attention of the board.

It’s like speak up. There should be a relationship between the bank and the regulator which permits speak up. The trouble in the past was that the regulator would be all over you and send in enforcement teams. What’s needed is a relationship of trust. Just as you need to build a relationship of trust, of trustworthiness in the eyes of your customers, that needs to be a part of the mutual relationship between regulator and regulated. The regulator comes to consult you about what he’s proposing to do and you feel you can openly talk to the regulator about problems without being locked up instantly. The regulators have a responsibility to be trusted.

Here we are talking about a no blame culture, aren’t we?

The danger is in some respects we’re going the other way. You and I might think that it’s appropriate for senior executives in a bank to have specific accountability for what happens on their watch. It’s very important that that doesn’t lead to precisely the opposite – to concealment for fear of what could happen. It’s very important to strike the right balance. This is far beyond financial performance.

So is culture the new challenge for governance, and has governance hitherto been too limited to board processes?

A great deal of work was done by Adrian Cadbury (founder of the UK Governance Code) on board processes. We made a lot of progress on corporate
governance. Then you move from the hard stuff – process – to the soft behavioural stuff. This is now on every board’s agenda. They may not be doing enough. They’ve all got the diagnosis. They’ve probably not got the prescription.

I think the problem is where the shareholders are. I’m a chairman and I want to get all this stuff right. But my shareholders aren’t interested. All they want is for me to go on delivering improved EPS or TSR or better quarterly earnings. I think there is a need for more to be done in this space. Beefing up the sensitivities of stewardship to cover this sort of stuff as well as financial performance is the next priority. I don’t believe and never have in the efficient markets theory. If you have a doubt about this, think about the 2008 shock. Crisis will happen again and, every time it happens, the public attitude to big business and market capitalism will take a further knock.

Unless asset owners – the long term shareholders like pension funds and sovereign wealth funds - recognise this point and the importance of putting the emphasis on what’s sustainable rather than just on what’s good this quarter, the problem will get worse, not better.

Do companies focus too much on short term earnings?

We made great progress with the repeal in the UK of the requirement for quarterly reporting. But not many companies have dropped it.

Isn’t it a good signal that that’s been repealed?

Yes but the government hasn’t made enough of it. They should say they are doing this to support a reorientation towards long term horizons, and say they’re getting out of companies’ way, removing a perverse incentive.

What about takeovers and their impact on culture?

A poorly implemented takeover will be catastrophic. Culture is usually the most prominent of the issues. The successful takeover requires much more attention and diligence to cultural issues than it ever gets. There is a lot of research to be done on why takeovers didn’t deliver shareholder value on a sustainable basis. The truth of the matter is that most of them didn’t.

It seems from what you’re saying that a recurring theme is trust.

You could have the best Harvard Business School recommended business structure, and it won’t work if there isn’t trust among the senior people. If you do have trust among the senior people, the organisation’s structure doesn’t matter all that much. Take a global financial organisation or a pharmaceutical company or an energy company. You could have a head office in London or New York and you could have a spectrum of whether you have a lot of autonomy in the region or hub and spoke from the centre. Which is right? My answer is neither. The challenge is to find somewhere in the spectrum and the criterion is the relationship of trust among the senior people.
Poor corporate culture has been highlighted as a primary factor in the destruction of trust in business. Companies with a strong cultural seam, linked to purpose and strategy, will stand out. At the Financial Reporting Council, we believe that embedding a healthy corporate culture is vital to the long-term success of business, and this is why we are focused on highlighting good practice through the work of the Culture Coalition.

The FRC’s mission is to promote high quality corporate governance and reporting to foster investment. It seeks to maintain an effective regulatory framework for corporate governance and reporting in the public interest; one that supports the needs of investors and supports boards and the professions in meeting the necessary high standards. Overall, we measure success by the impact we make, not by our level of activity.

At the FRC we are clear that regulation comes in many forms and needs to be fit for purpose in order to achieve the desired outcomes. When it comes to corporate governance, the principles of good practice apply across the board.
High standards of corporate governance and reporting are important for the fair and effective functioning of the capital markets. They benefit investors, companies and the wider public interest. The FRC is responsible for maintaining codes and standards of corporate governance, investor engagement, corporate reporting, audit and other forms of assurance, and for actuarial information. We monitor compliance with corporate reporting and auditing standards. We oversee the accountancy and actuarial professional bodies in their regulatory roles; and we operate independent disciplinary schemes for accountants and actuaries. Our Financial Reporting Lab helps companies and investors collaborate on improvements to reporting.

Ultimately it is for boards, preparers, auditors and other professionals to implement the standards we set; our role is to support them as far as possible by reinforcing best practice and providing a regulatory framework that is seen as realistic and helpful. This is why over the next three years, we intend to work with our stakeholders to encourage and nurture improvement rather than introducing new requirements that add to the regulatory burden.

And one of the ways we intend to do this is by promoting a healthy corporate culture.

Over the past decade we have seen examples of what a good company culture can do and what a poor culture can lead to. The FRC understands that addressing behavioural issues and embarking on cultural change in a company is not an easy task. However, we believe that there are strong links between governance and establishing a culture that supports long-term success. For business to prosper, we need to get corporate culture right at all levels to create trust in business, reduce company failings as a result of poor behaviour and serve the needs of wider society.

Codes put forward principles for good practice that make bad behaviour less likely to occur; and public reporting can make it harder to conceal such behaviour. But, by itself, that does not prevent inappropriate behaviour, strategies or decisions. Only the people, particularly the leaders within a business can do that.

In order to establish the appropriate culture, a board must define the purpose of the company, define the value it wants to be known for and the type of behaviours it expects within the company, in order to deliver its business strategy. This involves asking questions and making choices: how to align values and purpose to the company’s strategy; how to select new leaders and integrate them into the company culture, particularly at times of merger or acquisition; how to maintain culture under pressure; how to decide whether different parts of the business should operate different cultures, and how actively to communicate culture to shareholders in order for them to engage in constructive discussion. In order to do all this, the board must not just ensure that they pay attention to the findings of internal audits, but that they ensure sufficient internal audit arrangements are in place, and, like the FRC expects of external auditors, that they employ professional scepticism where necessary.

Our Culture Coalition is a collaborative effort with the IIA (Chartered Institute of Internal Auditors), CIPD (Chartered Institute of Personnel and Development) and others to improve governance and promote ethical conduct within businesses.
The difference in roles between the boards and executives is also important. The board’s role is to influence; work with management to identify the desired culture, and monitor and evaluate progress in embedding culture by seeking assurance and asking questions. The executive role is to drive and embed that desired culture throughout the organisation in a way that gains traction.

