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Artificial intelligence

‘While we cannot expect every board member to have expertise in data science, a real understanding of technological principles and the risks, regulatory, and social implications of AI certainly should be a pre-requisite for board members in any AI-centric company or one planning to capitalise on AI in the future.’

David Nolan

Board diversity beyond the FTSE 350

‘Companies often have inconsistent statements about board diversity spread across three or more sections of their annual report, making it difficult to identify their position on diversity or how they demonstrate accountability for change.’

Tracey Brady

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News

Board and employee relationship insight

'Working conditions, changing contractual arrangements and automation are all areas of increasing importance for investors who are calling for clearer company disclosures on workforce related issues', according to the latest Financial Reporting Council's (FRC) Lab Report, *Workforce-related corporate reporting – Where to next?*

Investors are seeking greater insight into:

- governance and management – how boards consider and assess the topic of the workforce;
- business model and strategy – how the workforce contributes to the success of the business model, whether it is considered a strategic asset and what changes to strategy might be needed to maximise workforce-related opportunities;
- risk management – the risks and opportunities related to the workforce and how the company is responding to these; and
- metrics and targets – how the company measures the contribution of the workforce and how the workforce's views are taken into account.

Both companies and investors reinforced the importance of the board's role, with investors seeking to understand how boards consider and assess workforce issues and how they provide oversight and integration of workforce matters into strategic decisions. Investors want more information about how boards engage on a range of sustainability-related topics, including the workforce, relevant to the company's business model and strategy and how workforce-specific risks are being managed and addressed.

Companies should describe the board's oversight of workforce-related matters and how the board has engaged with the workforce; describe management's role in considering and managing workforce issues; and describe what impact the board's consideration of workforce matters has had on strategic decisions.

Business model and strategy

Investors are interested in the workforce as a strategic asset and how the company is ensuring it maintains an effective workforce to support the sustainability and success of the business model. They are clear that whilst the workforce is clearly a cost it is also a vital asset, helping a company stay competitive or achieve its strategy and drive value. Investors often expect companies to report on their workforce more widely than just direct employees.

Companies should describe: who the company considers its workforce to be (including total headcount, demographics and employment composition); whether, and how, the company invests in the workforce as a strategic asset; how the workforce creates value for the organisation and what opportunities there are to grow that value; how the workforce model supports the business model and strategy; and how workforce-related risks and opportunities affect the company's business, strategy and financial planning.

Risk management

Investors want a better understanding of the risks and opportunities presented by the workforce and how the company is responding to them, which risks can be quantified and assessed and the assessment of changes in the risk during the year.

Some companies considered workforce matters to be a business risk. Companies continue to refine the metrics they manage and monitor internally in relation to the workforce, as they view them as helpful in flagging up issues for further consideration. Companies should describe the organisation's processes for identifying, assessing and managing workforce-related risks and opportunities; describe which opportunities and workforce-related risks are most relevant to the company; and describe where the risks and opportunities sit in the business and how they are managed.

Metrics and targets

Deciding which metrics to report has been the biggest area of discussion in relation to workforce issues. Companies and investors highlighted the same five elements of performance disclosure as being important in relation to workforce issues: alignment to strategy, transparency, information in context, reliability and consistency.

Overall investors want quantitative disclosure and qualitative description. They seek transparency over the definition, scope and boundary of workforce disclosures and would also like to see more disclosure around the governance and oversight over the formulation of these metrics.

Companies should describe: the metrics most relevant to an understanding of the workforce, including how they were identified; how the company is enhancing and incentivising its workforce to deliver value, including targets used to manage workforce-related challenges and performance; how the desired culture is being driven from the top including how 'buy-in' has been achieved from the workforce; disclose employee engagement numbers, retention and turnover statistics, values applied in the working environment or other measures used to monitor workforce culture; and describe remuneration and other benefits and disclose training and development and progression statistics.

The Report focuses on workforce matters but many of the reporting recommendations could equally apply to other sustainability-related topics, such as climate change.

For the full Report go to: https://bit.ly/2UhZu4f

International

Global CG trends 2020

Global issues in 2020 include a greater focus on the environmental and social part of ESG, the increasing importance of corporate purpose, better board oversight of corporate culture, a more expansive view of board diversity and companies facing wider forms of activism according to a report by Russell Reynolds Associates.

> 'As institutional investor voting power grew dramatically, so did demands for gender diversity.'

