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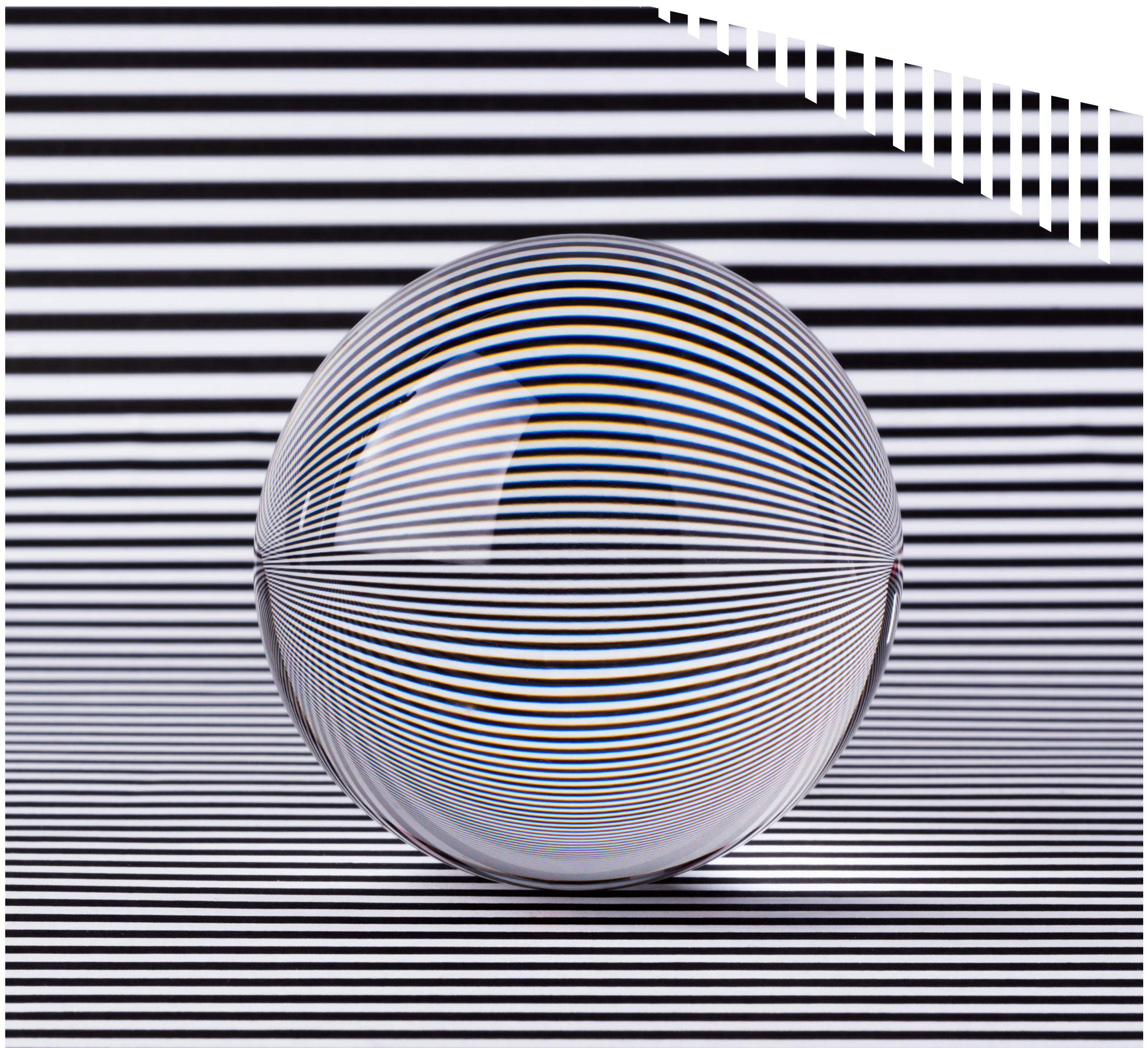
BOARD STRATEGY AND RISK INSIGHTS

GOVERNANCE THROUGH TRANSFORMATION AND DISRUPTION



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INTRODUCTION

The pressures on boards are increasing and directors are faced with two key challenges. First, adapting governance to support organizations in developing the speed, adaptability, and innovation to thrive in the dynamic global environment.