The collaboration of business functions such as HR, internal audit, risk, finance is also seen as crucial when trying to embed a desired culture and provide comprehensive assurance to the board. Our report of observations will be published this summer and we look forward to sharing the findings with our stakeholders. We are all responsible for upholding good values and behaviours in corporate life. These are central to the way an organisation achieves its objectives and the better they are integrated into business models, the better the UK economy will prosper reputationally and financially.
Investors have had no shortage of reminders of the risks posed by poor corporate governance. Shareholders in Volkswagen saw the value of their equity almost halved following the emissions scandal that engulfed the car maker last September. Corruption at Petrobras has contributed to a near 80% slide in its share price since mid-2014. Pharmaceutical giant GlaxoSmithKline has been repeatedly rocked by bribery charges. Indeed, poor governance across the finance sector contributed significantly to the 2008-09 financial crisis.

Despite the destruction of shareholder value wrought by poor governance or outright illegality, many institutional investors – and sovereign wealth funds (SWFs) in particular – have opted to remain silent in the wake of scandal. They have often failed to hold company management to account. And they have acted as passive actors when their interests, and those of their beneficiaries, would have been best served by them exercising their rights as the owners of the companies in question.

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1 I am grateful to Matthew McAdam, Athanasia Karananou and Olivia Mooney at the PRI for their help in preparing this article.
One of the six pledges that institutional investors make when they sign up to the UN-supported Principles of Responsible investment (PRI) is to become “active owners”, and incorporate environmental, social and governance (ESG) issues into their ownership policies and practices. We believe that applying this principle, and the other five on which the PRI rests, can have a positive impact on investment performance, and will better align investors with the broader interests of society. Why do we believe that, and how might investors, including SWFs, best pursue active ownership?

Clearly, the most important reason is that governance failures can lead to substantial financial losses. Indeed, of the many so-called ‘non-financial’ factors, it is failures of governance that can most directly lead to substantial losses. Where environmental and social factors can often weigh on a company’s financial performance over long time periods, governance scandals can have immediate financial impacts. Moreover, it can be argued that the majority of environmental and social impacts are themselves the result of poor governance – whether at Volkswagen, the breakdown in employee relations at South African platinum miner Lonmin that culminated in the Marikana shootings in 2012, or the safety failures that led to BP’s Deepwater Horizon disaster in 2010, for example.

There is considerable empirical evidence that supports this. In a meta-analysis of some 200 high-quality academic papers, a landmark study by the University of Oxford and Arabesque Partners came to the somewhat intuitive conclusion that “the majority of current studies suggest that superior governance quality leads to better financial performance.” Specifically, it cites a study finding that a portfolio that goes long well-governed firms and short poorly governed firms created an annual outperformance of 10% to 15% over the period 1990 to 2001.

The analysis also found that portfolios weighted towards companies with improving ESG metrics outperform those with strategies based on static ESG criteria. “It is therefore logical for investors to seek to influence the companies into which they have invested in order to improve the company’s ESG metrics,” the report says.

This approach has found real-world expression in the ‘CalPERS effect’, where engagement by the California pension giant with companies on corporate governance has shown to be correlated with improved performance. Specifically, in 2014 CalPERS, which was also a founding signatory to the PRI, disclosed that the 188 companies it engaged outperformed the Russell 1000 index by an average of 14.4% over the five years after the engagement began. In the three years prior to engagement, they lagged the index by nearly 39%, on average.

The assumption behind these figures is that “many corporate assets are poorly managed and that resources spent on identifying and rectifying those cases can create substantial opportunity and premium returns for active shareholders,” according to Andrew Junkin, Managing Director at investment advisors Wilshire Associates, who wrote the report analysing the findings for CalPERS.

There are other reasons for institutional investors to devote more attention to the governance of the companies in which they invest. The first is the ‘agency problem’, where company management, acting as agents to company shareholders, may seek to act in their own interests rather than those of the shareholders. Possibly the most egregious example was the collapse of Enron in 2001, when company management engaged in false accounting to inflate the value of Enron’s stock.

The second is that poorly governed companies may expose their investors to indirect reputational exposures. A case in point was a Dutch TV programme in 2007 that revealed investment by

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some of the country’s leading pension funds in manufacturers of cluster munitions and landmines. The UK’s Church of England pension fund was caught out in 2013, when it emerged that it had a small investment in Wonga, a pay-day lending firm, at the same time as the Archbishop of Canterbury was campaigning against what he argued were “unethical” practices by such firms.

SWFs are far from immune to such exposures. Norges Bank Investment Management – which manages Norway’s oil fund – has faced criticism over an alleged lack of oversight at SCA. Last year, evidence emerged of corruption around expense claims and the misuse of corporate jets at the Swedish financial services group. Other investors accused NBIM, which had an 8% stake in the company, of failing to hold executives to account.

There are also reasons specific to the nature of SWFs that reinforce the case for their embrace of leading corporate governance practices. First, as significant investors, they often hold much larger stakes in individual companies than most institutional investors. Since ownership in many companies is very fragmented, even a shareholding of a few percent can make an investor one of the top 3-5 owners and ensure that an investor’s voice is heard clearly at board level.

Second, SWFs also tend to be long-term investors. Again, this gives their views more weight at board level. It also means that they are able to capture the improved share price performance that follows improvements in corporate governance.

Third, SWFs are often ‘universal owners’, with diversified portfolios across most major equity markets. For such universal owners, many ESG-related externalities are internalized in the overall portfolio: while an individual company may prosper by tolerating worker exploitation in its supply chain, or by dumping pollution into the environment, other companies in its portfolio, and the wider society and economy, are likely to bear the costs. In corporate governance, bribery is a case in point. While one portfolio company may win a contract by paying bribes, a more ethically run company in the same portfolio loses out. Meanwhile, the corrupt payment is lost into the black economy. Finally, the counterpoint to reputational risk is reputational advantage. Since the financial crisis, the investment community has suffered from a trust deficit. SWFs in particularly – especially those outside the OECD – have been perceived as opaque and viewed with suspicion by many stakeholders. Transparent, publically communicated corporate governance policies offer SWFs the opportunity to present a different face: one of responsible investment with the best interests of their investee companies and beneficiaries (ultimately their country’s citizens) at its heart.

There are, of course, countervailing pressures discouraging SWFs – as with other large investors – from stepping up their oversight of corporate governance. Some have traditionally avoided transparency, given their size and concerns they could disrupt markets by making public pronouncements. The perception that SWFs may have political, rather than purely investment objectives, has also encouraged some to take a deliberately passive approach to investment.

But, to a large degree, SWFs are no different to other classes of institutional investor: most are just beginning to appreciate the advantages of better managing ESG, while a small number have taken a lead.