The Report, *2020 Global & Regional Corporate Governance Trends*, is based on interviews with global institutional and activist investors, pension fund managers, proxy advisors and other corporate governance professionals who identified the corporate governance trends that will impact boards and directors in 2020.

Environmental and social issues

Beyond the global emphasis on good governance, environmental and social (E&S) issues appear to be taking the greatest precedence for investors, moving from being a national or regional focus to being truly global. Many boards and management are playing catch-up on how best to define, integrate and oversee the E&S issues that are material to their business.

In 2020, boards will be expected to strengthen their oversight and knowledge of material E&S matters and disclose their connection to the business in the form of risks and opportunities. Consensus is expected around reporting frameworks such as the Task Force on Climate-related Financial Disclosures (TCFD) and Sustainability Accounting Standards Board (SASB) to help guide companies when reporting on E&S criteria.

Increasing importance of corporate purpose

Corporate purpose and stakeholder considerations have been business norms in various parts of the world for decades. In August 2019, 181 out of 188 member CEOs of the US Business Roundtable signed an amended Statement on the Purpose of a Corporation, setting aside the traditional view that maximising shareholder returns is number one priority.

This was followed by an announcement in December 2019 from the World Economic Forum that the 2020 update of the Davos Manifesto (last published in 1973) would focus on principles that guide companies into the Fourth Industrial Revolution.

The Manifesto and the Business Roundtable's Statement challenge companies to put stakeholders at the heart of a company's purpose, however there remains a great deal of scepticism about the practical application of these documents and public opinion in many countries appears to be shifting against shareholder primacy.

Board oversight of corporate culture and HCM

Investors are asking what the board is doing to ensure the corporate culture is robust and can withstand transformation and change. Investors would like more transparency on board involvement in culture and human capital management (HCM) to determine whether boards are providing adequate oversight: data and analysis on corporate culture will play a key part in this. In 2020 directors should recognise the impact of culture on recruitment, retention and productivity and management will need to satisfy the board that the company has the culture and talent needed to execute strategy successfully.

Broadening board diversity

Considerable strides have been made globally around board gender diversity. As institutional investor voting power grew dramatically, so did demands for gender diversity. In 2020 boards will begin to experience additional pressure to consider ethnic and racial diversity. This pressure will vary by country: in the US it will be driven by investors such as Vanguard; in the UK it will be as a consequence of the Parker Review; in Japan the push to add more international directors will also broaden board diversity; and in Canada, it will be the Business Corporations Act legislation that will require federally-incorporated companies to disclose detailed information on the diversity of board directors and senior management.

There will continue to be jurisdictions around the world where it will be harder for this trend to gain impetus because the collection of data on ethnicity and race is illegal or highly regulated.

Wider forms of activism

Globally, investor activism continues to evolve and grow, creating diverse styles and approaches that change from year to year. What remains constant is that directors must maintain a degree of vigilance, ready to respond to activists or allay the concerns of investors. In 2020 increased activism success rates are expected and greater influence from both the traditional 'activist' investors in this space as well as larger non-governmental organisations. In some countries, employee shareholder activism around '#metoo' or climate risk has been successful in attracting public attention and in having an impact on management decision-making. To prepare for these situations boards are improving their effectiveness through more robust board evaluation processes. Boards are also engaged with management in scenario planning to ensure role clarity in crisis situations.

For the full Report go to: https://bit.ly/2OjUNmM

International

WEF Global Risks Report 2020

The global economy is facing an increased risk of stagnation, climate change is striking harder and more rapidly than expected, and fragmented cyber space threatens the full potential of next-generation technologies according to the World Economic Forum's *Global Risks Report 2020*.

Produced in partnership with Marsh & McLennan and Zurich Insurance Group, the Report is part of an expanded Global Risks Initiative that includes sustained analysis at the global, regional and industry levels and which seeks to bring stakeholders together to develop sustainable, integrated solutions to the most pressing global challenges.

The urgency of climate change dominates everything. All five of the top global risks by likelihood (and three by severity of impact) are climate-related:

1. Extreme weather events with major damage to property, infrastructure and loss of human life.
2. Failure of climate-change mitigation and adaptation by government and business.
3. Major biodiversity loss and ecosystem collapse (terrestrial or marine) with irreversible consequences for the environment, resulting in severely depleted resources for humankind as well as industries.
4. Major natural disasters such as earthquakes, tsunamis, volcanic eruptions and geomagnetic storms.
5. Human-made environmental damage and disasters.