Second, boards face growing mandates and a near-constant onslaught of unpredictable events and tough scrutiny from regulators, activist investors, employees, commentators, politicians, and—most importantly of all—customers. In the midst of this, board oversight is a complex balancing act as organizations safeguard core business, manage social responsibilities, and develop innovative new propositions all at an increasing pace.

In this context, Marsh & McLennan is pleased to host our 10th annual Strategy & Risk Committee Forum at the National Association of Corporate Directors' (NACD) Global Board Leaders' Summit and convene leading voices on the future of board leadership.

These articles provide a selection of recent board-focused insights from Marsh & McLennan on disruptive trends and challenges facing the boardroom as well as links to further reading on these issues.

We invite you to reach out to us if you would like to discuss these issues further.

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TABLE OF CONTENTS

Being Attuned to Forces of Change Is Vital for Corporate Performance 4

Culture Alignment Could Make or Break Your Deal's Value 7

Navigating a New Political Reality 9

Creating an Agile Boardroom for the 21st Century 11

D&O Liability: Three Emerging Areas to Watch 14

What You Need to Know About Cyber Insurance and Regulatory Change 17

From Cars to Cornflakes, Libor's Departure Will Ripple Through Corporate America 20

It's Time to Focus on the CHRO: The Hidden Innovation Hero 23

Toxic Corporate Cultures—and How to Deal with Them 26

Metrics for Gender Inclusion that Every Board Should Monitor 29

Embracing Board Diversity: Go Beyond the Numbers 31

Further Reading 34

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BEING ATTUNED TO FORCES OF CHANGE IS VITAL FOR CORPORATE PERFORMANCE

PUBLISHED BY

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We are living through a period of immense upheaval—economic, geopolitical, technological, societal, and environmental—which makes it harder for companies to succeed with the business models that served them well in the past. Indeed, over the past five years, the profits of the top 700 multinational companies have fallen by around 25 percent.

The annual *Global Risks Report*, prepared by the World Economic Forum with the support of Marsh & McLennan Companies and other partners, and launched in the run up to the annual World Economic Forum meeting in Davos, Switzerland, explores the key forces shaping uncertainty, volatility, and disruption in the world today. Some key takeaways are set out below.

THREE GLOBAL RISKS STAND OUT

First, 2019 is unlikely to see any let-up in political friction—neither on the domestic front in many countries, nor on the global stage. Almost all the global risk experts surveyed for the report reckoned that economic tensions among major powers and trade relations will deteriorate this year, and levels of gloom about broader geopolitical discord were only slightly lower. Against a backdrop of rising societal frustration, many democratic governments are incapacitated by deadlock or division, while rising levels of pushback are on the radar of more authoritarian regimes.

Is this more problematic than twelve months ago? Arguably, confrontational positions are more entrenched and the pressure on government delivery is more acute. Levels of brinkmanship may reach an extraordinary pitch, with the possibility of disastrous missteps. And all this is taking place against a more bearish economic outlook, where a snapping of fragile ties may suddenly drain market confidence.

Second, the evolving cyber threat landscape has become integral to national security agenda. Cyber is the global risk of most concern to US business leaders (a view shared indeed by executives across advanced economies), with the scope for breaches and widespread damage escalating in line with the ever-greater deployment of digital applications across business ecosystems.

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The risk is exacerbated by a clear asymmetry between the capabilities of state-affiliated hackers and the security arrangements of most individual companies, which has obliged governments to play a stronger role in supporting corporate endeavors. This, in turn, has escalated to policy level concerns about the use of foreign technology in critical infrastructure, exposures generated through corporate supply chains, and more intrusive foreign state data requirements on company operations abroad.

Third, the long-term toll from extreme weather and climate change could dwarf all others, if we collectively fail to make the rapid and far-reaching transitions required in the next twelve years to prevent global temperature rises from exceeding the 1.5^{0}C target. For the global risk experts surveyed for the report, extreme weather and the failure of climate adaptation and mitigation measures dominated risk concerns on a ten-year horizon, and a suite of national climate assessments have spelled out the consequences for individual countries.