Certainly, among SWFs, a handful of funds have developed market-leading responsible investment policies and procedures. One example is Norway’s oil fund – the Government Pension Fund Global (GPFG). The fund has been vocal in terms of setting out the standards of corporate governance it expects from the companies in which it invests. Its manager, Norges Bank Investment Management, also a founding signatory of the PRI, publishes annual responsible investment reports on behalf of GPFG, setting out the principles to which it adheres and its activities in the previous year.

It is an active owner, using its votes to promote good corporate governance and, since last year, publishing its intentions ahead of shareholder meetings. In 2015, it voted against 9,000 company-backed resolutions. And it does not shy away from...
divestment: last year, it sold out of 73 companies on environmental or governance grounds.

Other funds have also developed sophisticated responsible investment policies. New Zealand Superfund, for example, has developed a comprehensive Responsible Investment Framework\(^3\) that sets out how it integrates consideration of ESG issues into investment decision-making. That framework is based upon the PRI’s six Principles, and standards such as the International Corporate Governance Network (ICGN) guidelines on proxy voting, and UN Global Compact principles for corporate responsibility.

Among other things, it stresses its active ownership of the companies in which it invests, to encourage high governance standards and to enter into dialogue with companies that significantly breach standards to encourage improved practice.

Similarly, Australia’s Future Fund takes the view that “good governance (i.e. how an organization is structured, operated and controlled and how it manages environmental, social and regulatory risks and opportunities) protects and creates investment value”. To that end, it has set out nine voting principles relating to, inter alia, corporate disclosure, shareholder rights, board composition, oversight, poison pills and remuneration systems.

Meanwhile, and perhaps less publicly, some of the older sovereign funds have become more active shareholders. According to a recent investor relations survey\(^4\) by Bank of New York Mellon, 65% of 550 respondents from publicly listed companies had communicated with SWFs in 2015, up from 57% in 2013. Overall, 42% had engaged with NBIM, 38% with the Government of Singapore Investment Corporation, and 30% with the Abu Dhabi Investment Authority.

So what steps should be taken by SWFs that want to implement best practice on corporate governance? The good news is that there is a substantial body of experience, frameworks and advice available. As a starting point, there are a number of governance standards and codes aimed at institutional investors in general, and SWFs in particular, that provide an initial framework for improved corporate governance performance.

Of particular relevance are the so-called Santiago Principles. Launched in 2008 by the International Working Group of Sovereign Wealth Funds, the 24 voluntary “Generally Accepted Principles and Practices” (GAPP) cover all aspects of SWF activities. GAPP 21 directly addresses governance. It recommends that, if an SWF chooses to exercise its ownership rights, it should do so in a way that is consistent with its investment policy and protects the financial value of its investments. It should also publicly disclose its approach to voting securities.

Other standards include the UN Global Compact, stewardship codes developed by various governments, including those of the UK and Japan and, of course, those developed by the organisation that I chair, the PRI, which has a wealth of tools and resources to help signatories get started.

More generally, stewardship and corporate governance should be framed within the bigger picture of managing ESG or non-financial risk. Such risks might better be understood as ‘future financial’ risks – that is, risks that have not yet found expression in a company’s financial performance.

We would argue that it is incumbent upon all institutional investors, including SWFs, to understand these risks (and opportunities). This requires resources: from external investment consultants and, internally, in terms of training for existing staff, and possibly hiring a dedicated internal responsible investment and corporate governance specialist.

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Meanwhile, all large investors should put in place policies and processes to ensure that corporate governance as well as social and environmental issues are addressed in the investment policies and process.

In conclusion, the evidence of the business case for embracing best practice corporate governance is compelling. The tools to help SWFs do so are widely available. The experience of those SWFs that have led on this issue paves the way for others. The financial benefits await.

Specifically, investors should:

- Develop and publish clear responsible investment policy and investment beliefs. These are important in signaling intentions to staff, external managers, investee companies and beneficiaries.

- Apply those beliefs to their investment mandates, including requiring that managers monitor and report back on implementation.

- Consider the use of proxy voting firms, if they have a very large number of holdings that make active ownership challenging.

- Consider the use of longer-term performance metrics for managers.\(^5\)

- Cooperate with their peers. The PRI’s Clearinghouse, for example, has brought together institutional investors to engage collaboratively with companies on issues such as director nominations, anti-corruption, and integrating ESG issues into executive pay.

One of the business scandals that attracted the most media attention in recent years - the fraud involving Volkswagen’s tampered engines - has been joined by such other similar scandals as those of Toshiba, Barclays and many other large corporations. These scandals have highlighted the importance of establishing a control environment within organisations that defines how operations should take place and genuinely influences the way in which people act.

The ramifications of these scandals go far beyond the immediate fraud, possible liabilities or falling company share prices, to mention but a few. In a global and permanently interconnected and informed world, negative impacts on reputation can cause a company to disappear entirely as a result of distrust from consumers. In recent years especially, we have also witnessed an overall loss of confidence of society in the business world in general (companies and their main players as boards of directors & senior management) due to misbehaviours in business management. A lack of confidence - a factor that is tough to quantify - can have catastrophic effects on everything that can be measured.
The absence of a suitable control environment has led to the failure of numerous major companies, meaning that building solid trust is more important now than it has ever been in the past. This is what stakeholders (shareholders, customers, regulators and watchdogs, employees, suppliers) and society in general expect from any organisation, and it is what every company should aspire to achieve.

The changes taking place in the field of business and the way in which organisations operate, especially in recent years, have impacted on business endeavours and are the root cause of a need to update theories and concepts on the design, implementation and operation of internal control. One essential element for the correct operation of an internal control system is the ongoing oversight of its effectiveness, a task that should fall to the internal auditor.

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) - the body recognised as the global authority on internal control issues at organisations - establishes the fundamental aspects of internal control and is responsible for drafting the Internal Control-Integrated Framework COSO Report. COSO defines internal control as a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.

COSO establishes five significant and inter-related components within internal control models: the control environment; risk assessment; control activities; information and communication; and, finally, monitoring activities.

The control environment provides the guidelines on conduct by the organisation: discipline, ethical values, organisational structure and capacity, segregation of duties and professional development. It forms the basis for all internal control components but is also the most intangible aspect, thus making it the most difficult to assess.

The board of directors. From “tone at the top” to “commitment from the top”

The aforementioned global convergence on internal control and responsibility by the board of directors for establishing a control environment is no trivial matter. The way in which an organisation operates should be defined by the board of directors itself, as should the rules on conduct applicable to employees regardless of their various levels or hierarchies; rules that the board should also follow. In other words, we must move away from “tone at the top” towards “commitment from the top”. It affects senior management and all company employees in a top-down approach, thus reasonably ensuring full compliance with the objectives sought regarding operations, information and compliance with the regulatory framework governing the organisation.