Though inextricably linked with environmental risks, worryingly absent from these top five global risks are economic risks.

Global risks are not isolated and interconnections between pairs of global risks were assessed, the top most strongly connected being: extreme weather events + failure of climate change mitigation and adaptation; large-scale cyber attacks + breakdown of critical information infrastructure and networks; high structural unemployment or underemployment + adverse consequences of technological advances; major biodiversity loss and ecosystem collapse + failure of climate change mitigation and adaptation; and food crises + extreme weather events.

The Report also highlights how risks are perceived differently by those born after 1980 who ranked environmental risks higher than other respondents in both the short and long term. Almost 90% of these respondents believe 'extreme heat waves', 'destruction of ecosystems' and 'health impacted by pollution' will be aggravated in 2020, compared to around 70% for other generations. They also believe that the impact from environmental risks by 2030 will be more catastrophic and more likely.

Economic stability

Despite warnings in 2010 of gaps in global governance and inadequate investment in infrastructure, 78% of 750 global experts and decision-makers think 'economic confrontations' and 'domestic political polarisation' are likely to rise and will have severe impact in 2020. Collaboration between world leaders, businesses and policy-makers is needed more than ever and there is a clear need for a multi-stakeholder approach to mitigating risk, however, the Report forecasts a year of increased domestic and international divisions and economic slowdown.

Climate threats

Environmental concerns dominate the top long-term risks by likelihood among WEF's multi-stakeholder community; three of the top five risks by impact are also environmental. According to the survey, 'failure of climate change mitigation and adaptation' is the number one risk by impact and number two by likelihood over the next ten years. 'Biodiversity loss' is ranked the second most impactful and third most likely risk for the next decade and this has critical implications for humanity, from the collapse of food and health systems to the disruption of entire supply chains.

Digital fragmentation

While digital technology is bringing tremendous economic and societal benefits to much of the global population, issues such as unequal access to the internet, the lack of a global technology governance framework and cyber insecurity all pose significant risk. Geopolitical and geo-economic uncertainty also threaten to prevent the full potential of next generation technologies from being realised. Survey respondents rated 'information infrastructure breakdown' as the sixth most impactful risk in the years until 2030.

Health systems

Health systems around the world are at risk of becoming unfit for purpose. Changing societal, environmental, demographic and technological patterns threaten to undo the dramatic gains in wellness and prosperity that health systems have supported over the last century. Increases in longevity and the economic and societal costs of managing chronic diseases have put healthcare systems in many countries under stress and progress against pandemics is also being undermined by drug resistance. As existing health risks resurge and new ones emerge, past successes in overcoming health challenges are no guarantee of future success.

There is still scope for stakeholders to address these risks, but the window of opportunity is closing. Coordinated, multi-stakeholder action is needed quickly to mitigate against the worst outcomes and build resiliency across communities and businesses.

For the full Report go to: https://bit.ly/2UjIfzq

Global News

Attitudes to business ethics

'Overall, trust in British business to behave ethically has declined in the last year', according to a survey from the Institute of Business Ethics. The annual online survey *Attitudes of the British Public to Business Ethics*, found that just over half (57%) of the British public now say that they consider British business to behave ethically, compared to 62% in 2018 and 47% in 2003 when the survey was first launched.

The top issues concerning the public have remained the same in 2019: tax avoidance (33%, same result as 2018); executive pay (29%, up five percentage points on 2018); environmental responsibility (28%, up four percentage points on 2018), and fourthly exploitative labour and work-home balance for employees (18%).

Notably, the most common issue differs between men and women: for women it is environmental responsibility (33%) ranked third by men; for men it is tax avoidance (36%) ranked second by women.

Business appears to be increasingly proactive in addressing certain issues of public concern, such as discrimination in the workplace and openness of information: the prominence of discrimination as an issue has fallen slightly perhaps because organisations may now considered to be embracing diversity and inclusion better than in previous years; and the current low rating of concerns about openness with information possibly suggests that the public are unclear as to how data is being used or that there is little concern about it.

Environmental responsibility remains a significant issue driven by the changing narrative of climate change, the climate emergency and the publicity given to activists. That said, the 2019 figure of 28% is still lower than that of 2003 (36%). The issue of work-home balance has gained more prominence in recent years with 18% of respondents regarding this as an issue that needs to be addressed and suggesting that there is an opportunity for business to do more.

