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GOVERNANCE

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The crisis in governance

'Nevertheless, toothless enforcement against the company directors responsible for scandals and bother still looks likely to remain the order of the day and plague the future nearly as much as it does the present.'

Gerry Brown

Overseeing cyber risk at board level

'Measuring what matters is key. Directors should ask management about the metrics used to identify and manage risk. By measuring the right things, and having adequate governance attention, corporations can better manage their risk environment.'

Roberta Sydney

Content

Editorial Board

Publisher
Lesley Stephenson
Tel: +44 (0) 1278 793300
Email: lesley@governance.co.uk

News Editor
Katharine Jackson
Email: katharine.jackson@governance.co.uk

News

Online participation at 2021 AGMs

A poll of 60 listed UK companies by global share registrar Computershare has suggested that three out of every four (76%) are considering some form of online participation in their annual general meeting (AGM).

Current coronavirus pandemic restrictions impacting large public gatherings won't be lifted in full until 21 June at the earliest, but some companies must hold their AGMs before that date and as such must balance company law obligations with appropriate health and safety precautions.

Computershare says that virtual and hybrid meetings – in which shareholders can participate in the meeting online – have proven a popular alternative among clients in other parts of the world over the last year and that 46 out of 60 UK listed companies it polled said that they are considering hybrid or virtual meetings as an alternative to a traditional purely face-to-face gathering.

In addition, the poll suggested an appetite to retain the online elements of their company meetings once restrictions lift and physical gatherings can again take place without restriction, with more than one in two, 31 (51%) respondents saying that they would supplement physical meetings with webcasts or similar technology.

Mark Cleland, CEO, Issuer Services, for the UK, Channel Islands, Ireland and Africa, at Computershare, said:

> 'The pandemic has driven increased demand among shareholders for opportunities to engage with companies electronically, including voting and taking part in online AGMs.

'Around the world, companies have also found that online AGMs and electronic engagement events create opportunities to interact with investors more effectively, particularly for those with a geographically diverse shareholder base.

'Our poll suggests that more companies are looking seriously at different technological options, including video, that best suit their needs, and we expect more may choose to continue expanding electronic participation at meetings once we move beyond the pandemic.'

Computershare said hybrid meetings, which allow for limited physical attendance combined with remote shareholder participation, including voting and being able to ask questions; could provide a solution for many companies, and 25 of the 60 (41%) or over one in three respondents to its poll said that they would consider a hybrid approach if restrictions continue.

In last year's Capital Analytics survey of UK listed companies, 71% said that their experiences of AGMs in 2020 would influence how they conduct their 2021 meetings and beyond Below are Computershare's key tips for organising an AGM during the pandemic:

Start AGM discussions early
Companies should engage with their registrar, legal advisers and other relevant stakeholders to understand the rules on in-person gatherings and understand the options available to them as early as possible.

Review the company's Articles of Association
Companies can usually hold hybrid meetings so long as their articles do not explicitly prevent them. Companies should be sure whether their articles expressly prohibit electronic attendance or engagement, do not mention them at all or clearly permit it. If a company cannot hold a hybrid meeting but wishes to, it must first update its articles. In the meantime, they can consider using available technology to engage with investors either alongside the AGM, or separately. This gives shareholders the opportunity to interact with the company despite the participation not officially constituting AGM attendance.

Communicate regularly and clearly with shareholders and investors
Companies should ensure their shareholder communications clearly set out the meeting's format, how and why questions could be moderated, grouped and addressed, what technology it will use and any relevant contingency measures, such as what happens if there is a problem with internet connections. It should also state how shareholders can gain access to the meeting and how they can submit questions before and during. Companies should also ensure that they offer all available voting options, including electronic proxy appointment, and wherever possible, online voting during the meeting. Companies may also want to reissue this information to shareholders electronically before the event.

Make it easy for shareholders to look up arrangements
Companies should consider housing important information – including how to access the meeting and what information shareholders need to enter the event – on a dedicated web page and set up a specific email address for shareholders to send questions to ahead of the meeting. Shareholders may also benefit from suitable reminders of proxy appointment deadlines.

Publish all questions
Many shareholders expect companies to publish every question asked and the company's answers. This should include any associated answers, questions not answered (and why), and any discarded or grouped together.

https://www.computershare.com/uk/business/share-registry/manage-your-meetings-and-votes

International

Business ethics – global trends

The Ethics & Compliance (E&C) profession in the US continues to make progress by instilling elements that encourage ethical behaviour and promote ethical culture in the workplace according to a recent survey published by the Ethics and Compliance Initiative. The survey, *The State of Ethics & Compliance in the Workplace*, also found that, overall, global trends largely mirrored those of the US.

Although many factors influence ethical behaviour, the survey focused on the interplay of four behaviours: pressure to compromise ethical standards; observations of misconduct; reporting misconduct; and retaliation experienced by employees for reporting misconduct.

Ethical culture

More than one in five US employees indicated that their organisation has a strong ethical culture. However, there is a gap between the perception of top management and non-management employees. The global median for strong ethical cultures was 14%. Employees from India were the most likely to perceive working in a strong ethics culture (28%) and employees from France the least likely (8%).

Pressure to compromise standards

Thirty per cent of US employees said they had experienced pressure to compromise their organisation's workplace ethics standards and 44% said they were experiencing more work-related pressure now compared with pre-Covid-19.

Top management and middle management experience more pressure to compromise standards than first-line supervisors or non-management employees, the difference between non-management and top management being quite pronounced. In 2020, 12% of non-management employees said they experienced pressure to compromise standards, whilst 51% of top managers and 63% of middle managers said the same. Top management and middle management's awareness of and/or involvement in major organisational changes appear to be a key driver of the higher rates of pressure that occurred in 2020.

The global median (29%) also showed higher levels of employees reporting pressure. Countries experiencing higher levels of pressure include China (the highest at 53%), India, Mexico, Spain, the UK and the US. Others have been experiencing less pressure including Brazil and Russia (the lowest at 16%).

Observed misconduct

Forty-nine per cent of US employees reported observing misconduct that violated their organisation's ethics standards. The most frequently observed types of misconduct included: management lying to employees; conflicts of interest; improper hiring practices; abusive behaviour; and health violations. Thirty-eight per cent of top managers and middle management observed misconduct compared to 9% of first-line supervisors and non-managers.