Given the uncertainty surrounding multilateral climate agreements, business leaders will need to navigate a dual challenge: responding to increasing pressure from investors, customers, and other constituents (such as state and municipal authorities) to commit to climate-related goals, all while developing contingency plans that anticipate greater climate-related challenges.

CROSS-CUTTING CONSEQUENCES

First, the undermining of multilateral arrangements and promotion of nationalist agenda is sapping systemic will and capacity to resolve cross-border challenges. Not only is this spawning new risks and permitting intractable problems to fester—in the near term it is placing companies of all shapes and sizes at the mercy of political wrangling.

Increasingly subject to new tariffs, sanctions, investment constraints, legislative and regulatory requirements, requests for favors, and unwarranted attacks, firms need to be prepared for the prospect of high performance volatility, shock events, and an erosion of competitive positioning.

Second, a tightening nexus of political, economic and technological risks is threatening much-needed investment in infrastructure, a form of investment that is so vital for business continuity, economic progress, and societal prosperity. Analysis suggests that the shortfall of expected investment versus global need will amount to $18 trillion by 2040 (a $4 trillion shortfall in the US alone), requiring a 23 percent increase in current annual investment to close it.

The onslaught from natural catastrophes and the escalation of foreign state-sponsored cyberattacks is threatening the reliability of assets and systems on which we all depend. At the same time, economic protectionism and national security concerns are jeopardizing infrastructure development programs, affecting capital availability, supplier choices, and construction costs. Better public-private cooperation is needed both to enhance the resilience of critical infrastructure and to ensure new projects are attractive for investors.

Third, many of the structural shifts in the global risk landscape have engendered considerable emotional strain for individuals and communities, and the continuous psychological impact should not be underestimated, both in the workplace and society at large.

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Looking simply through a business operations lens, a failure to grapple with these developments may herald productivity issues, accidents, insider threats, and industrial action among other potential disruptions.

In the rush towards new business models and workflow automation opportunities, firms should reflect hard on how to cultivate the right enabling environment for personnel, in terms of working conditions, career opportunities, and financial security arrangements, even when job security cannot be guaranteed.

CORPORATE GOVERNANCE IMPERATIVES

These are challenging times, to say the least, and the board and management teams have no choice but to embrace a world beset by complex uncertainties and strategic emerging threats. Few companies are under the illusion that they can control or inoculate themselves from these macro-level risks, but many have yet to fully appreciate the many ways in which their business might be affected, and to use these insights to arrive at effective and affordable responses.

The 2018 NACD Blue Ribbon Commission report on the governance of disruptive risks clearly articulated the importance of adaptive governance in a world where disruption is continuous. Boards have a vital role in helping set the tone from the top by demanding good intelligence on disruptive risks and establishing the right forum for discussing early warning signals and strategic implications. They should also set expectations of management teams as to how this type of risk thinking should percolate through the entire organization to spur agile, creative solutions that will help business leaders better navigate the challenges of a fast-changing world.

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CULTURE ALIGNMENT COULD MAKE OR BREAK YOUR DEAL'S VALUE

PUBLISHED BY
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Informed business leaders involved in mergers and acquisitions (M&A) are prioritizing culture alignment during their due diligence and integration. They are leveraging a disciplined, analytical, and practical approach to uncovering the risks of combining company cultures. As a result, these same leaders are better positioned to identify realistic synergies between the two companies and prioritize integration planning to deliver economic value.

Mercer's recent research report, *Mitigating Culture Risk to Drive Deal Value*, found that 43 percent of M&A transactions worldwide experienced serious cultural misalignment, causing deals to be delayed or terminated or negatively affecting purchase price. Culture issues were cited as the reason 67 percent of M&A transactions experienced delayed synergy realization. Leaders also noted that 30 percent of deals fail to ever achieve financial targets due to cultural misalignment and subsequent problems, such as productivity loss, flight of key talent, and customer disruption.

According to insights gleaned from M&A advisors, business leaders, human resources professionals, and employees in our survey, mitigating culture risk is of vital importance to M&A deal value. In all, these stakeholder groups work for companies that employ some 43 million people around the world and who have been involved in more than 4,000 deals over 36 months. Their perspectives underscore that cultural alignment is critical for effective organization change in M&A, and call for a clear business strategy and an understanding of deal rationale and the requisite integration risks to successfully execute any transaction. In a workforce context, culture is about individual behaviors that deliver business outcomes and how operational drivers are leveraged to reinforce those behaviors.

