CARIBBEAN CORPORATE GOVERNANCE INSTITUTE

CERTIFICATE IN CORPORATE GOVERANCE
MODULE 3 -STRATEGY AND RISK

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INTRODUCTION

1. Directors of limited liability companies domiciled in Trinidad and Tobago are, by virtue of section 60(b) of the Companies Act Chapter 81:01, required to *direct the management of the business and affairs of the company*.

2. Moreover, directors and officers, by section 99(1) of the Companies Act Chapter 81:01 are required in exercising their powers and discharging their duties to:-

   (i) act honestly and in good faith with a view to the best interest of the company; and

   (ii) exercise the care, diligence and skill that a reasonably prudent person will exercise in comparable circumstances.

3. The requirement to act prudently applies both to directors and officers; *officers* include a general manager, comptroller, secretary and treasurer or any other person performing the same or substantially similar functions[1].

4. A director and officers' legal duties and fiduciary obligations are very strictly defined and interpreted because of a growing public disquiet over corporate excesses. In the UK, as a result of this disquiet, various reports were presented, namely, the Cadbury Report (1992), the Greenbury Report (1995) and the Hempel Report (1998) which all underscored the need for maintaining shareholder vigilance.

5. In the United States, following the *WorldCom, Enron* and *Martha Stewart Living and Omnimedia* debacles, directors' duties are much more onerous and demanding as a result of legislation intended to curb corporate excesses. In 2002 the Sarbanes-Oxley Act widened the definition of *insider* as it relates to insider trading to include anyone who makes use of specific confidential information for his own benefit.

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[1] section 4 of the Companies Act Chapter 81:01

6. The Sarbanes – Oxley Act underscored the need for transparency and accountability by requiring CEO's and CFO's to certify that financial statements are accurate. It also entrenched *whistle blowing* as a result of which corporate governance in the United States has shifted significantly from being market driven to being rule driven. In Trinidad and Tobago we have started this process of rule driven corporate governance so that by section 25 of our Integrity in Public Life Act Chapter 22:01 you cannot benefit from *insider information* which is information gained from the execution of your office for your private gain.

7. It is submitted that in Trinidad and Tobago directors and officers, by virtue of their fiduciary duties to the company, are responsible for both corporate risk assessment and management; this is in the context that in the last 25 years the whole notion of *risk* has undergone a transformation. In the 3rd Edition of *Corporate Governance – Principles, Policies and Practices*, Bob Tricker noted that 30 years ago the phrase *corporate governance* was unknown but today Google has 322 million references to it.

8. Similarly, in the Cadbury Report in 1999 *risk* was only mentioned in the context of the board's responsibility to avoid fraud. Now, in a Global Enterprise Risk Management Survey, the Insurance Group Aon, in 2013 underscored the directors' duty to manage and leverage risk through:-

   (1) board level commitment;

   (2) developing risk management strategy and policy setting; and

   (3) moving away from risk avoidance and mitigation to risk leveraging and risk management options.

9. Moreover, recent events have demonstrated that *cyber*-attacks and the security of corporation information is the most virulent form of risk and that this is no longer a *technical* issue involving only the IT personnel. This is because hackers can enter corporate systems through malware in external links such as credit card payments systems, video conferencing equipment and even external access to printers, thermostat controls and vending machines.

10. Accordingly, the board's responsibility which was previously to define strategy and risk appetite, must be extended if only because directors and officers are liable for loss and damage arising from risk management systems which are incompatible with the *de facto* commercial operations.

RISK MANAGEMENT

11. This requires that:-

    (1) the risk leveraging and management function report directly to the board; and

    (2) the effectiveness of the risk assessment and management process must be monitored and assessed and its results disclosed.

12. None of this is new; in 1999 the Turnbull Report drew attention to the importance of board level risk assessment; in 2009 the UK Corporate Governance Code included principles on the board's responsibility for risk management. In 2010 the International Corporate Governance Notebook (ICGN) underscored that the risk oversight process begins with the board and in 2012 the UK's Financial Reporting Council (FRC) required listed companies to disclose their principal risks in their annual report.

13. It is proposed that the analysis of risk in any organisation involves a number of iterative phrases:-

- Risk **I**dentification - to recognise and identify the risk
- Risk **A**ssessment - to assess the risk
- Risk **E**valuation - to prioritize the risks from the point of view of exposure (this is the same as Risk Response); and
- Risk **M**onitoring - to devise systems which are robust, efficient and effective to reduce or leverage the risk

14. When **IAEM** is operational then the board devises strategies to ensure business continuity and to report to stakeholders including shareholders; the reports are generally contained in the annual reports.

15. **IAEM** is often carried out by the Audit Committee (AC) but there is merit in appointing a Risk Assessment Committee (RAC) as a standing board committee with a specific and dedicated **IAEM** mandate and to propose Business Continuity policies; this is because:-

    (i) ACs may be oriented in the past;

    (ii) AC's priority is with audit outcomes and approving accounting information for publication; and

    (iii) Risk Assessment requires a pro-active dedicated focus with a results orientation approach.

16. A typical RAC has 4-5 members with appropriate business experience; it is ideal for independent directors meeting 2-3 times yearly but more often as is necessary; senior management and external risk experts are likely to advise the RAC.

17. It is necessary for the RAC to have its ears to the ground and to discern and filter potential risks; the RAC's methodology should eschew a piecemeal approach or a *silo* or *bucket* approach where risk response is sporadic and reactive and for these purposes, particularly for financial institutions, it is necessary to move managers into risk management functions early in their career programme reporting to a Chief Risk Officer (CRO). In Goldman Sachs a balance has now been achieved between risk taking traders and potentially risk averse traders by complementing their functions.