The global median for observed general misconduct was 33%. Employees in China observed misconduct at the highest level in 2020 (46%) and employees in Germany the lowest (20%). Overall, the most common types of misconduct were consistent across employees regardless of their location, the most common type being favouritism toward certain employees.

Reporting misconduct

Eighty-six per cent of US employees said they reported 'every' or 'some of the behaviour' they thought violated their organisation's ethics standards, however the rates of reporting for the most common types of misconduct were much lower. In the US employees were most likely to report incidents of abusive behaviour (60%), while they were least likely to report favouritism towards certain employees at the expense of others (40%).

Top management, middle management and first-line supervisors are much more likely than non-management employees to indicate that the E&C programme in their organisation is effective. Non-management employees continue to lack confidence in the reporting processes at their organisations:

- 35% indicated that they did not report misconduct because they did not believe corrective action would be taken;
- 32% said that they did not trust that their report would be kept anonymous; and
- 29% did not trust that their report would be kept confidential.

The global median for reporting misconduct was 81% in 2020. The reporting of misconduct was highest in India (97%), followed by the US (86%), Mexico (85%), and France and the UK (both 82%). Russia had the lowest level of reporting (64%).

Retaliation

The rate of retaliation against employees for reporting wrongdoing in the US was 79%. Retaliation is at an all-time high across all management levels, with top managers and middle managers driving much of this increase in recent years (an increase of 62% and 67% respectively). In contrast, retaliation rates amongst non-management employees increased by 24%.

The global median for retaliation was 61% in 2020, a 28% increase on 2019. Employees from all countries surveyed reported higher rates of retaliation. The largest jumps were observed in Brazil, China, France, Germany, Spain and the US, with employees from India reporting retaliation at the highest levels (90%). Rates of retaliation were lowest in Russia (41%).

For the full survey go to: https://bit.ly/3eXxUC8

International

Investor focus on ESG accountability

Now, more than ever, investors are using proxy votes to express their views on company behaviour, rather than relying on company disclosures. And after an unprecedented year, the blurred lines between what constitutes E, S or G are highlighting the challenges of a one-size-fits-all approach to proxy voting according to US global investment manager Nuveen in their 2021 proxy season preview.

The global pandemic has motivated investors to increase their focus on the strategic impacts of environmental and social responsibility on long-term shareholder value. However, in 2020 less than 25% of the ESG reports of S&P 500 companies were aligned with the Sustainability Accounting Standards Board (SASB) reporting framework, only 16% of reports referenced the Task Force on Climate-Related Financial Disclosures (TCFD) and only 5% of companies published complete TCFD-aligned reports.

As investors continue to push companies on environmental and social issues, improved transparency and standardisation, companies are seeking Securities and Exchange Commission (SEC) approval to omit shareholder proposals from ballots through no-action requests. The SEC process allowed 63 resolutions related to environmental and social issues to be omitted in 2020, thus limiting the ability of shareholders to bring certain proposals to a vote.

‘Shareholder proposals are also being used to push companies on performance toward a low-carbon transition.’

Climate-related proposals
While shareholder proposals have increased in volume, they have also evolved and now request information on the governance of environmental issues or the business strategy to promote the outcome of racial equity or the low-carbon transition. Climate-focused stakeholders have filed 126 proposals for the 2021 proxy season, however fewer than half focus on traditional transparency requests. Greenhouse gas (GHG) reduction targets and strategy is the most popular topic, followed by lobbying disclosure requests and board oversight of climate and sustainability strategies.

Shareholder proposals are also being used to push companies on performance toward a low-carbon transition. Many key 2021 proposals targeting the world’s largest emitters have gone to companies that already disclose information related to climate risks and/or have GHG reduction targets.

Board diversity
Investors continue to unite around calls for board diversity. In 2020 the focus was on gender diversity, however in 2021 there is an increased focus on race/ethnicity in the boardroom. Whereas less than 10% of boards in the Russell 3000 (none in the S&P 500) lack gender diversity, nearly 40% of Russell 3000 boards lack racial and/or ethnic diversity. Many mainstream investors have now put companies on notice regarding diversifying their boards beyond gender. However, most investors are calling more for transparency on board race/ethnicity composition than action on board refreshment.

Workforce transparency
Diversity and inclusion is now the most common human capital management issue addressed in proxy statements. Beyond the boardroom, investors have increased their interest in workforce diversity and inclusion. There has been a dramatic increase in shareholder proposals requesting disclosure of Employer Information (EEO-1) Reports. Investors with public campaigns on workforce transparency have stated an intention to file more than 40 shareholder resolutions requesting disclosure of EEO-1 data. In 2020, a total of only 22 shareholder proposals requesting EEO-1 data were filed and only eight went to a vote.

Multiple shareholder proposal advocates also focus on racial equity from a supplier, customer and community perspective. Proposals typically request that the company demonstrate accountability to racial equity in its business practices, whether through a tangible action or a third-party assessment, and validation of the value of the company’s policies and practices.

Political activity
Shareholder proposals on political activities have been the most-voted proposals of the past two years. Many companies have already announced policy changes on direct political contributions. It remains uncertain whether and how companies will reconsider other political activities and whether that assessment will extend to addressing other societal issues.

Executive compensation
While many companies proactively incorporated ESG factors into compensation packages, ESG factors typically get included as part of an holistic assessment of a variety of strategic factors. The metrics evaluated and the bonuses awarded specific to ESG performance are often less transparent. Shareholders are requesting that executive compensation includes management accountability for implementing ESG strategies and commitments. The requests range from a broad look at integrating SASB metrics to more company-specific issues.

In 2021 increased attention on ESG from shareholders, stakeholders and regulators is likely to see increased votes against boards that are not keeping pace with ESG transparency and accountability. With the call for standardised and material ESG disclosures, investors will be able to further assess company performance and translate their assessment into proxy votes.