It is significant that more than 550 of the research participants (from 47 countries) were compelled to write in a response identifying their perceived top leadership opportunity to create stronger cultural alignment in M&A and engage the workforce. The top five opportunities for leaders, identified by 86 percent of responses and ranked in order, follow:

1. Transparent and frequent communication on the business environment, senior leadership decision making, and business targets and results.

2. What leaders say compared with how they behave during integration.

3. Fostering an environment of collaboration and teamwork.

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4. Driving a performance-based culture, including setting realistic targets and rewarding individual performance.

5. Assigning clear decision-making rights, reducing bureaucracy, and empowering individuals closest to the customer to make decisions.

This research, combined with client experiences, reveals a proven path to mitigating culture risk in M&A. Board members can position senior leadership and deal teams to better understand the financial risk embedded in cultural misalignment simply by adopting and practicing the following principles:

- Recognize cultural misalignment with target companies as an operational and reputational risk.
- Set and socialize a clear deal thesis to all stakeholders in your diligence process that includes intended operating competencies and talent gaps to be acquired from the target.
- Insist on cultural diligence when having exclusive conversations with a seller, including time for one-on-one conversations with senior management who are aware of the potential transaction.
- Document and quantify operational red flags and inconsistencies that are evident at the target company, and price them into the deal.
- Exhibit the same willingness to walk away from cultural deal breakers as a dealmaker would show when there are financial irregularities.

As stated in the recent Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset, it's vital to recognize that if culture is left to chance at any organization, it can absorb precious energy and put the brakes on achieving its purpose and strategic goals. This statement hold great weight at newly combined organizations.

But if led and managed well, culture is the rocket fuel for delivering value to stakeholders and shareholders of newly combined companies.

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NAVIGATING A NEW POLITICAL REALITY

PUBLISHED BY
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In our increasingly polarized society, every brand or brand action has become politicized. According to Edelman's 2018 Earned Brand study, 64 percent of consumers admit to buying or boycotting a brand because of the position it takes on an particular issue. It's becoming harder for a brand to stand on the sidelines, willingly or not. And it has never been more important for companies to get it right when they do engage.

At Lippincott, we advise our clients that to succeed in a changing world, their brands need to be built on a strong foundation of purpose. This is becoming one of the most important filters through which decisions are made. As such, the board should ensure that corporate leaders are successfully navigating this new political reality.

SETTING THE COMPANY UP FOR SUCCESS

When treading the murky waters of brands and politics, companies should exercise caution at every turn. And it's important to remember that companies don't inherently have permission to comment on the issue of the day. Building that permission takes time and consistency—in other words, it takes more than merely having a corporate social responsibility program on the books.

For leaders and the board, defining a company's purpose and positioning it to last mean being clear about your values and the beliefs and actions the brand will take to support those values. While a company's purpose can be aspirational, it must also be rooted in business strategy and be achievable through the company's products, people, and broader community

of stakeholders. It needs to be tangible, guiding the company's hiring, rewards, innovation, and corporate giving decisions.

THE EVOLUTION OF CORPORATE LEADERSHIP

In the traditional organizational structure, product, marketing, and policy business lines were in charge of their own domains. But society has broadened its definition of marketing beyond product features and price to include policy and values.

Patagonia's donation of its $10 million tax break to fight climate change generated goodwill. Nike's Colin Kaepernick campaign won praise and profits, though it also sparked boycotts. And

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Delta Air Lines' decision to sever ties with the National Rifle Association following the recent spate of school shootings in the United States cast Delta into the political debate, even if its actions were intended to remove the company from it. Any decision to weigh in on societal issues—including the decision to remain silent—come from the top, and the impact of those decisions radiates across the company.

The roles of leadership within a company are changing, demanding both the operational skill set and a softer, empathetic one. Boards need to be prepared to identify and hire corporate leaders who bring these skills to the table. The corporate leader of the future will bring to the company a bold and inventive playbook that looks beyond marketing tactics to sociopolitical strategy, and beyond operational excellence to social engagement and community building.