If management can adequately convey the organisation’s culture and values, it can instil a way of doing things that will benefit every level of the company and avoid situations that pose either financial or reputational threats. Let us not forget that senior management is responsible for establishing a level of tolerance and risk appetite for the organisation, as well as assessing the likelihood of an impact from the risks inherent to the organisation’s activity. This will enable all risks to be managed - including fraud - and procedures to be applied for preventing and detecting them.

Besides establishing the control environment, senior management is also legally required in many places around the world to oversee this environment. This task is usually delegated to an audit committee which should relay on the internal auditing department in order to detect timely internal control weaknesses and propose solutions and improvements to remedy those weaknesses.

The publication entitled Entorno de Control: Siete preguntas que cualquier Consejero debe plantearse [Control Environment: seven questions that every board member should ask themselves], drafted by the FÁBRICA DE PENSAMIENTO - the think tank of the Institute of Internal Auditors of Spain - identifies the seven key aspects that
determine the strength of any control environment at an organisation.

**Seven keys to a sound control environment**

The first key is *to define and instil throughout the organisation the corporate culture, values and principles*. The important factors in this regard include: having a clear, transparent and measurable declaration on the ethical values and principles governing company business in the organisation’s Mission and Vision; publishing a Code of Conduct, requiring formal acceptance at all levels of the organisation, training employees on ethics and implementing a penalty system for non-compliance; and creating an hotline for employees, customers and suppliers.

Another aspect to consider is that the *board of directors should undertake the task of overseeing the internal control and risk management system with a sufficient degree of independence from company management*. Best practices recommend formally defining the responsibility of the board of directors or the audit committee in a specific charter, as well as having a majority of board members who are external and independent from company management in order to guarantee the oversight of decision-making.

Two issues are fundamental in this regard. On the one hand, the board members responsible for oversight should have a high level of skill and experience in terms of internal control and risk management, as well as a sound knowledge of the business.

On the other hand, it is important for the board to have an independent internal auditing department to provide support on oversight tasks, and a fluid communication between the board and senior management, internal and external auditors, and other external consultants should be guaranteed.

A *clearly defined and well communicated organisational structure* allows activities to be planned, executed, controlled and supervised, authority and responsibilities to be defined, and suitable information channels to be created. An up-to-date and well communicated organisational structure that reflects the various levels of the organisation should be accompanied by appropriate policies on the segregation of duties, including those of key positions. It should also include the updating of procedures and the reporting structure should be coherent with the organisational structure, among other improvements.

Those organisations that choose to ignore the importance of formalising, communicating, measuring and appropriately remunerating the fulfilment of duties by their employees and executives are less efficient, less sustainable and run the risk of underusing their resources. Hence, in order to build a sound control environment, it is highly important *to establish human resource policies that reflect achievement of objectives, an incentive system that does not favour excessive risk-taking and professional competence*. These policies should be spread to all employees and levels of the organisation in order for individual performance goals to be coherent with the overall objectives of the organisation in the short and long term.

As part of the processes, the organisation should also *plan succession for key positions and correctly allocate authority and responsibility for taking decisions*.

Best practices indicate that the board should ensure that succession plans exist for critical positions in the organisation; those that facilitate business continuity. The loss of a critical employee can paralyse an organisation, or result in deviations from objectives or a loss of competitive edge. Furthermore, the implementation of programmes to identify qualified employees enables the long-term development of talent, the transfer of knowledge and for all employees to achieve their aspirations within the company.

In order to achieve a correct allocation of authority, the organisation should implement a formal model based on its objectives, as well as regular reviews of the business model to ensure that the risk appetite
approved by the board and senior management is maintained. The risks of not defining or implementing these and other improvements in this regard are clear: increased potential for an accumulation of power that encourages fraud and generates conflicts of interest. However, formally determining authority clarifies duties and responsibilities, provides decision-making security, and formalises and improves internal communication.

A final “quick win” that determines whether the organisation has a strong control environment is to have mechanisms for adapting to and managing change. The speed and magnitude of the changes caused by the economic climate, technological revolution, and increase in new regulatory requirements mean that an organisation that fails to innovate exposes itself to a high risk of failure. This innovation should be accompanied by a commitment to risk management, especially regarding everything related to business continuity and the monitoring of external changes that could lead to a competitive edge.

The change on the horizon

Those organisations that manage and generate change in an ordered manner have clear and formalised processes and procedures to define their operations and monitor their most immediate environment. Similarly, they should consider the changing objectives and expectations of their stakeholders, whose growing demand for organisations to be sustainable and responsible in all areas further strengthens the need to constantly manage change.

The environment in which organisations operate is moving ever faster. Companies are more international, the lines between sectors are becoming blurred, and the threats to companies are multiplying and diversifying: cybernetic attack, social conflict and other, even more serious threats appearing on the horizon, such as water shortages... that make companies more fragile while complicating their ability to anticipate risks.
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SHOULD INTERNAL AUDIT ASSESS CORPORATE CULTURE?

“I did not realise that Internal Audit is now auditing gossip?” This was the response from a CEO when a Head of Internal Audit I know mentioned that he wanted to assess the corporate culture of their organisation.

More so in our region, it is not unusual for management to still hold a view that Internal Audit should focus on financial numbers or processes. When it comes to areas such as strategy and governance, some executives are still doubtful about why this should be on Internal Audit’s radar, let alone “softer” areas such as culture.

As someone who is from this region, speaks the language, understands the culture and has been fortunate to live and work in three Gulf countries, and also to have lived and worked in Europe for many years, I can somewhat understand this uncertainty. It is because of “culture”!

One of the best (and simplest) definitions of culture is “it’s the way we do things over here”. Traditionally, Internal Audit was all about auditing the financial information and 9 out of 10 internal auditors were qualified accountants coming from external audit firms when Internal Audit started. The profession has evolved since then, in small but fast steps. What internal audit practices looked like when I
first started working, is (fortunately) nothing like what it is today. The practice continues to change. The popular expression “The only thing that is constant is change” holds true for our profession. The drivers of change have been rapid, but the actual change pace has been different across the world. In our region, I think the pace is reasonable, but we are starting from a lower base so it seems we are always trying to catch up. So the way we do Internal Audit here did not include auditing “culture”. This is why we are still having conversations on the lines of “Culture = Gossip”!

I have started my current position just over three years ago. The first year was the typical understand the company, build up the team, change processes, develop relationships etc. By the end of it, we had everything in order and even had it vetted by the global Institute of Internal Auditors. They undertook a quality review of us, and awarded us with the highest level of accreditation. We were the first listed UAE company to achieve this accolade. However, there was one thing that was always lingering through my mind though. As an auditor we tend to try to read between the lines; sometimes too much and can be in an endless search of root causes. You keep asking “But why” (like a three year old!) whenever you look at processes, numbers, systems, behaviours etc.; From things like why do my colleagues not return calls, why do they not accept the calendar invitation you send but expect you to show up, why do they answer their phone when it rings in the middle of a meeting, to more audit related matters such as why did management ignore this control, why did no one blow the whistle, why has this person not been fired, why is this policy or framework still not implemented and so on. We were always coming back to the same answer – “culture”.