For the full briefing go to: https://bit.ly/3h8roen

Global News

SEBI listed company updates

The Securities and Exchange Board of India (SEBI) has extended the requirement for listed companies to formulate a dividend distribution policy from the top 500 listed entities to the top 1000 listed companies on the basis of market capitalisation. The policy should be disclosed in the annual report and the company website and should include the following:

- the circumstances under which shareholders of the listed entities may or may not expect a dividend;
- the financial parameters that will be considered while declaring dividends;
- internal and external factors that will be considered for declaration of dividends;
- policy as to how the retained earnings will be utilised; and
- parameters that will be adopted with regard to various classes of shares.

Any changes to the policy, and reasons for the changes, should also appear in the annual report and company website.

The Board has also amended the Listing Obligations and Disclosure Requirements Regulations relating to the constitution and role of the Risk Management Committee (RMC) of listed entities. These amendments have also been extended to the top 1000 listed entities by market capitalisation from the existing top 500 listed entities.

The RMC shall comprise a minimum of three members, the majority being board members, including at least one independent director, and it should meet at least twice per year. The quorum for a meeting of the RMC shall be either two members or one-third of the members of the committee, whichever is higher, including at least one member of the board of directors. Appointment, removal and terms of remuneration of the chief risk officer should be reviewed by the RMC, jointly with the nomination and remuneration committees.

The role of the RMC includes formulation of a detailed risk management policy and ensuring that appropriate processes and systems are in place to monitor and evaluate associated risks and also reviewing the policy on an annual basis. Risks include financial, operational, sectoral, information, cyber security and sustainability – specifically ESG related risks and impact.

The RMC also has the powers to seek information from any employee, obtain outside legal or other professional advice and secure attendance of outsiders with relevant expertise, if it considers it necessary.

Organisational resilience index

'Despite the challenges of 2020, business leaders' confidence in the resilience of their organisations has risen', according to BSI's fourth annual *Organisational Resilience Index* Report, which surveyed 500 senior leaders globally.

As a whole, perceived organisational resilience across organisations globally rose in 2020, with 33% of companies fully confident in their organisation's resilience. Many of the organisations interviewed felt that the measures they had in place prior to the pandemic were successful and helped them survive, stabilise and begin to rebuild, boosting their confidence for the future. The perceived qualities of leaders to shore up resilience has changed over the last 12 months, with supplier management, business continuity and community engagement all emerging as rising priorities.

The Report shows that there is a clear association between those reporting a stronger financial performance and those with stronger perceptions of their own organisational resilience. The index found that leaders remain cautiously optimistic, with 57% of businesses in the UK, US and India expecting their financial performance to improve this year.

However, the index found that financial security and confidence is not evenly spread globally. Despite businesses in Japan and China reporting similar financial setbacks in 2020, only organisations in China expect a better year in 2021. Japan had the largest proportion of organisations reporting a worse year in 2020 and is forecasting the weakest recovery with only 38% expecting a better year in 2021. Respondents suggested that this slower return to confidence in Japan is reflective of business culture rather than market conditions. In contrast, US firms were the least likely to report a reversal of fortunes in 2020 and, alongside India, are the most likely to forecast growth, with 64% expecting a stronger 2021.

The Report identifies the aerospace industry as being least confident of its organisational resilience following the upheavals of 2020, just 43% expect an improvement in 2021, in contrast to 67% of business leaders in the built environment, 61% in healthcare, 57% in food and 56% in automotive.

Despite the upheaval caused by the Covid-19 pandemic, diversity and sustainability continue to remain high on the agendas of organisations worldwide. The Report found that looking after the wellbeing of employees, customers and communities was vital for rebuilding organisational resilience.

Global News

Disclosure web portal

With the rate of foreign stock ownership in the Japanese market growing, a large proportion of listed companies are proactively working to disclose company information in English. The Tokyo Stock Exchange Inc (TSE) has launched a disclosure web portal, *JPX English Disclosure GATE*, to promote better English disclosure from listed companies anxd increase investment opportunities for overseas investors.

When TSE surveyed listed companies yet to disclose in English, many cited the large amount of resources needed for the preparation of English documents as their main obstacle. The new web portal will provide information that aims to help reduce the burden for companies. At the same time, the TSE will work to improve accessibility of this disclosed information to overseas investors.

The new portal includes:

- *Company announcement service* providing overseas investors with easy access to English materials published by listed companies, including corporate information disclosed in accordance with the TSE rules; filed information; and PR information.
- *Listed company search* providing information on TSE listed companies ranging from basic data and filing information to corporate governance.
- *Corporate governance information search* providing information based on listed company reports, such as corporate governance policies, basic company information, management decisions on appointments of outside and independent directors, shareholder and stakeholder information and internal control systems.
- *English disclosure information* based on voluntary responses from listed companies on whether they disclose information, such as financial results, corporate actions and notices of general shareholder meetings, in English.
- *TSE IR Movie Square* for investor-orientated videos such as company introductions and messages from corporate representatives.
- *Investor transcript* service providing transcripts in Japanese and English through the TSE's information delivery system.

The portal also includes an English materials distribution service, English language sample disclosure forms and a list of terms in Japanese and English.

As part of the market restructure planned for April 2022, the TSE foresees that companies listed on the new Prime Market will be required to work to improve mid- to long-term corporate value through constructive dialogue with institutional investors both in Japan and overseas. The TSE will continue to encourage strengthened English disclosure and improved accessibility as the foundations of that dialogue.

2021 interim reporting season

Ahead of the 2021 interim reporting season, a Report by the Financial Reporting Council (FRC) Thematic Review: Interim Reporting has highlighted examples of good practice in company's interim reporting and areas where further improvements are required.

The FRC reviewed the reports of 20 quoted companies across a range of industries to assess the quality of interim reporting.

Timely and reliable interim reporting is vital for investors, creditors and other stakeholders to properly understand a company's financial position, performance and liquidity.

A notable feature of interim reporting is that, compared with annual reporting, there are considerably fewer prescriptive requirements about the content of the interim report.

The purpose of the FRC's thematic review was to highlight areas of good practice they have observed in recently published interim reports and to make suggestions for improved reporting to meet the needs of stakeholders. Overall, the FRC was pleased with the quality of interim reports, with most companies taking into account FRC Covid-19 recommendations to enhance their disclosures, particularly in relation to going concern and the statement of cash flows.