BUILDING A NEW PLAYBOOK

Along with a clear brand purpose, there are a number of best practices that boards and the company's corporate leaders should look to in order to navigate this new reality for brands.

Recognize that most situations aren't simple issues of right and wrong. Political and ethical topics are nuanced and complex, and there are often competing dimensions to manage against. In these cases, don't assume your personal views are that of your customers, or that those of your most vocal stakeholder groups are widely shared. This is when a strong, clear, and well-established brand purpose must be your guide.

Stay true to your purpose. A stated stance or a campaign will quickly be seen as a superficial marketing vehicle if companies fail to link their motives to deeper cultural beliefs and actions. Audiences leveraging the media tools of the day can be unforgiving—a lesson that brands from Pepsi to Uber have learned the hard way.

Consider your whole stakeholder community. The broader the customer base, the more leadership should focus on issues that represent your community across the board, rather than specific issues that may affect a small, but loud, subset.

Think about your employees. A company's willingness to embrace the political pulpit and lead with purpose has wide-ranging implications beyond consumers' willingness to buy. It also affects a community's permission to operate, a shareholder's willingness to invest, and perhaps most critically, a company's ability to attract and retain talent.

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CREATING AN AGILE BOARDROOM FOR THE 21ST CENTURY

PUBLISHED BY

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Is it possible to govern an organization fit for the third decade of the twenty-first century using a board model from the early twentieth century?

The pressures on boards and governance models to change are increasing and directors are faced with two key challenges.

First, boards must adapt governance to the needs and demands of an agile institution. Organizations of all sizes must increase their speed, adaptability, and innovation to thrive in today's dynamic global environment. This extends to board oversight and governance.

Second, boards are dealing with a growing number of mandates and a near constant onslaught of unpredictable events and tough scrutiny from regulators, activist investors, employees, commentators, politicians, and—most importantly of all—customers. Amid these pressures, board oversight is a complex balancing act as organizations safeguard core business, manage social responsibilities, and develop innovative new propositions, all at an increasing pace.

AGAINST THIS BACKDROP, IT IS TIME TO ASK: IS YOUR BOARD AGILE?

An agile board is able to identify and respond effectively to the rapid and unexpected changes in the internal and external environment. It is characterized by a forward-looking and exploratory approach that challenges and nurtures both current and future business, enables quicker decision-making, and supports the organization to be more adaptable and innovative when confronted by change. The transition to a more agile board will require re-thinking the board agenda, board composition, and board practices.

BOARD AGENDA

In the face of rising regulatory and compliance regimes, a board's overflowing and largely prescriptive agenda is often filled with backward-looking tasks and is mostly dedicated to traditional and procedural governance matters. This limits the time and opportunities for a robust group discussion of strategy.

For example, the recent NACD Public Company Governance Survey found that 70 percent of directors believe their boards need to strengthen their monitoring of strategy execution and

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their understanding of risks and opportunities affecting company performance. Yet improving the rigor of preparing board agendas ranks last among areas for board improvement: Just 27 percent of respondents ranked it important or very important to improve board agenda planning.

Board agendas need to shift from largely fixed, backward-looking reviews—which are often determined by habit—to flexible, forward-looking agendas. Changes to the pace and structure of a board agenda will need to be implemented alongside new processes to set the agenda to ensure that board discussion is focused on the strategic topics that matter most. For example, updates can be provided to board members instantaneously between meetings, using tools such as a board portal, to provide access to timely data related to ongoing issues. This could release time on the crowded board agenda for forward-looking discussions. Indeed, simply a focused analysis of how the board applies its time or plans the agenda could reveal improvement opportunities.

BOARD COMPOSITION

Board composition is key to bringing fresh thinking to and in stimulating mental agility in the board room. Despite considerable recent focus on diversity in terms of gender, race, nationality, and cognition, many boards are, in reality, still composed of individuals from similar backgrounds. One recent analysis of 2018 board composition showed that about 25 percent of Russell 3000 directors served for more than 15 years before stepping down, and female directors hold 16 percent of board seats in the Russell 3000. Twenty percent of the Russell 3000 have no female directors at all.