In terms of gender, for both men and women four of the top five issues are consistent: corporate tax avoidance, environmental responsibility, executive pay and work-home balance.

Particular relative differences are seen on corporate tax avoidance and executive pay (ranking higher among men) and work-home balance and harassment and bullying (ranking higher among women).

Singapore Exchange reporting requirements

The Singapore Exchange (SGX RegCo) is introducing quarterly reporting requirements applying only to companies associated with higher risks, while strengthening continuous disclosure requirements on all listed companies.

These changes are part of continuing efforts by SGX RegCo to enhance its regulatory regime by taking a more targeted approach. SGX RegCo will also make explicit the scenarios where material information must be disclosed on a timely basis.

Under the new requirement a company will have to report its financials on a quarterly basis if: it has received a disclaimer of opinion, adverse opinion or qualified opinion from its auditors on its latest financial statements; its auditors have expressed a material uncertainty relating to going concern on its latest financial statements; or SGX RegCo has regulatory concerns with the company, for example if it has had material disclosure breaches or where it faces issues that have material financial impact.

All other companies need only report half-yearly, though they are encouraged to consider providing voluntary business updates to shareholders in between their half-yearly financial reports.

Companies should consider the investors' expectations, the competitive environment and their long-term business strategy when deciding whether to provide voluntary updates.

SGX RegCo is: strengthening continuous disclosures requirements in areas that are of high investor interest such as interested person transactions, significant financial assistance, significant transactions and secondary fund-raising; and making it explicit that disclosure obligations apply not just to materially price-sensitive information but also trade-sensitive information (it has issued new guidance to issuers on situations requiring timely disclosure of material information).

It has also set out its expectations on the handling of material information by companies, including making immediate announcements where there is a change in the issuer's near-term earnings prospects or where there are ongoing developments. SGX RegCo has also established a whistleblowing office to more effectively address any tipoffs, feedback, complaints and short-seller reports on companies.

The risk-based approach to quarterly reporting replaces the current reporting requirement based on companies meeting a certain minimum market capitalisation and brings Singapore in line with other global markets, including Hong Kong, Australia and the UK. The enhancements to the continuous disclosures requirements and the new approach to quarterly reporting came into effect from 7 February 2020.

Global News

Board role in ESG governance

'Despite increased expectations on environmental, social and governance (ESG) issues from regulators and the investment community, a majority of Hong Kong-listed companies (63%) have yet to integrate ESG into their business models and many of them have limited knowledge and lack the expertise to address the issue', according to a report, *Integrating ESG into your business: A step-by-step ESG guide for Hong Kong-listed issuers*, published jointly by KPMG, CLP Holdings Limited and The Hong Kong Institute of Chartered Secretaries.

The Report points out that the recent amendments to the existing *ESG Reporting Guide*, published by The Stock Exchange of Hong Kong Limited and coming into effect from 1 July 2020, represent a critical step in bringing this issue to management routinely, with an emphasis on the board's role in the governance structure for ESG matters.

There is consensus that ESG is a part of good corporate governance and ESG integration principles must be supported from the top down.

ESG frameworks can be useful perspectives for companies to manage risks and tackle challenges. In addition, investors and asset owners alike are increasingly demanding more ESG-focused investing and ESG reporting plays an important role in how investors make their decisions and focus on the top priority issues that make the greatest impact on the business and stakeholders.

To move ESG from a peripheral issue and truly integrate it into business practices, in addition to top management buy-in, the Report highlights the importance of:

- developing a vision-led and goal-driven sustainability strategy and a robust data management system for progress tracking and target setting;
- building proactive ESG procedures with sufficient board oversight; and
- identifying and addressing ESG-related risks.

The Report points out that it is crucial to communicate the efforts with stakeholders regularly, including the publication of an annual sustainability/ESG report in line with local and international reporting standards, such as those developed by the Sustainability Accounting Standards Board (SASB) or the Task Force on Climate-related Financial Disclosures (TCFD), that businesses could follow to communicate sustainability information to their investors. They should also engage a third party to conduct independent assurance on the sustainability/ESG report and data.

Strengthening independent checks

Following high-profile corporate governance scandals, the National Diet of Japan has passed a law to strengthen independent checks on major listed firms by obliging them to have outsiders on their board of directors and make executive compensation more transparent.