For significant events and transactions taking place during the interim period, such as impairments, many companies provided detailed explanations and other helpful information normally reserved for the annual reports and accounts.

There remain, however, opportunities for further improvement, and preparers are encouraged to consider carefully the findings of this thematic when preparing their forthcoming interim reports. The FRC expects companies to communicate material information clearly and concisely.

The full report can be accessed here: https://bit.ly/3osDSyZ

Feature

The crisis of governance

Gerry Brown has studied the recent BEIS White Paper and found it wanting. He argues that what UK governance needs is not more consultation but proper implementation and enforcement of the existing regime.

The crisis of governance is a real problem that affects us all. Wherever you choose to look there is a crisis of governance with many and various governance challenges. The businesses we work for as well as many other institutions we depend on are only as effective as their governance. All too often, as the ongoing litany of scandals and bankruptcies in the public, private and third sectors shows, governance is being challenged and sometimes failing. And often failing badly.

Many of the crises that come to public attention do so when it is too late. These failures often involve significant financial sums so, understandably, the sheer size of these numbers attracts media and government attention to police the situation. Inevitably, of course, once the financial elephant has run away from the company accounts circus, it is already way too late to prevent meaningful damage.

Though proclaiming himself as the Minister most likely to stop further scandalous damage by the herd, the recently mooted Kwasi Kwarteng White Paper *(Restoring Trust in Audit and Corporate Governance)* appears to still want to fail to catch these metaphorical runaway business elephants. But, instead, still be seen to be doing something and vaguely consulting about it too. Like so many before him, Mr Kwarteng looks likely to settle for some additional eye-catching headline snatching initiatives – doubtless gussied up with flimsy extra red tape – rather than bother with the less glamorous but more effective grind of enforcing existing corporate governance regulations.

Clearly, it should go without saying that it is important to avoid shareholders, customers, the workforce, patrons and – most importantly but most frequently overlooked – the wider community bearing the exogeneous cost burdens of corporate governance failures and, instead, to hold company directors responsible. Indeed, looking to find some positives from Kwarteng's White Paper, these proposals laudably include 'Malus and clawback clauses' designed to penalise companies that fail or get embroiled in scandals as well as some attention-grabbing signals about a welcome review of the audit and accounting regulatory and supervisory body. Nevertheless, toothless enforcement against the company directors responsible for scandals and bother still looks likely to remain the order of the day and plague the future nearly as much as it does the present.

Though I hold no mandate for accounting forms of any stripe, consulting over re-arranging the organisational structure and seating plans of the present accounting regulator with additional emphasis upon financial reporting issues via this White Paper focuses on the symptoms of the problems and, thereby, sets aside the chance to influence circumstances at source. To switch and mix my metaphors, if unexpectedly heavy rain sees our rivers swell then only addressing the deluge at the points downstream where water bursts the banks misses the upstream opportunities to prevent and mitigate damage. As currently presented, the Kwarteng White Paper prefers to only wade onto the flooded plain and ignores so many other very important corporate governance issues. If choosing our approach better, it is clear that we do not need more rules downstream especially since we already have a good UK Corporate Governance Code on the statute book to govern and enforce boardroom behaviour and practice.

Of course, there is a rich tradition of government ministers responding to real or imagined business malfeasance and corporate scandals by commissioning reports – especially in the area of corporate governance – as well as endlessly defining and re-defining the roles of directors and non-execs. These changes are either delivered with sound and fury or tremulous whispers but, invariably, accomplish more or less the same thing. Namely, little or nothing beyond unintended effects while still leaving many of the key issues either unresolved or without effective legislative teeth. Any brief history of these committees and reports must include mention of the Cadbury Report (1992), the Greenbury Report (1996), the Hampel Report (1998), the Higgs Report (2003), the Walker Report (2009) and the Code of Corporate Governance (2012).

With Treasury bookshelves already heaving with these official Audit Reports and Corporate Governance Reviews aplenty, properly functioning audit committees as well as the enforcement of existing substantial guardrails and safe-guards that already appear on the Companies Act statute book and the Combined Code would be a both quicker and more effective solution than the delay of further consultation over this latest White Paper. I would suggest that the following measures (below) honour the direction and analysis of the original Greenbury Report. Though nearly three decades old now, the suggested measures, improvements and recommendations remain – in most part – still relevant today. These measures include:

- Requirement for companies to publish their board improvement plans resulting from board evaluation so that they would be more committed to, for example, improve board diversity and more training for board members.
- The FRC to be more rigorous in enforcing the Code requirement for all board appointments to follow a proper selection process.
- Change the legal title of Non-Executive Directors to Independent Directors to better describe their role.

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Other notable Greenbury recommendations, based upon best company practice largely arising from the work of the Cadbury Committee, included that the roles of Chair and Chief Executive should be separate to avoid undue concentration of power; that all boards should require a minimum of three non-execs and that these non-execs should be selected by a formal process; remuneration committee memberships should be made up of independent non-execs, while the Chair of the committee should also be a non-exec. Looking at one aspect of the numbers that so attract Mr Kwarteng's attention, audit committees should consist of at least three independent non-execs. It would be helpful to better corporate governance if one-third of the entire board retired annually by rotation and that the Annual Report should state reasons for retaining any directors aged over 70 at the time of their election/re-election.

Having written about these matters, I need no further persuasion that company boards constituted obeying basic good governance principles and practices with properly trained and effective independent non-execs are much more likely to avoid financial elephants leaving the circus to run amok and trample our good governance forests. Or, if you prefer, fast flowing waterfalls and rivers overwhelming the communities downstream. It should be obvious that if Mr Kwarteng stopped holding his telescope the wrong way round or glance up at the departmental bookshelves, he might instead decide to insist upon greater enforcement of the existing powers and legislation.

‘It is all too easy for less diligent companies to over pay executives, gift egregious dividend payments or file erroneous annual accounts at Companies House with little fear of examination or prosecution.’