To affect change, boards and their nominating and governance committees will need to work with executive search firms, associations, and other networks to access a wider and more diverse pool of potential candidates. Currently, most directors are recruited from known networks of the current board members and the executive team, although there is a growing trend of using executive search firms. Indeed, given the limited number of women in corporate pipelines, if boards want to increase the number of women or broader diversity on boards, they will likely need to break out of traditional director recruiting grounds and processes. For example, according to Catalyst, women hold just 5 percent of S&P 500 CEO positions and just 26 percent of executive positions. There are only three African American CEOs of Fortune 500 companies.

Boards also need to reconsider what the most desired candidate capabilities are when recruiting board members. Most boards currently focus on industry experience, financial expertise, and past executive experience when setting a recruitment matrix. Far less emphasis is placed on experience with topics such as strategy, information technology, international economics and risks, cybersecurity, marketing, digital media, and human resources. Boards should consider contrasting their current recruitment list against the greatest challenges facing most organizations, including digital or technological disruption, talent shortages, and a turbulent geopolitical environment. Doing so reveals that the need for cognitive diversity is fierce.

BOARD PRACTICES

Re-focusing the board agenda may be difficult in the face of rising oversight requirements and shifting board composition may take time to achieve. Shifting existing practices and mindsets is no straightforward task, but starting small and learning by doing can be significantly more effective in stimulating agility.

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For example, simply changing the format of board meetings or where members sit around the board table can shift the dynamics and conversation in the room. Implementing alternative decision-making techniques, such as “red teams” (a group of board members providing deliberately provocative perspectives to stimulate debate), “tenth man” (avoiding groupthink by assigning one board member to be contrarian should the board unanimously agree on something), or “six thinking hats” (considering ideas in six different thinking styles), can also serve as powerful ways to generate greater mental agility around the board table. Boards could pilot a “studio style” approach to board meetings and committees, applying design thinking and cocreation principles to increase understanding, insight, and creative challenge around key business issues. This tactic in particular may suit less formal meetings, such as the annual strategy offsite.

This process of experimenting with and testing new approaches, then refining, practicing, and embedding the changes to formalize new behaviors at board meetings are hallmarks of an innovative and agile organization.

Greater use of digital and analytical tools within the board environment can also enable access to a much wider range of insights, generating deeper understanding and contrary ideas. For example, using real time virtual focus groups to understand the direct perspectives of different communities on key issues will provide much richer insight and understanding than written reports, key performance indicators, or face-to-face briefings can achieve by themselves.

The challenges that boards are facing are only set to grow in complexity over the next few years. Providing fresh perspectives on difficult issues will be a key differentiator between boards and will play a fundamental role in how organizations adapt and thrive in the future.

This article first appeared on the NACD BoardTalk Blog.

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D&O LIABILITY: THREE EMERGING AREAS TO WATCH

PUBLISHED BY
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The risks for businesses are constantly evolving, and the pressures on company boards and officers are continually growing. Gone are the days when directors' and officers' main concerns were related to company mismanagement and misrepresentation claims. Chief among the potential risks boards must now deal with are emerging technologies, cyber-risk issues, and ever-expanding litigation against companies and their boards. Given the emergence of these three threats, it is imperative that you and your fellow board members review your directors and officers liability (D&O) insurance for any lapses in coverage.

EMERGING TECHNOLOGIES

Technology is advancing like never before, and businesses are using innovative technological tools to revamp everything from back-office processes to the products and services they deliver to customers. But with the excitement of new and arguably better solutions come a lot of unknowns.

Although artificial intelligence (AI), blockchain technology, digital assets, and quantum computing are all emerging technologies with something to offer businesses, each also presents potential exposures that must be understood and addressed. Whether it's the lack of regulation, the evolution of existing regulations to keep up with new technology, a company's inability to keep up with the times, or a board's failure to properly disclose associated risks or costs, these new innovations can give rise to exposures that are now only being discovered by courts of law and insurance companies alike. For example, the failure to adequately disclose the potential risks associated with the implementation of AI, or misrepresentations about those risks, could lead to a potential directors and officers (D&O) insurance claim.