We were also doing a Governance audit and found that culture underpins governance - as well as pretty much everything else in the organisation. You can have the best designed governance framework with all the checks and balances but the reality is that governance is largely people driven when it comes to implementing the framework and people are affected by the culture. They do say “Culture eats Strategy for breakfast” and I would add “and everything else for lunch and dinner”. At that point we realised that we should be auditing culture. I have started researching it, and whilst many internal audit teams globally have done some work around culture, and some of my colleagues and professional bodies have published papers on the subject, I was not convinced about the approaches taken. I felt the right balance between an assurance and a consultancy report had not been achieved. Most teams have been approaching it with a compliance lens and checking if boxes have been ticked (e.g. code of ethics is in place, values defined and communicated etc.). The remaining teams were largely basing their opinions on a survey they sent out to employees. I felt that we needed something more methodological yet allows you to exercise your professional judgment.

We knew the challenges we would face when auditing such a “soft” area for the first time. We also knew what skills we had in the team, and wanted to be true to ourselves and to our stakeholders; so we decided to engage a consultant to work with us on this. Our primary reasons were to have: 1) a subject matter expert to complement existing skills; 2) a robust methodology; 3) benchmarks so our findings and recommendations are practical and not text-book ideas. We went through a comprehensive tendering process and selected a consultant who offered the most diverse approach to satisfy us that the results will be methodological, yet based on evidence, benchmarks, professional judgment and expertise. We also looked at the people who could be in the project and if they would provide a fit with our organisation and with the objectives of the audit. The importance of this should not be underestimated and is often overlooked! As part of a culture audit you will interact with all levels of an organisation and will need to be a strong communicator, facilitator and not shy to challenge senior employees or deliver difficult messages in a constructive manner.

Throughout this period there was a large educational / awareness campaign to build up to the start of the audit. We had plenty of discussions with our Audit Committee and various
Management functions. We started raising the topic as a root cause to some of our top risks and as such needs to be assessed. We would bring it up whenever there is a relevant opportunity (e.g. in audit closing meetings if we see that the root cause of some issues was culture, we would have that conversation). This paid back and we had great support when it came to kicking off the audit. At no point was culture referred to as gossip or were we asked not to do it!

Because culture is not a process, per se, you need to think about where you start and end, and also about your criteria of evaluation. We were fortunate that, as an organisation, we had our values and behaviours defined. We decided to focus on assessing how far we are from living those values and behaviours. We also looked into whether these were adequate for us and if our policies and frameworks were in sync.; for example, we checked if our policies truly enable “Innovation” as one of our values.

We had a very diversified approach which included document reviews, interviewing senior leadership, running an employees’ survey and holding focus groups.

The audit went very well and resulted in many pleasant surprises for us, such as:

1. Engagement of the senior leadership team as not witnessed in any previous audit. Everyone wanted to speak to us about culture!

2. Everyone we spoke to was so candid, which helped us learn what we are good at and where we need to improve as an organisation.

3. One of the most satisfying feelings for an Auditor (I know we can be weird!) is to see that spark in our client’s eyes when you are presenting the results of your work, because you have given them insight or ideas on how to solve one of their biggest problems. We had that! This was then followed by the CEO deciding to discuss the results with the Chairman the following day!

So, should Internal Audit assess “Culture”? Absolutely! Yes it is not a process per se, but it is also not a ghost running throughout the organisation. It underpins many internal control components particularly the Control Environment areas under frameworks such as COSO. In fact, I would say in today’s world you cannot conclude on the effectiveness of the entire Internal Controls system of an organisation without looking at culture. As a CEO or an Audit Committee member, you should be demanding an opinion over culture if your Internal Audit team is not covering it.

My advice to anyone embarking on this is:

1. Education and communication – start early and do not give up.

2. Subject Matter Experts and benchmarks – involve experts for their knowledge, methodology and benchmarks.

3. Tailor the approach to your environment and build on what is in place – there is no one size fit all.

Happy auditing!
Role of women in business in the MENA region has been growing rapidly during the last few years. Women, as entrepreneurs, business leaders, and top executives, play an important role in the wealth creation in the region. Experience and research also show that company boards benefit greatly from the contribution women members bring. Businesses led by diverse boards that reflect the whole breadth of their stakeholders and their business environment will be more successful businesses. This program is designed to broaden the cadre of independent directors serving the region’s boardrooms by targeting women entrepreneurs, business and political leaders and academics to serve as directors. It blends executive education, exposure to leading board members, and application in one-of-a-kind program.

• WDP develops a network of women entrepreneurs, business and political leaders who can take more active role in corporate governance advocacy;
• Builds the capacity of women leaders to serve as professional directors through a well renowned director development program along with the exposure to directors of global companies.

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“It is evident that diversity positively impacts board performance as well as organizational performance.”
Cyber security can be defined in a number of different ways but perhaps from a business perspective is best described as the body of technologies, processes and practices designed to protect an organisation’s information assets from compromise – these assets include computers, mobile devices and cloud-based systems. By compromise, we mean loss of the confidentiality, integrity and availability of the information asset, often leading to reputational damage, revenue loss, and reduced shareholder and customer confidence.

1 billion data records were compromised in 2014 (PWC’s 2015 US State of Cybercrime Survey).

In the early days of cyber security incidents, organisations were often reluctant to go public if a breach occurred. However, non- or limited disclosure has ceased to be a viable option with the regulatory requirements to notify when a breach has occurred and the rapid spread of information via the press and social media. In addition, ‘hacktivists’ (those gaining unauthorised access to computer files or networks to further social or political ends), organised crime and malicious perpetrators now often quickly go public following a successful hack as part of their agenda to gain attention. As a result, organisations can be left exposed very quickly.
Changing board involvement

It is, therefore, not surprising that cyber security is now firmly on the agendas of organisational boards. The biggest challenge that boards now face is making necessary adjustments to the way they approach cyber security governance. Historically, boards tended to view security risks exclusively as part of IT risks, rather than making the connection with enterprise-wide risk management. The inability of boards to understand the full extent of risks associated with cyber security governance has meant that key questions have gone unasked, and unanswered. The consequence in some cases has been unexpected security breaches.