It is all too easy for less diligent companies to over pay executives, gift egregious dividend payments or file erroneous annual accounts at Companies House with little fear of examination or prosecution. The number of times company directors have been remanded in custody at Her Majesty's Pleasure for business scandals is pitiful in comparison to instances where the threat of some actual time in the chokey might have taken the edge off or stopped some of the more outlandish boardroom activities, actions and behaviours. To quote a recent *Financial Times* leader ‘If the UK is to tackle the mountain of fraud forecast as a result of the pandemic and government support the Serious Fraud Office needs to raise its game and the government should give it the legal tools it needs to get past the foothills’.

Recent research undertaken by Henley Business School could provide food for thought for Secretary of State for Business, Energy and Industrial Strategy Kwarteng. Their already drafted key recommendations include: more and better training for independent directors so they are better able to carry out their complex and vital jobs; the need for all directors to be professionally qualified including a special qualification for independent directors; better, more professional approaches to selection and recruitment; increasing board diversity, with particular emphasis on BAME and disabled recruitment, but also greater diversity of background, experience and mindset.

‘If the UK is to tackle the mountain of fraud forecast as a result of the pandemic and government support the Serious Fraud Office needs to raise its game and the government should give it the legal tools it needs to get past the foothills’.

Though historically a contentious topic of debate, HBS advocate remuneration for all independent directors, including in the voluntary sector, to increase participation by people who are at present deterred because they cannot afford it or cannot spare the time. Along with self-development for directors and especially for Chairs, to ensure they are effective in their roles. Whatever aspect of the corporate governance of business life Kwasi Kwarteng wishes to consider, there already exists a welter of practical solutions on hand to quickly implement.

Finally, while the proof is going to be in the pudding when it comes to this White Paper, I would also question the value of yet more cumbersome and bureaucratic processes which just result in more stifling box ticking red tape and do nothing to help the UK become an even more attractive location for international business. Despite Kwasi Kwarteng's best intentions going down this White Paper route, even if he achieves his stated aims the likeliest result is going to be grand-sounding after the event, gentle taps on the wrists with a few extra new compliance boxes to tick rather than any root and branch reform of corporate governance behaviour of boards of directors.

Gerry Brown is Chairman of private equity firm Novaquest Capital Management and also the author of ‘The Independent Director’, his new book ‘Making a Difference’ as well as the lead author of the recently published ‘The Independent Director in Society’. https://theindependentdirector.co.uk/

Feature

Activism: mind the governance

Luca Giacolone looks at what boards should be doing to lessen the likelihood of being the target of an activist investor.

Introduction

Shareholder activism has evolved from a mostly US phenomenon to a global one, with numerous companies across the UK, Continental Europe, and Japan being subject to a growing number of investor demands, such as selling non-core assets or improving capital allocation. Moreover, as activist funds have continued to grow and their methods have become more widely accepted by traditional investors, companies of all sizes and in all geographies have become potential targets for activists.

Campaigns focused on ESG issues are also becoming more common, with some activists making them a core part of their campaigns with the aim of leveraging all of the target company's vulnerabilities. The latest example being the campaign at ExxonMobil initiated by newly formed Engine No 1, which is challenging the company's slow transition away from fossil fuels.

This increased activism has often shown a lack of preparedness from boards, who find themselves unable to provide reassuring responses to the well-crafted arguments presented by activists. In 2019 SquareWell Partners undertook a survey to better understand how asset managers evaluate activist situations. The respondents to the survey managed approximately $10.4trn in assets and the results highlighted the changing attitudes toward activism. Eighty-seven per cent of the surveyed asset managers considered activism to be a useful market force.

With the increased reach of activists and their ability to gather support from traditional investors, it is imperative for boards to conduct a continuous assessment of the vulnerabilities of the management teams they oversee. This is even more important given the current environment as shareholders will want to understand the lessons learned from the Covid-19 crisis, such as any gaps identified in the company's risk and crisis management strategy and the board's preparedness to respond. Boards are also expected to emerge with a better view on the quality of the management bench, the resiliency of the business, and what skills and experience might be missing in the boardroom. Board members are likely to be held accountable at companies that are perceived not to have taken the necessary measures to manage the crisis, including the protection of its workforce.

Governance flaws attract activists

Boards should carefully review their corporate governance practices and disclosures to uncover and address any potential weaknesses and try to proactively address some of the gaps, or at least have mitigating factors readily available to communicate. Failure to do so may turn into a 'gift' for a potential activist, who will leverage any governance shortcomings to reinforce calls for change and garner the support of traditional investors. In the 2019 survey, 87% of respondents stated that they would be more likely to support an activist if it would result in governance improvements at the target company.

'A board's effectiveness is a key focus area for activists when determining whether to initiate a campaign.'

A board's effectiveness is a key focus area for activists when determining whether to initiate a campaign. Any vulnerabilities surrounding topics, such as board independence, board expertise, diversity, or refreshment, are likely to be picked up by activists and used against the company to weaken, and in some cases break, the trust between the board and its shareholders.

SquareWell Partners' review of CEO changes at the world's largest 500 companies shows that almost one-third of the companies that appointed a new CEO in 2020 had an activist on their shareholder register. The choice of CEO is probably the most critical decision that board members will have to make during their tenure and one that reflects the board's quality the most, whether it be the quality of their succession plans or the strength of the executive remuneration policies they craft. On executive pay specifically, whenever pay is not aligned to performance, most investors take this as a sign that the board is 'captured' by the management team they are expected to oversee.

Action items for boards

Know and engage your shareholders

Activists' stakes tend to be around 5% to 10%, and their success in reaching their objectives will depend on their ability to convince other shareholders. While the receptivity to activists varies among institutional investors, with some being more management friendly, monitoring the shareholder base and, most importantly, conducting regular engagements will ensure that boards hear concerns sooner and prepare accordingly.

When engaging with shareholders, having their elected representative, ie an independent board member, will go a long way in establishing trust. Demands for access to board

Feature

members across all geographies is increasing, the latest example being BlackRock which in its 2021 engagement priorities explicitly calls on companies to provide access to an independent non-exec during their engagement.

Furthermore, meetings should be held not only with portfolio managers but also with stewardship teams, which play an increasingly important role at large institutional investors and often act as final decision-makers when deciding to support an activist or not. As large investors have all developed their own voting policies and rely less on the recommendations of proxy advisors, a good understanding of the preferences of investors will allow the company to be in a position to proactively address any concerns and secure the support of large shareholders in the event of an activist campaign.