The House of Councillors approved the Bill to amend the Companies Act by a majority vote and the Bill was approved by the House of Representatives in November 2019. Although more than 90% of large companies listed on the Tokyo Stock Exchange's first section already have outside directors, the government hopes to reinforce corporate governance by making the practice law, with the aim of promoting board independence to bolster investor confidence in capital markets in Japan rather than as a precise measure to promote corporate value.

The revised law is also designed to increase transparency in executive compensation at major companies and boards of directors will now be required to disclose outlines of executive pay, whether it is offered in cash or shares and in a fixed or variable amount, as well as other matters including whether the power to decide individual directors' compensation is delegated to a representative director. Another new provision urges firms to clarify how they will cover costs for potential lawsuits targeting their executives, such as lawyer fees and damages.

Rules related to general meetings of shareholders have also been changed. The revised law allows companies to send documents related to the meetings in electronic form at least three weeks before shareholders' meetings, giving shareholders more time to consider the agenda of meetings, and also limits the number of proposals a shareholder can submit to ten in principle.

The government's draft Bill had also included a provision enabling companies to reject abusive proposals that were defamatory or sabotaged shareholders meetings. But the provision was deleted after the Opposition said it would be difficult to judge whether proposals amounted to an abusive exercise of shareholders' rights.

Large companies that meet certain criteria such as having capital of over ¥500m or liabilities of at least ¥20bn would be subject to the law. Excluding the provision for electronic documents for shareholders meetings, the revised law is set to take effect by June 2021.

Feature

Artificial Intelligence

David Nolan argues that it's critical in the age of AI that organisations are able to create cultures that encourage trust and responsibility and that this principal is embodied in their leadership.

AI, robotics, Industry 4.0, nanotechnology. These are words we hear on a daily basis and the rate at which products and services are developing is exponential. Advances in wireless technology, the rise of super-computers and increasingly sophisticated machine learning architectures are fuelling development of ever more powerful AI tools and many products and services use multiple AI technologies. According to a PwC Global study https://pwc.to/378qrKB, AI is set to contribute up to €13.33trn to the global economy by 2030.

As a quick re-cap, AI is defined as a computer science-based program or system that replicates a human level of intelligence. AI technologies extract concepts and relationships from data, enhancing what humans are able to achieve and in some cases, automating processes.

Many experts believe that the best AI will not just be faster or cheaper than human decision-makers, but reach better conclusions by seeing things which people cannot. However, whilst we have brilliant minds creating these complex, transformational innovations, there does not appear to be a robust and consistent approach to the emerging ethical and governance issues at either an operational or boardroom level across the sectors most implicated when it comes to AI.

It is perhaps a sign of the times that MIT Media Lab has launched a course on the Ethics and Governance of Artificial Intelligence, to address issues such as the interaction between governance structures, algorithmic decision-making, autonomous systems and machine learning.

One sector at the cutting edge of this technology is the life sciences and pharma. Currently, the largest area of AI application is medical diagnosis such as radiology and pathology where computer programs can already interpret radiography images and translate patient data into diagnostic information far faster than a human clinician, with greater accuracy. Over the next five years, the AI market in biopharma will be driven by drug discovery, precision medicine, medical imaging and diagnostics and research according to a Deloitte Report *(Intelligent Biopharma – Forging the links across the value chain* https://bit.ly/39mmWli) all of which will help to dramatically improve patient care.

The sector is no stranger to the importance of sound regulation and governance. Last year we spoke to a number of senior Regulatory Affairs (RA) leaders about the increasingly complex regulatory challenges they are facing in their day-to-day work and the emerging issues they feel will impact the regulatory affairs field more widely over the next year.

'In summary, it's clear that never before has strong leadership been so important when it comes to successfully navigating what is still largely unknown in terms of the impact of AI in the years to come.'

Some were concerned that regulatory frameworks must evolve to become agile enough to cope with new types of therapies – cell and gene manufacturing, in particular – because they are essentially based on historical precedent rather than evidence-based science. As one RA executive put it, 'it's inconceivable now that one regulatory professional can keep everything they need to know in their heads at one time. You can't really be an individual expert for everything anymore'.

Despite these challenges the sector already recognises that these new innovations require new approaches. Our work with AI-focused biotech start-ups, indicates that ethical issues are increasingly being considered in the early stages of the development process, and not after the product has been designed and tested limiting potential risk.

Clearly, the AI revolution is not only an issue for life sciences and pharma. The transport, finance, technology, energy and defence sectors are also deeply involved in AI and this is only set to grow. They too will have to address ethical and sound decision-making and governance frameworks.