To address this, many organisations have now moved to having an independent risk committee that functions outside of the Audit and Risk Committee. This means the organisation is better able to focus on all aspects of risk management right across the organisations that have a relevance to information assets. The fact is that boards need to be provided with the right information and set the risk appetite and culture for the organisation. They must lead by example, and that means keeping abreast by maintaining their own awareness levels and training at an appropriate level.

A number of specific developments are reinforcing the responsibilities of senior management in this area. For example, the much anticipated Senior Managers and Certification Regime (SM&CR) for the financial sector in the UK (due in March 2016), will place a statutory requirement on senior managers to take reasonable steps to prevent regulatory breaches in their area of responsibility. And the latest revision of ISO/IEC 27001 emphasises that accountability for asset security sits at the very top of the organisation.

Boards need to consider if they are asking the right questions, or even seeing the bigger picture regarding cyber risks. The good news culture mentality at board level can mean that finer details are missed. An over-reliance on controls that may have been in place for some time can mean that effective management and monitoring of the original risk are compromised, while many controls are untested, or become part of tick box exercises, which simply get passed up as metrics to the board. Being properly breach-ready has to start at board level.

Defence-in-depth approach

The defence-in-depth (onion ring) approach, in which multiple layers of security controls are placed around information assets, is a good basis from which the board can ask questions. The five layers of defence are: (1) user, (2) application, (3) perimeter (network/physical), (4) server, (5) database in which our assets are stored.

In relation to the user level, the organisation must be able to drill down to look at the privileged user, authorised and non authorised access, and statistics for compliance at this level. Application layers must also deliver statistics on current versions, upgrades, secure coding and access controls. Similar levels of information must be available for all other layers.

Vulnerabilities on servers and the network are extremely important with many organisations still having unsupported systems as part of their day-to-day operations. This makes them easier to attack. The NOPSEC 2015 State of Vulnerability Risk Management report shows that system vulnerabilities and misconfigurations are still the main cause of security breaches. With organisations taking on average 170 days to detect breaches, it is very clear that boards must pay closer attention to the management of vulnerabilities in these areas. Despite having more vulnerabilities per asset recorded, cloud providers recorded shorter remediation times, fixing vulnerabilities in less than 30 days.

It is also important that close attention is given to suppliers. With risk in the supply chain a key security factor, all providers should be held to account to provide evidence of best practice security.
Risk management based on trends

The Cisco 2016 Annual Security Report has shown that, of the 115,000 Cisco devices on the internet, 92% were running software with known vulnerabilities. 31% of these devices were at “end of sale” and 8% at “end of life”, meaning they would not any longer be eligible for receiving patch support. These statistics can be viewed alongside the NOPSEC report figures that show it takes on average 103 days for organisations to remedy a security problem, with banks showing an average of 176 days. Boards must take such risks into account and combine them with other associated risks, such as risk in the supply chain, inadequate resource bandwidth, capability and expertise, to create an aggregated risk profile from which to make sound risk decisions, on whether to mitigate, manage or transfer their risk. They must use this information when making decisions on spend, and for strategic business planning especially in the area of IT infrastructure spend.

Boards must also obtain briefings on trends that may be of assistance in implementing proactive risk management. These include Blockchain, the decentralised ledger that allows global computers to become sequentially constructed transactional spreadsheets that are linked together in blocks. Each block is made up of discrete private data and uses a public header and cryptography to link and secure each block. Bitcoin was one of the first applications to make use of this infrastructure and since then many more have come to market. Ripple is the second largest, and is of great interest to the financial community because of its ability to carry our micro transactions at high levels of granularity cost-effectively.

Big Data is now also playing a major role in many organisations. Big Data analytics have often been used to gain insight into customer trends, but also offer considerable potential for future threat correlation and incident handling for cyber security teams.

Key considerations for Boards

- Carry out regular incident handling and response to security breaches as exercises at board level.
- Lead by example in setting the security and risk culture of the organisation.
- Ask the same questions during day-to-day management of cyber security governance as during an actual breach – where are assets, who has access to them, can they be compromised, if so by whom, possible reasons for such an attack, how an incident would be handled, and processes and procedures to be employed during a breach.
- Be aware that the pace of release of vulnerability updates and patches will continue with the large software and system providers such as Microsoft, Oracle and Adobe. Distributed Denial of Service attacks, where a network is brought to its knees by flooding with useless traffic, continue to increase with many senior executives being successfully targeted with fake email campaigns (spear phishing).
- Recognise that security risk should be considered in terms of the enterprise-wide risk framework rather than being seen as purely IT-based.
- End point security will become increasingly important and must be tracked and managed, as freedom of choice in what device to use will also increase. Effective encryption will be very important, but should not result in neglecting other areas of cyber security.
- The physical side of cyber security, as the first line of defence, should not be overlooked and must be part of all reporting procedures.
- Recognise fiduciary responsibilities, including cyber security governance. Track the progress of raising the security maturity level of the organisation, so that it is in a state of continuous improvement and not reactively responding to cyber security requirements.
• Track statistics to ensure security is considered at the start of projects, rather than being bolted on later or even excluded entirely.

• Keep security as a regular board agenda item and apportion adequate time to understand the metrics provided.

• Continue to set up risk committees that are separate to the Audit and Risk Committee, to facilitate looking at cyber security in a more granular way.

75% of UK CEOs are now citing cyber security as the third major threat after over-regulation and geo-political uncertainty, (PwC 2015 security report), and this is being echoed globally by their peers. While third parties can be used to transfer responsibility, liability will remain firmly at the top of the organisation. The ethical responsibility of boards will continue to increase to cover the digital dimension, and the way the organisation manipulates its data, protects and secures it.

Board competence and commitment in meeting these challenges will be vital in ensuring the organisation is breach ready.
As one of the most stable corporate banks in the UAE, Bank of Sharjah has built relationships with some of the region's largest businesses, striving to offer the most solid, dependable and long-run banking solutions.
Stephen Davis is a senior fellow at the Harvard Law School Program on Corporate Governance and a nonresident senior fellow in governance at the Brookings Institution. He is a member of the Hawkamah Journal editorial board.

When the body of Robert Maxwell washed ashore in the Canary Islands in November 1991, the scandal over the media tycoon’s epic misuse of shareholder funds and employee pensions was only just beginning to unravel. Investigators were never able to determine whether Maxwell committed suicide, had been murdered, or died of natural causes. But there is no doubt about something else: the fraud he perpetrated at the Mirror Group fueled reforms in Britain that spread and were adapted worldwide to form the modern corporate governance movement. What is striking, looking back, is how much the private sector was the author of those early reforms. Politicians and regulators were largely content, despite a firestorm of public outrage against Maxwell, to set the table for business, investors and professional bodies—many of whom were thought implicated, if only by inaction, in the scandal—to convene and agree governance solutions. Today, by contrast, it is striking in many markets how much the public sector and political interests, attentive to grassroots distrust of business leadership, are now driving corporate governance. More than ever,
governments are seeking to write governance rules. Even in markets such as those in the GCC where lines between public and private sectors are more permeable, insights from this international phenomenon are important for companies and shareholders.