‘The worst mistake a board of an underperforming company can do is to be complacent and not provide reassurance that shareholders’ concerns are understood.’

Know your weaknesses and control the narrative

Poor performance calls on boards to outline the actions taken to restore performance and ensure investor confidence in the board and management. The worst mistake a board of an underperforming company can do is to be complacent and not provide reassurance that shareholders’ concerns are understood. A lack of an adequate response from the company may signal to investors that the board does not have a clear vision and in turn increase the validity of an activist’s plan. In the context of the Covid-19 crisis, investors are most likely to raise concerns if the company has significantly underperformed during the pandemic, especially relative to their peers. In this respect, boards should scrutinise their companies’ response to the crisis and ask themselves whether the company has taken the necessary steps to take advantage of any opportunities created by the pandemic, and whether the pandemic has highlighted weaknesses in the company’s business model.

Don’t ignore E & S matters

Covid-19 accelerated investors’ interest in ESG. With record flows into sustainability funds and more investors implementing guidelines on these issues, a company’s approach to ESG should be made a standing agenda item during board meetings. A close monitoring of the ratings provided by ESG research and data providers is key in this instance as they largely influence how investors view a company’s performance on ESG.

In addition to Engine No 1’s campaign against ExxonMobil, which criticises the company’s pace of change in responding to the energy transition, another example of activists integrating environmental and social arguments in their campaigns is provided by Third Point’s campaign against US chipmaker Intel Corporation. In this campaign, Third Point raised questions over Intel’s human capital management due to issues with talent retention.

Board quality and effectiveness

As stated above, any potential governance flaws would be used by activists to call for change at the company. As such, it is fundamental for a board to conduct a regular assessment of its composition, independence, expertise, diversity, and overall effectiveness, vis-à-vis the expectations of its shareholder base. The following questions could serve as a starting point:

- Is the board evaluating whether the company has the right executive leadership in place to navigate a post-Covid world?
- Are there any independence concerns? Does the board have an independent Chair and/or has it appointed a lead independent director?
- Does the board have the right skills to oversee management’s execution of the company’s strategy?
- Are there any concerns with regards to long-tenured directors on the board and have any of them contributed to the decisions driving underperformance? Has the board communicated to investors its approach to board refreshment?
- Do all of the directors have a track record of overseeing good governance practices at the companies they served on or are currently serving in an executive or non-executive role?
- Has a robust board evaluation been conducted in the past year? Are weaknesses being addressed?
- Has the board been responsive to shareholders concerns in the past (including on executive pay-related topics)?

Regardless of the outcome, few boards come out of an activist campaign unharmed. As such, to avoid the time-consuming, costly, and long-lasting reputational harm caused by activist campaigns, boards should accelerate making tough decisions, if necessary, on leadership changes and board composition. Prevention is better than remedy.

Luca Giacolone is an ESG Adviser (Vice President) who started his career as an auditor for PricewaterhouseCoopers (PwC) in Milan, Italy. Most recently he worked as a research analyst at a governance research and data platform company in London, UK. In such role, Luca developed in-depth knowledge of corporate governance issues while providing compliance solutions for issuers and regulators. He holds a Master’s degree in Law and Accounting from the London School of Economics and Political Science.

Luca.Giacalone@squarewell-partners.com
https://squarewell-partners.com

Feature

Overseeing cyber risk at the board level

Roberta Sydney provides key questions for boards to consider as they oversee cyber risk and prepare to recover from incidents.

Attack targets for cyber hacking are numerous and growing with the ubiquity of the Internet of Things (IoT) and Artificial Intelligence (AI) along with the number of connected devices in our offices and homes. Further, remote work, a growing global trend pre-Covid, will likely be a permanent fixture – further broadening the attack surfaces for bad actors. Amidst this backdrop, cyber attacks are up 6,000% worldwide since the pandemic began, adding to the challenges that boards and management are handling. According to Dell/EMC, in 2019, cyber attacks on businesses cost approximately $600bn annually worldwide.

‘A company should not build a $2,500,000 fence to protect a $10 bill.’

Which data to protect?
A company should not build a $2,500,000 fence to protect a $10 bill. Creating and maintaining a cyber programme costs money – and boards should oversee how management spends that budget to protect mission-critical assets and systems. In a mobile technology world, it is impossible to protect everything. Therefore, prioritisation is a must. Boards should ask management to identify essential data and designate business-critical systems and to reassess that list as the business grows and evolves.

Resources like the US National Institute of Standards and Technology (NIST) Cybersecurity Framework can help identify the weakest links: (1) identify key assets, (2) protect against intrusion, (3) develop a way to detect when things go awry, and (4) create a recovery and business continuity plan.

How bad can it get and how long does it take to detect a breach?
It is not a question of whether there will be a breach, sadly, but when and how significant it will be. The recent NotPetya attack on a global retailer cost $15m daily in revenue and it took the company almost five days to recover. Further, NotPetya spread in seconds after the initial infection. Hundreds of servers, desktops, and phones for this highly connected business were rendered useless, impacting 10,000+ employees. The malware exploited operating system vulnerabilities and burrowed into third party software via a software patch. While good detection and prevention strategies were in place, they did not prevent the event. Therefore, boards need to ask management about their recovery strategy as a key component in business continuity management.

One fact that might scare boards and management is how long it takes to detect a breach. FireEye reports that the ’median well-time’, which is the amount of time an attack goes undetected, is lengthy and differs widely between regions. They reported that the mean well-time for 2018 in the Americas was 71 days, EMEA was 177 days and APAC was 204 days.

A board needs to ask management about breach detection measures, attempted cyber attacks and engage immediately when a significant breach occurs.

Is overseeing cyber risk also a ‘people’ issue?
Some think that cyber is just a technology issue. However, people are a critical element in an effective cyber risk management programme. *Security Magazine* reports that insider attacks – caused by human error or malicious attacks – are among the most difficult to prevent and detect. Boards should ask management for reporting on periodic penetration testing – also known as red-teaming – to determine if additional training is required. Often, these tests reveal that sophisticated phishing emails fool employees and board members who inadvertently click on links.