Currently, there is discussion around whether fundamental principles and codes can be agreed across sectors and industries. Also, how about collaboration between organisations that involve academic research institutions in order to build a set of fundamental ethical principles for AI development.

This could mean organisations considering putting in place AI Advisory Bodies to consider ethical codes, fostering discussion, and publishing guidance for specific industries and regulators. There are also those who argue that there is also a role for governments and/or other global bodies in this important discussion.

There's no doubt that business leaders will need to find a balance between governance, regulation and innovation. In fact, good governance has never been more important as key decisions made on AI today will help to shape the future in a major way.

Feature

In particular, boards have a duty of oversight, which requires that directors have in place an effective reporting or monitoring system as well as an information flow that allows them to detect potential risks to the company. It's important that board members are informed about developments regarding AI at all levels as this could have a transformative impact on their businesses.

To help keep up with all of this, in 2018, the European Commission established the independent High-Level Expert Group on Artificial Intelligence (AI HLEG). The group published a set of guidelines in April 2019 listing seven key requirements that AI systems should meet in order to be trustworthy https://bit.ly/37dWpVH . The piloting phase was completed in December 2019.

These guidelines represent a valuable pointer to the key issues that boards should have on their radars. In no particular order they are: human agency and oversight, technical robustness and safety, privacy and data governance, transparency, diversity, non-discrimination and fairness, societal and environmental well-being and finally, accountability. Trustworthy AI should be: (1) lawful – respecting all applicable laws and regulations, (2) ethical – respecting ethical principles and values, (3) robust – both from a technical perspective while taking into account its social environment.

The importance of this 'social environment' is one that many in the technology industry are acutely aware of. In a 2018 blog post about facial recognition, Microsoft president and chief legal officer, Brad Smith, noted that, 'advanced technology no longer stands apart from society; it is becoming deeply infused in our personal and professional lives …. Issues relating to facial recognition go well beyond questions of bias themselves, raising critical questions about our fundamental freedoms'.

In contrast to Smith's candour on these issues, Google has often been seen as much less transparent. Its controversial involvement in a US Department of Defense drone program known as Project Maven was shrouded in secrecy until their involvement was revealed by the specialist IT media last year. Amid protest from employees, Google said it would pull out of the project once its contract expired, and it also published a wide-ranging set of AI ethics principles that included a pledge never to develop AI weaponry surveillance systems or to contribute to any project that violated 'widely accepted principles of international law and human rights'.

What this highlights is that the question of public trust is paramount, particularly trust in major corporations including Silicon Valley. AI systems will not empower human beings or enable them to make informed decisions if the motives of their creators are viewed with suspicion or hostility or the systems themselves are seen as flawed or biased. Yet as a 2018 KPMG Report, *Guardians of Trust* https://bit.ly/2SetvAx , found, that trust is lacking even among industry executives, with only 35% of global IT and business decision-makers involved in strategy for data initiatives having a high level of trust in their own organisation's analytics.

So it is significant that Edelmans's 2019 AI Survey found that more than two thirds (67%) of technology executives felt that their industry is under-regulated, a sentiment shared by 69% of the general public. More than three-quarters of both groups are also worried that the technology industry isn't thinking through the long-term consequences of AI development. Moreover, when it comes to regulating AI, 60% of the public believe that AI should be regulated by a public oversight body and only 15% feel the industry should regulate itself.

Privacy and data governance are another pillar of trust. In addition to ensuring full respect for privacy and data protection, adequate data governance mechanisms must also be put in place whether this is for financial data, health records or information gathered via social media.

Central to all of these issues is also the question of accountability. As the *Guardians of Trust* Report put it, AI tools 'are simply machines and, as such, cannot be held accountable for the decisions or insights they produce'. In other words, the buck stops with the companies that develop the systems and with their management. 'For an analytical enterprise, an effective framework of enablers and controls is a board priority,' the Report notes. 'Boards will remain responsible for the actions and inactions of an organisation.'

In summary, it's clear that never before has strong leadership been so important when it comes to successfully navigating what is still largely unknown in terms of the impact of AI in the years to come. While we cannot expect every board member to have expertise in data science, a real understanding of technological principles and the risks, regulatory, and social implications of AI certainly should be a pre-requisite for board members in any AI-centric company or one planning to capitalise on AI in the future.