Before exploring those lessons, it is instructive to trace the intersection of politics and business from corporate governance origins. In May 1991, just months before Maxwell’s plunge into the Atlantic, three UK groups had tapped Sir Adrian Cadbury to chair a committee to probe “the financial aspects of corporate governance”. Two of these—the accounting profession and the London Stock Exchange—were private sector bodies. The third was the Financial Reporting Council (FRC), an independent regulator. The resulting Cadbury code was not the first formal standard of corporate governance; Ireland’s pre-dated it by a year. But the Cadbury report gained international traction like none other.

Despite the presence of regulators, the text was crafted by capital market players and then implemented as a voluntary code under the then-novel comply-or-explain approach. Over succeeding years UK governments pressed for periodic reviews of the code, but still left decisions over content almost entirely in the hands of the private sector. In a parallel track, the Bank of England, concerned about the scarcity of skilled independent directors at UK companies, had served as a catalyst, but not operator, in founding Pro Ned, a clearinghouse of board candidates. In France, the employers’ organization asked banker Marc Viénot to author a code, while the country’s fund management association later framed rival standards. Similar trajectories could be found in other jurisdictions; the public sector provided the nudge to improve corporate governance, but private sector entities managed content. Even the first international principles issued by the Organisation for Economic Co-operation and Development (OECD), a body composed of sovereign states, were based largely on guidance generated by an elite private sector body chaired by US super-lawyer Ira Millstein.

Throughout the period, corporate governance was largely considered an arcane and specialized corner of the capital market, drawing comparatively little public attention except episodically in response to scandal. It is no accident, for instance, that the Cadbury Committee’s charge was to focus narrowly on the “financial aspects” of governance. To take one simple but telling gauge, a Google search of the term ‘corporate governance’ for March 1998 yields 1.35 million results. The same search for March 2016 yields 32.9 million.

Arguably the tide began to turn toward more fulsome attention in the run-up to the election of Tony Blair’s Labour party in Britain. In a 1996 speech in Singapore Blair announced that he would aim to build something he termed a “stakeholder economy”, one that would be “run for the many, not for the few.” Sure enough, in 1999, amid mounting public dismay over high executive remuneration, Trade and Industry Secretary Stephen Byers unveiled legislation that sought to solve a political problem using a corporate governance toolkit. The act would, by 2003, compel each listed company to put its remuneration report to an annual, non-binding shareholder vote of confidence. Here was government intervening in governance not merely as a convenor, but as a definer of content. Note that the Blair government acted not in response to investors—who were conspicuously absent among advocates of ‘say on pay’—or on grounds of corporate performance, but to address voter pressure on a matter of social equity. We have since seen ‘say on pay’ legislation spread to multiple markets for similar reasons.

Labour sought to extend the approach to other corporate governance frontiers in efforts to demonstrate responsiveness to public concern about CEO pay. While it decisively lost the May 2015 general election to the Conservatives, Labour adopted a platform that promised to compel employee participation on the board remuneration committees of public companies. That would have marked a radical shift in UK practice toward the German co-determination model of board oversight. Across the Channel, the European Commission took a more direct approach, adopting hard limits on compensation.
at financial institutions as a means of responding to public opinion that such enterprises were principally responsible for the financial crisis. EC measures imposed a cap on bonuses and required regulatory approval of certain pay packages.

Other examples followed of governments seizing the initiative to accomplish public sector objectives through changes to the rules of corporate governance. Perhaps the most dramatic was the least heralded at inception. In 2003 Norway’s parliament adopted legislation mandating a quota of 40% women on company boards, with implementation starting in 2006. Once again, the impetus was not related to market failure in a narrow, economic sense; it was to satisfy social pressure for gender equity. At first, other jurisdictions, even those elsewhere in Europe, took scant notice of Norway’s action as anything but an idiosyncratic move by a small and peripheral market. But in 2012 the European Commission announced its own 40% soft quota of women on corporate boards for the whole of the EU. Member states have since adopted versions of that. Further afield, India now mandates at least one woman on every public company board. And in the UK, which has so far shunned prescribed quotas, both the last and current governments have used the bully pulpit unreservedly to press rapid gender diversification of corporate boards, holding out the prospect of legislation in the absence of progress.

Of course, more empirical evidence seems to be surfacing every day that demonstrates a connection between diversity and performance. So there is increasingly a legitimate business case to be made for measures aimed at breaking up what may be depicted as a monoculture at the top of many public companies. But the impetus behind lawmakers’ quota initiatives, as well as steps they have devised to rein in remuneration, may fairly be characterized as stemming from political rather than value objectives.

US policymakers, despite cultivating a reputation for keeping non-financial objectives out of capital market frameworks, have in recent years proven nearly as drawn as their international counterparts to the siren call of corporate governance as an antidote for social faults. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, for instance, contained at least two measures that may be described as falling into this category. First, Congress wrote Section 1502 to crack down on human rights abuses in the Democratic Republic of the Congo. It required corporations to disclose if their products contain so-called conflict minerals, such as diamonds, mined and traded in war-torn areas. Second, Dodd-Frank Section 953(b) ordered the Securities and Exchange Commission to develop rules mandating that listed companies disclose a ratio comparing CEO pay with median compensation of all other employees. There may be entirely legitimate reasons for both, just as for board quotas and pay curbs. But they were not measures asked for by either business or (with a few exceptions) investors, and they had at best only indirect relevance to corporate performance or investor protection.

The raucous 2016 US presidential candidate election campaign offered perhaps the strongest evidence so far that the gray line between civil government and corporate governance may be thinner than ever. The Occupy movement, which had kindled public wrath at Wall Street’s role in the financial crisis, had long faded from the scene by the time candidates on the right and left opened their party nomination campaigns for the White House. But grassroots resentment, it turned out, was simply waiting to be stoked. Democrat Bernie Sanders built his entire insurgent effort during primaries and caucuses on the promise to break up large financial institutions, crack down on high CEO remuneration, and compel corporate boards to consider social interests. Former Secretary of State Hillary Clinton, for her part, felt obliged to compete in those same contests with parallel policy ideas such as curbs on short termism (“quarterly capitalism”), disclosures on corporate political spending, bars on tax inversions, controls on drug pricing, and fresh attacks on board approval of skyrocketing CEO pay.