Since breaches can cause great losses to an organisation, its revenue stream, its stock price, as well as its reputation, a board should ask regularly about the human side of the cyber programme.

Who owns cyber risk management at the board level?
Cyber is part of risk management as with other marketplace risks that corporations face. Boards should understand the risks, and then manage or mitigate them. Often, cyber risk is relegated to the Chief Technology Officer or Chief Information Security Officer (CISO), and the topic is placed under the purview of the already stretched audit committee. Setting up a board risk committee that incorporates cyber into its enterprise risk assessment framework and having the full board engage in regular conversations about the full suite of risk management and business continuity planning activities is a preferred approach.

Measuring what matters is key. Directors should ask management about the metrics used to identify and manage risk. By measuring the right things, and having adequate governance attention, corporations can better manage their risk environment.

Has management allocated sufficient resources?
Knowing how costly breaches can be in time, reputation, and money, boards should ask management what additional cyber risk management measures should be implemented, and at what cost. Kris Lovejoy, Global Cybersecurity Leader at EY,

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says that she hasn't yet met a management team that says it has sufficient resources to protect the company's key assets, and to detect a breach quickly enough. According to EY, approximately 74% of CISOs are also dealing with pandemic-related budgetary impacts.

The board should ask about how the next dollar would be deployed if additional budget monies were allocated. And, if a board hears that resources are lacking, ask why and determine if it is a misallocation problem.

'Cyber is part of risk management as with other marketplace risks that corporations face. Boards should understand the risks, and then manage or mitigate them.'

When and where should cyber considerations be built in?
Companies should build cyber risk management into product design and operations processes from the outset. Car companies don't manufacture and sell vehicles that go on the road, whereupon the safety engineers are then asked to 'add in' security features to make the cars safe. This analogy applies to how management incorporates cyber protection design into the introduction of new systems, vendor interfaces, and system integrations with merged companies, among others.

Planning to harden interfaces with each new technology system or vendor is an important step in deployment. Identifying potential backdoors and access-points is key to advance planning to detect hacking attempts and to prevent entry from bad actors seeking to infiltrate each of these new vectors.

Boards should remember that all connections are susceptible. A hacker used an IoT-connected fish tank to infiltrate a casino's high-roller database, exporting data through a tank thermostat. According to Hemu Nigam, founder, and CEO of Cyber Security Affairs 'this was one of the most entertaining and clever thinking by hackers I've seen'.

Furthermore, Greg Touhill, retired Brigadier General of the US Air Force and cyber security expert recommends that boards ask management if all corporate accounts use multifactor authentication. He says that relying on usernames and passwords is a high-risk approach in today's environment.

In sum, cyber security teams should engage before, not after, an organisation connects or rolls out new technology.

How to recover from a cyber attack?
Business continuity and crisis management are key components of risk management for cyber and other risks. Boards should ask management if and how the organisation could recover if an attacker breaches the perimeter and encrypts or wipes data. To recover well requires pre-planning and designating in advance who is to lead each element of the communication and response effort. After an incident occurs is not the time to consider hiring a crisis communication consultant or to designate who needs to be engaged in the response effort.

Boards can ask management to run tabletop exercises to stress test the crisis management plan, and to identify gaps. I participated in a tabletop on one of my boards that revealed that no one had included the Human Resource Manager in the communication flow – a fact that was painfully obvious once employee computer access was cut off (with no notice) during the damage assessment phase.

While extensive and expensive, recovery usually follows a similar pattern: invoking a cyber incident response plan, performing forensic damage assessment, preparing the recovery, removing the malware, or rebuilding systems, restoring the data into production environments, while communicating internally and externally, as appropriate.

In conclusion

- Directors should stay current regarding cyber security and ask management to prioritise assets and budget accordingly to protect them.
- Boards should ask management how they are designing and building in security on the front end of digital initiatives.
- Train board members and employees to recognise phishing emails, since this is not simply a technology issue. Cyber risk extends throughout the connected device network. Use independent third parties for penetration testing.
- Boards should ask management about pre-planning for a breach and recovery, including a communication plan, leadership plan, and other aspects of business continuity management.

Roberta Sydney is an independent board director and serves on the board of Plaxall, Inc. a Long Island City based real estate and manufacturing business where she chairs the compensation committee and serves on the governance committee. She also serves on the board of Azalea LLC, as well as Tiedemann Advisors, a $22B global wealth manager. She also serves as adviser to several real estate technoloagy start-ups. Her prior corporate experience includes senior roles with financial services institutions, including State Street Global Advisors and the Boston Company. She earned a BA in French from Wellesley College, an MBA from Harvard Business School, and an MS in Real Estate Development from MIT. She is an NACD Board Leadership Fellow and was named among the 2020 Directors to Watch by Private Company Magazine.

Feature

ESG revolution in the US

Lyndsey Zhang reviews recent ESG regulation reforms in the US and examines the impact of global ESG trends on US corporations.

Since the concept of ESG – a focus on the societal and environmental impacts of companies – was introduced to the business community in 2005 with the landmark report from the IFC *Investing for Long-Term Value*, ESG has been widely adopted by institutional investors as an important consideration for portfolio risk management. Since the UN launched Principles for Responsible Investment (PRI) in 2006, PRI signatory has been widely recognised as a requirement for obtaining the public status of a responsible investment company, as confirmed by the dramatic increase in the number of PRI signatories – from 63 firms in 2006 to 3,100 firms in 2020, with the total amount of assets under management increasing from $6.5trn to $110trn in the same period of time.

> '… disruption in the global supply chain alone has raised concerns regarding health and safety, diversity and inclusion, climate change and the real purpose of business.'

Discussion of ESG has reached a boiling point recently, as the Covid-19 pandemic, social and political protests and environmental disasters have highlighted the role businesses can and should play in society. Specifically, disruption in the global supply chain alone has raised concerns regarding health and safety, diversity and inclusion, climate change and the real purpose of business. Up until the recent decade, the US has been known for its shareholder primacy, best articulated by the Nobel-prize winning American economist Milton Friedman, who declared that the social responsibility of business is to increase its profits. Recent developments seem to indicate that times are changing, as US regulators and companies start to keep pace with societal trends. Here's a brief look at how the ESG movement is beginning to take hold in the US.