18. Summarily, therefore, the following are advanced:-

    (1) appointing a RAC which advises the board;

    (2) mandating the RAC to identify, assess, evaluate and manage all risks including:-

(a) corporate strategic risks (exposure to threats from outside the company);

(b) management level risks (exposure to risks arising from the company's activities); and

(c) operational risks (exposure to hazards within the company)

(3) mandating the RAC to devise a strategy for submission to the board to ensure business continuity in relation to these risks together with its recommendations to leverage the risk.

THE FUTURE OF RISK MANAGEMENT

19. Bob Tricker in the most recent 3rd Edition of *Corporate Governance – Principles, Policies and Practices* makes the point that over the next 30 years a director's pre occupation will be in relation to:-

(1) Shareholder Activities

Through lobbying by interest groups on issues like pay for performance, climate change, human rights and the political complexion of companies;

(2) Technology

Paperless board meetings but concerns about ease of access and directors' access to unreliable information from non-traditional sources which do not receive the *imprimatur* of the CEO. Equally, advances in software will permit board information platforms giving directors immediate and uncontrolled access to the company's data and financial information; the once per month board paper will go the way of the dinosaurs so it is better to give your new director, by way of orientation, an I-pad than a contact sheet;

(3) Gender Diversity

Tricker notes that a UK government commissioned report by Lord Davies *Women on Boards* recognised the different skillsets and perspectives and recommended that 40% of all boards appointed from FTSE 100 companies should be female. Norway's Quota System introduced since 2000 has been followed by India, Malaysia and South Africa and eleven (11) European states now have laws to promote gender equality on company boards. A recent study[2] has demonstrated clear improvements in corporate governance and financial performance as gender diversity has grown;

(4) The Governance of Strategic Risk

The Risk Management System need to evolve to reduce the risks in relation to *cyber*-crime, interactive market based systems, social commentary, internet, data theft and hacking. This means that Risk Expertise is needed at board level.

(5) Integrated Reporting

Increasingly companies are communicating electronically with shareholders through integrated reporting which captures a coherent linked narrative explaining current company events and directors' expectations as well as strategies and policies including anti-bribery, anti-corruption and whistleblowing for the future. Strategic Reporting in the future may go far beyond traditional metrics and may include comments on risks, market, models and product development as well as reporting on sustainability, pollution indices, carbon emissions and human rights issues with shareholder demand for more access to information previously shielded. This is already happening as classical audited annual reports are being replaced by more frequent financial reviews, strategic reports, risk analyses and corporate governance reviews;

[2] Littenfeld, Doreen and Neil Beckman's 2014 Study on The Imperatives for Gender Diversity on Boards

(6) Shareholder Interaction

Another trend is the expectation from significant shareholders for personal interaction with board members;

(7) Corporate Social Responsibility

The rise of Corporate Social Responsibility (CSR) as a marketing/promotion tool on the basis of the increasing trend for companies to report on corporate governance including (but not limited to) how employee, customer, government and investor relations are handled, how business ethics and sustainability are incorporated into policies and protocols and whether whistleblowing, bribery, corruption and human rights abuses are included.

(8) Principle or Rule Based Corporate Governance

Whether corporate governance should be principle or rule based? – In the US, corporate governance is increasingly enforced by the Rule of Law through federal and regulatory laws consistent with the US Sarbanes- Oxley Act of 2002 which was a response to the collapse of Enron, WorldCom and Arthur Anderson. These laws have been reinforced by SEC requirements. The US Rule Based Model must be compared with the Principle Based Models operating in the UK, Australia, Canada, Hong Kong, India, Malaysia, New Zealand, Singapore and South Africa where corporate governance is often discretionary based on Codes and Best Practices. Both competing systems have not converged, despite the view that the American Model will prevail because the world needs access to American finance. What has converged is the financial accounting standards in the form of the International Financial Reporting Standards (IFRS) so much so that the SEC has stated that it intends to move to the IFRS from the Generally Accepted Accounting Principles (GAAP). The trend though is toward rule based corporate governance standards.

(9) Globalisation

This is the establishment of *meta* nationals where boards are no longer domiciled in one country or several countries but operate globally above them for instance Nestle or Astra Zena or BP.

(10) Taxonomy

The trend is towards *taxonomy* or the re-classification of corporate entities from the traditional two (2) groups, namely, public and private companies to distinguish different species and sub-species of corporate entities and to avoid the homogenous model. One approach is to distinguish companies by the way in which power is exercised so that the South Korean *Chaebols* can be contrasted with the Japanese *Keiretsu* and the Italian *chained companies*; another approach is to distinguish them in relation to regulatory controls so that NGO's, charities, professional bodies and not for profit foundations are individually recognised. Yet another approach is using investment as a form of distinction so that state agencies are distinguished from public companies and private companies but account will be taken of membership driven agencies like trade unions, co-operatives, savings and loans associations and even professional bodies.

(11) Leveraging

The growing political and wealth generating capacities of emerging economies in China, India and Brazil are increasing the leverage of firms domiciled in these countries and their disproportionately greater access to capital means that they are overpowering the traditional Anglo/Eurocentric companies in relation to governance, reporting and shareholder value.

CONCLUSION

20. It is submitted that while risk management is a board function, devising strategy to reduce or leverage risk is an operational one but under board supervision; it is for this reason that the board must not only cause the implementation of protocols and policies to ensure

business continuity but it must empower executive management to periodically review them having regard to the dynamic of international trade.

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