More surprising, perhaps, were volleys launched against Wall Street by candidates standing for the nomination of the Republican party, which had traditionally been identified with enterprise.
Businessman Donald Trump, for instance, was highly critical of political donations by big financial institutions and floated the idea of appointing hedge fund firebrand Carl Icahn as US Treasury Secretary. Texas Senator Ted Cruz cited the rise of “crony capitalism” and painted big Wall Street banks as villains. With trust in CEOs low and skepticism about business high, there seemed few political rewards to be reaped from a platform advocating that business should be left to its own devices, at least at the time of this writing.

Of course, not all markets in the GCC region would draw a clear distinction between civil governance and corporate governance, especially where the state or the ruling family plays a guiding or catalytic role in the economy. But the lesson that may be drawn from the interplay of these forces in other markets is that parties in control of corporate governance rule-making are most likely to be those who maintain a healthy ‘license to operate’—that is, who are perceived as maintaining public trust. Even in close-knit GCC markets the rise of social media and the import of outside ideas and practices, arguably, have enhanced the importance of public confidence in enterprise as a social factor in political and economic stability. The lessons from elsewhere seem clear. In the immediate aftermath of Robert Maxwell’s death the private sector in Britain, France and elsewhere was still considered worthy enough to fix itself. But by the turn of the millennium, sentiment had switched decisively against the market as its own physician. Rightly or wrongly, business was tagged as lagging in addressing matters such as income inequality, gender discrimination, and economic opportunity. Public policy had to intervene with correctives or risk political backlash or social unrest. Enterprise has therefore had to live with rules developed by and for outsiders that may be overly rigid and inapt for effective private sector use.

How could private sector actors seek to regain leadership or forestall excessive intervention in corporate governance by political actors? Or to put it another way, how might business claim a license to operate to assume a leading role in governance standard-setting? The answer must involve collective action, since no single enterprise has sufficient clout to earn a license to operate on behalf of an entire sector. But pursuit of a collective reputation for trust is an odyssey marked both by the “tragedy of the commons” as well as by what Bank of England Governor Mark Carney has dubbed the “tragedy of the horizon”. That is, while actors might have a shared interest in cooperative behavior, they have individual commercial motives that often compel them to work against the common good. Moreover, while they might have common interests in long-term objectives, a range of structural factors tend to force them to act short term. Thanks to these twin ‘tragedies’, it is rare to find markets where companies proactively demonstrate joint capacity to behave long term and contribute meaningfully to ameliorating legitimate social faults. Indeed, it is often rare in many markets to be able to identify high-profile business leaders prepared to advocate such collective action.

There are exceptions, though. Focusing Capital on the Long Term (www.fclt.org) is a project initiated in 2013 by McKinsey and the Canada Public Pension Plan Investment Board; its advisory board consists of corporate, institutional investor and sovereign wealth fund leaders. FCLT seeks to position influential capital market actors as champions of sustainable economic growth. Other similar vehicles have arisen to address issues such as climate change. Cases with the greatest prospect for success are those that equip business with eyes on, and the ability collectively to react to, fast-evolving social pressures. They can in this way hope to bank social capital that earns them the trust to develop and self-policing the next round of corporate governance reforms—before political actors do it for them.
ON GOVERNANCE & GROWTH

Consider this case

A second generation family transitioning into the third generation owns and operates a family business. In 2015, the total turnover of the business is 4 million per year and the dividends distributed from net profits amount to USD 540,000 per year.

The 2nd generation is formed of 3 brothers. They share the company equally. They are all married with 3 children each. Under this scenario, each family of the 2nd generation earns USD 15,000/month, leaving the per capita at USD 3,000.

Discarding the inflation rate, which may be as decisive as stagnancy in returns from the company, each 2nd generation family member earned USD 3,000/month and got used to this amount for their way of life.

If the family business remains at its own volume when the 3rd generation takes over management, we will be having 9 siblings married with 3 children each, all sharing the USD 45,000/month return. By a simple calculation, we get the following figure:

9 siblings * 5 family members = 45 family member in total
USD 45000 / 45 family member =1000$ per capita.

Now let’s factor in the inflation at 3% per year, which is a conservative figure. A generation is 30 years.

With 30 years of inflation at 3%, you would need 2,36 times the amount of money in 2045 to buy you the same item you could have bought in 2015, which cuts your purchase power by 2,36. In other
words, the USD 1000 per capita has a purchasing power of USD 423. In more words, to sustain the same living standard of the 2nd generation, the 3rd generation has to earn USD 7080 per capita.

Based on this scenario, the family business has to grow by 7 folds in 30 years in order to sustain the same living standards for all the family members.

This brings us to governance and the many questions raised on the relation between governance and growth.

First, on family governance and growth

Experts in family governance plan the sustainability and wealth of families for the coming 100 years. To do so, they focus mostly on financial sustainability amongst other criteria, such as culture, organization, legal matters, philanthropy, etc. Given the above case study, the growth of the family business is the first concern they raise to the family members considering that said growth fuels the sustainability of the family through generations.

Second, on growth and family governance

The growth of the family business is a prerequisite for the sustainability of the family within the family business structure, otherwise family members would have to grow outside the family business. An application of the above case study, should the family business stagnate when the 3rd generation gets on the market, a USD 1000 of income per capita, equivalent to USD 423 in purchasing power, would push many members of the family to seek business or employment elsewhere, if the market offers a bit more, especially if the family business is saturated, if the outlook is not promising, if the family sense of belonging is weak, if..., if...

Third, on corporate governance and growth

Unlike sales, growth is not a direct consequence of implementing sound governance inside the family business. However, the corporate governance framework is a control and management style that may, if well implemented, improve the efficiency of the business and lead it to growth. In other words, when it comes to sales, the more you sell, the more you grow. When it comes to governance, the dynamic differs: you have to first implement a corporate governance framework starting from the top to the bottom. This already takes time and effort since it is a change in culture and management. Sound governance will improve transparency, control and efficiency. Investors, lending institutions, suppliers and consumers then will gain better confidence in the well governed business. Growth follows.

Fourth, on growth and corporate governance

Growth encourages business owners to implement corporate governance frameworks within their business due to the positives it bears on transparency, efficiency, oversight, accountability and other important principles, which, as explained above, attracts in turn new investments, markets and businesses, and fuels consequently further growth.

Whether a family owned business or not, governance is an essential for growth.

Results of a survey published by the IFC\(^1\) show that the premia to be paid by investors in a company with better governance is substantially higher compared to companies with average governance. In developing markets it can increase by 57% and in emerging markets it can double. Additionally, investors are more inclined to study investing in companies in countries with improving governance. This is strengthened by the volatility of markets and the recurrent financial crises.

For all of the above, governance should be considered a priority to be implemented in companies, and in families where applicable.

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\(^1\) http://www.ifc.org/wps/wcm/connect/dbfd8b004afe7d69bcb6b94e6f4d75/IFC_EMI_Survey_web.pdf?MOD=AJPERES
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