Equally, boards need to be aware that merely ensuring compliance with formal regulation may not be enough: such is the speed of technological progress that governance frameworks can quickly start to lag behind unless they are kept under constant review. It's also critical that organisations are able to create cultures that encourage trust and responsibility and that this principal is embodied in their leadership. This means ensuring a business culture that will attract and retain people who are visionary, strategic, and agile with the capacity to lead in a complex environment combined with a strong ethical compass and values.

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Feature

Board diversity beyond the FTSE 350

Tracey Brady discusses the findings of a recent review carried out by the Company Matters team into board diversity in AIM and FTSE 100 small cap companies.

Why did we undertake this piece of research? Easy, there is a lot of research measuring the FTSE 350 and whilst those companies account for a big slice of the economy not all of them are UK based and many are large global corporates. So is there merit in looking a bit wider and seeing what's happening below the FTSE 350? We think so. In our sample the companies are almost all UK and in the FTSE small cap or listed on AIM. An interesting and diverse group of businesses, but are they paying attention to what is happening from a societal perspective where the public want more transparency and to understand and trust business once again.

Perhaps we can start to make greater and faster change with some of the smaller companies as opposed to expecting everything to come from some of the global monoliths of the FTSE 350 which can feel removed and distant. Can trust be built from smaller sound UK businesses 'doing the right things' and behaving as 'good corporate citizens'? So let's start by shining a light on some and see what is happening. Diversity and the metrics we have chosen are a starting point for a conversation and a foundation on which to build in the future, it is by no means perfect but it is a start.

The idea of board diversity has gone from radical to widely accepted as being what makes boards work well. Companies have seen growing pressure to up their game on values, purpose, stakeholder engagement and culture. Major investors are now more likely to vote against re-election of the nomination committee Chair if demonstrable progress isn't made and if the minimum thresholds of female representation aren't met. Boards are not asking 'why' anymore, they're asking 'how'.

We analysed the boards of 100 largest companies of the FTSE Small Cap index (FTSE SMC 100) and in the AIM 50 index by looking at their annual reports and appointments. We reviewed their board diversity and how they report on their approach. We've found that board diversity in these indexes is increasing but it remains low, particularly in the AIM UK 50. In these companies, 15% of directors are women and 36% have all-male boards. These figures are barely higher than the FTSE 100 in 2011.

We've seen more encouraging results in the top 100 companies of the FTSE Small Cap index which, at the time of writing, has a gender balance of 28% women (better than the FTSE 250). This is fairly recent as 44% of new appointments in this index over the last 18 months were women, which is a higher rate than the FTSE 350.

We can only hope this is the direction of travel. Women hold 4 to 5% of executive roles in these companies and this is notoriously slow to change in all markets. The majority of these women are in CFO or FD roles, suggesting that is an 'easier' route for women to executive roles in the boardroom – even though women are no more likely to have financial experience than men. This is similar to the FTSE 350 where 60% of female executive directors are CFOs or FDs.

Ethnic diversity is low on these company boards too, showing very little change. More than 95% of directors are white and over 80% of boards are all-white. There are some exceptions where a board has more than one non-white director, but these are rare and typically non-UK incorporated or domiciled.

We've found that these companies have greater age diversity on their boards, particularly in male directors who range from 40 to 80+. This is partly because male non-execs have longer tenures and are more likely to be in executive roles, which tend to be younger. The average age of directors is slightly lower than the FTSE 350.

Another big change in the last few years has been higher expectations for companies to report accurately and transparently on:

- Their board diversity policies.
- How they're meeting targets (if at all).
- How their nomination committees account for diversity in appointments.

This reporting should give investors and stakeholders better insight into their board processes, but a review by the FRC found that this is a fairly weak area of reporting in the FTSE 350. We also found patchy reporting in our sample. In the FTSE SMC 100, more than half have basic or boilerplate reporting. Nearly one in six companies either state that they don't consider diversity as part of their appointments (ie an 'anti-diversity' policy), or fail to meet the Code's requirements by not mentioning diversity at all. Figures are even worse in the AIM 50 UK, where 42% have no mention or policy on diversity.

There are still reasons to be optimistic. In the FTSE SMC 100, companies are affected by the scrutiny placed on the FTSE 350. Many are making their way towards 33% women on boards at a similar rate. There are also a handful of companies taking their reporting seriously, giving investors and stakeholders good visibility into their policies and accountability.