What have US regulators done to drive the ESG movement?

Stakeholder Capitalism Metrics. The World Economic Forum (WEF), together with Bank of America, Deloitte, EY, KPMG and PwC, developed a new ESG reporting framework in September 2020: Stakeholder Capitalism Metrics. The framework provides guidance with criteria to measure a company's performance on ESG factors. The ESG reporting framework draws support from 120 WEF members, and a significant number of companies committed to implementing the reporting metrics immediately. Stakeholder Capitalism Metrics provide a common ground for future consultations with corporations, investors, regulators, NGOs and international organisations. In January 2021, led by Bank of America, KPMG and Mastercard, 60 US companies committed to the new ESG reporting standards. With wide adoption by major US companies, Stakeholder Capitalism Metrics can potentially develop more detailed ESG reporting metrics with reporting standards comparable to those required for companies' financial reports.

Nasdaq board diversity rule. In December of last year, Nasdaq filed a proposal to the US SEC establishing board diversity and disclosure requirements. Upon the SEC's approval, Nasdaq will become the first stock market in the US to require representation from people of colour, women and members of the LGBTQ community. Research shows gender diversity enhances the effectiveness of boards' monitoring and decision-making functions by fostering empathetic thinking and a more probing approach driven by female board members. Although the definition of board diversity is broader than demographic characteristics, and to cover all dimensions of diversity will take more time, further research and regulatory reform, Nasdaq's board diversity rule marks a symbolic first step on the path to greater diversity for US companies.

SEC commitment to ESG focus on climate change. In recent months, SEC has actively highlighted ESG reporting. In February 2021, following the appointment of the SEC's new Acting Chair, the SEC's Division of Examinations announced its 2021 focus on climate and ESG-related risks. In March, SEC formed a Climate and ESG Task Force in the Division of Enforcement and appointed the first senior policy adviser for climate and ESG matters. The Task Force is likely to drive the SEC's ESG initiative by emphasising enforcement of the current legal framework related to ESG investments. Whether SEC will take a principle-based or rule-based path for the new ESG regulation remains to be seen. Since applying a one-size-fits-all ESG reporting standard to companies from various industries may be too complex, most US corporations are expecting a principles-based adjusted approach by regulators. We should know more later in the year.

How have US corporations responded to the worldwide ESG trend?

US companies' reactions to ESG reporting and integration pressure. US companies have been trying to embrace sustainable reporting to satisfy regulatory requirements and investors' expectations. Their efforts have been stymied by the lack of universal reporting standards and much-needed clarification on the differences between CSR reporting, Sustainable reporting and ESG reporting. KPMG's 2018 report suggested that ESG integration needed to be a 'top down and bottom up' process, requiring a change in mindset from company leaders to influence changes in corporate culture and enable strategic ESG integration from different levels of an organisation. However, at this time there is no established set of best practices or pragmatic guidance for this method of

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integration. While consulting firms led by the Big Four (Deloitte, EY, KPMG and PwC) are working on establishing ESG-related professional services with research publications on climate-related and ESG reporting and integration related topics, some US companies are trying to find their own path to remain compliant or to stay ahead of the game, and others are simply waiting for new regulatory guidance.

ESG impacts to American corporations. According to a December 2020 report issued by Spencer Stuart, one of the world's leading executive search and leadership consulting firms and headquartered in the US, out of the 413 new independent directors appointed to S&P 500 boards, 59% are women and minority men. These new appointments in 2020 increased representation of women on S&P boards to 28% in 2020 compared with 26% in 2019. And this is the first time in the past 20 years that every S&P 500 board has at least one female director. Also in December 2020, Intel's new CEO appointment demonstrated how activist investors are empowering the voice of capital with active engagement.

In December 2020, Daniel Loeb, CEO of hedge fund Third Point LLC, one of the top 10 activist investors in the US, wrote to Intel's Chair requesting immediate action to improve Intel's human capital management strategy and strengthen its position as a global leader of PC and data center processor chips. Intel's stock price rose 6.1% shortly after the message. After Intel's new CEO Pat Gelsinger took the position, Loeb praised Intel's decision and confirmed Third Point LLC's plan to remain Intel's long-term shareholder. It's clear that shareholder engagement will become another influential driver for the ESG revolution in the US.

ESG revolution in the US banking industry. In February 2021, a US Stakeholder Intelligence company, alva, published its *US Banking ESG Report* based on publicly available information. The report revealed strong ESG performers, including Fifth Third Bank, TD Bank, Ally Financial, JPMorgan Chase and Bank of America. In the same month, US Bank appointed a new head of ESG for Fixed Income & Capital Market business to better develop the bank's business in the sustainable capital market; this incorporated a full range of ESG related options, including Green Bonds, and emphasised the bank's efforts to support diversity and inclusivity on human capital management matters. Moreover, the US banking sector will have the first climate focused bank, Florida-based Climate First Bank, coming in 2021. The bank has already announced its mission to become the largest profitable eco-conscious financial institution in the region, and its internal decision-making and analysis process will be guided by climate-related metrics. As an important stakeholder for businesses, the ESG influence from banks should not be underestimated.

The ESG movement in the US is advancing on all fronts, and the Covid-19 pandemic has only accelerated the advance. Be on the lookout for more changes as regulators further develop new ESG reporting standards and auditing mechanisms.

Whether US companies will embrace the ESG movement in all its facets is a lingering question. But the coming ESG revolution will no doubt redefine corporate purpose and reshape US board governance practices in the decades to come.

Lyndsey Zhang is the author of Amazon new release: The Surge - An Overview of China's Rapidly Evolving Corporate Governance and Coming ESG Revolution https://amzn.to/3bCpRK1. Lyndsey is the founder and CEO of Boardroom&Beyond, a company specialising in helping companies strategically integrate corporate governance and ESG best practice, and promoting leading companies in today's global sustainable movement

Website: www.boardroomandbeyond.com
Email: Lyndsey.zhang@boardroomandbeyond.com

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Governance Publishing and Information Services Ltd
The Old Stables, Market Street, Highbridge, Somerset TA9 3BP, UK
Tel: +44 (0) 1278 793300
Email: info@governance.co.uk Website: www.governance.co.uk