But there's still a long way to go. A review of the AIM market's reporting shows there are many companies making no attempt to engage with the need to diversify their boards or senior management. This is crucial, because companies in this index are a major talent pipeline for FTSE 250 executive and non-execs.

Feature

Reporting on diversity

How a company reports on diversity – both at board and senior management level – can give us a valuable insight into how seriously they are taking it; whether they have a clear Board Diversity policy, and if they consider diversity to be important in appointments and succession planning. For those companies following the Code this is expected as part of their annual reporting, alongside statutory reporting on the composition of the board, senior management and employees as a whole, mandatory for quoted companies (ie not AIM), and their gender pay gap which is mandated for all companies over 250 employees. In both cases, the reporting requirement should be driving discussion at board level.

> ‘The idea of board diversity has gone from radical to widely accepted as being what makes boards work well.’

Overall, reporting on diversity in the AIM UK 50 is less informative, both in comparison to the FTSE 350 and the FTSE SMC 100. Forty-two per cent of the AIM UK 50 have no mention of board diversity in their annual report. Another 42% include a simple or boiler-plate response – a statement of commitment to diversity but with no specific details. Only eight companies have reporting that gives additional detail with only nine companies explicitly stating they have a diversity policy. Just two set any measurable objectives for board gender diversity, while 18% mention gender as part of their director succession planning and 22% discuss initiatives they have in place for increasing gender diversity at their senior management level.

A fifth of companies in the AIM UK 50 have a policy that explicitly mentions board ethnic diversity. Only two mention it as part of their director succession planning, and none set any measurable objectives. Four companies mention initiatives they have for increasing ethnic diversity at senior management level, although none of them demonstrated meaningful commitment to these initiatives (for example including targets or periodic review.)

Reporting on diversity in the FTSE SMC 100 is generally better than in the AIM UK 50, and largely in-line with that of the FTSE 250, again suggesting regulatory pressure makes an impact. Eighty-six per cent have some description of an approach to boardroom diversity. Another 6% explicitly state that they do not have a policy on board diversity, and that they recruit based on merit or on skills and experience. Eight per cent have no mention of diversity at all, failing to meet the requirements of the Code.

More than half (55%) only provide relatively minimal or boiler-plate descriptions; for example by stating that their policy on board diversity is that ‘the Board should have a broad range of skills, and that consideration is given to the recommendations of the Code and other guidance on boardroom diversity’. Nearly a third (31%) provide extra detail. These companies for example state that ‘we believe that it is in the interests of shareholders that board appointments are made on the basis of merit but also believe that there are substantial benefits to be had from having a board composed of a diverse range of individuals, who are able to contribute to boardroom deliberations from different perspectives’. These proportions are almost identical to the FTSE 250 in 2018, where 58% of companies had a simple or basic gender diversity policy and just over a third provided more detail.

Forty-two per cent of FTSE SMC 100 companies mention that gender or ethnicity is a factor in director succession planning, although some of these only include a cursory mention. Just eight companies set measurable objectives for gender diversity at board level. Nearly a quarter (24%) mention that diversity is part of the board evaluation process – an encouraging proportion but one that could be much higher.

It is notable that while 86% of the FTSE SMC 100 explain their approach to gender diversity, only 46% actually describe this as a board diversity policy, despite reporting requirements stating companies should have a diversity policy. We found many companies which, for instance, state they do not have a formal board diversity policy but also state that when they recruit directors they pay regard to the need to have a diverse board, and also report on that diversity. This may then suggest a confusion in reporting, where boards assume a Diversity Policy is synonymous with setting diversity targets.

Given that under the requirements of the Code (and for the FTSE SMC 100, the FCA’s Disclosure Guidance and Transparency Rule 7.2.8A), companies have to describe their ‘diversity policy’ or explain why you don’t have one, it is concerning to see such patchy reporting and such reluctance to develop or report on a clear policy, even when they do clearly have an approach to diversity.

It is also common for companies to have statements about board diversity spread across three or more sections of the annual report, and in some cases having contradictory reports – stating in one section that they do not have a policy and then in another that they do. This confusion makes it difficult to identify those companies that are not supportive of diversity from those who have considered it but are not effectively reporting on it, making accountability difficult to ascertain.

Tracey Brady is Managing Director of Company Matters which is part of the Link Group. This article is extracted from Board Diversity in AIM and FTSE Small Cap Companies. The full Report can be found at https://bit.ly/39pARad

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