CYBERSECURITY AND PRIVACY-RELATED ISSUES

In the relatively short history of cybersecurity exposure, boards have generally considered cyber-related loss to be a top risk for companies. The threats these incidents can pose to organizations, directors, and officers are becoming more apparent. Those threats include an increase in:

- Securities class-action filings as stock drops associated with data breaches continue.
- Derivative lawsuit filings against directors and officers for alleged mismanagement or false or misleading statements related to cyber incidents.

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Over the past year, we've seen greater regulatory scrutiny and activity in the cyber exposure space, and it is not limited to civil litigation. The Securities and Exchange Commission (SEC), for example, has settled enforcement proceedings arising out of matters such as a company's purported material misstatements and omissions regarding a large data breach and alleged failures in cybersecurity policies and procedures surrounding such a breach that compromised the personal information of thousands of customers. We expect that the SEC and other regulators will continue to focus on cybersecurity threats and breaches going forward.

In addition to breaches, privacy regulations—such as the General Data Protection Regulation in Europe—are a priority for all boards and a major area of focus for regulators. For example, the Federal Trade Commission's recent acknowledgment that it has the ability to penalize individuals for their companies' privacy law violations is a reminder that individuals are not immune to these types of exposures.

In addition to liability concerns, cyber- and privacy-related issues can cause reputational harm. A rating agency recently downgraded its outlook on a company in large part because of breach-related issues. The impact of cyber- and privacy-related exposures on companies and their directors and officers are only beginning to play out.

LITIGIOUS ENVIRONMENT

One need not look far to find significant litigation risks for businesses and their boards of directors. According to an analysis by NERA Economic Consulting, 83 percent of completed company mergers are met with litigation, and one in 12 publicly traded companies are expected to be sued in a securities class action suit this year. What's more, following the March 2018 US Supreme Court decision in Cyan, Inc. v. Beaver County Employees Retirement Fund, companies going through initial or secondary public offerings are now more likely to be met with litigation in both state and federal court than before.

The world of corporate governance has changed. Business decisions are now closely scrutinized by the public. The use of email among company individuals forever preserves a record of discussions that once might have remained private. And actions taken in the public eye—including those through social media—can expose a company and its officers and directors to some form of liability.

Plaintiffs' attorneys, meanwhile, become more resourceful every day; even those firms that were previously not feared have turned filing lawsuits into a factory business. And smaller to midsize companies that once barely caught the eye of the plaintiffs' bar are now squarely in their crosshairs.

According to NERA, 441 new securities class actions were filed in 2018, the most in any year since the aftermath of the 2000 dot-com crash. 2018 was also the fourth consecutive year of growth in the number of filings, exceeding the 434 filings in 2017. In the first quarter of 2019, 118 securities class actions were filed; that puts us on track for 472 class actions this year, and a fifth consecutive year of growth.

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The heightened pace and total of securities class action filings that has continued into 2019 is, in part, attributable to the growing number of follow-on, event-driven securities litigation filings, as opposed to cases involving accounting misrepresentations and financial restatements that have historically made up the bulk of securities litigation. Event-driven litigation occurs when some adverse event at a company triggers a securities claim—based either on a stock drop following the announcement of such an event or in the form of a derivative action thanks to an alleged breach of fiduciary duty. In addition to cyber-, privacy-, and sexual harassment-related, event-driven litigation, an array of other incidents have led to securities claims, including mass torts, product defects, product recalls, food safety issues, anti-corruption scandals, and the California wildfires. These types of risks are difficult to predict.

The cost of litigating even a baseless case that is dismissed or settled early on can be significant, which has not gone unnoticed by D&O insurers. The more litigious environment coupled with years of falling premiums and expansions in coverage have brought the D&O market to a crossroads. The market has seen 14 years of generally soft conditions, providing buyers with favorable premium pricing and broad coverage enhancements. Over the last few quarters, however, we've seen a dramatic switch. Premium increases are now commonplace and policy negotiations have become more difficult as insurers face pressure on primary, excess, and Side-A—or personal asset protection—differences in condition pricing.

With the risks for directors and officers constantly becoming more numerous and complex, insurance is more important than ever. It's vital to consult closely with your insurance and legal advisors to ensure the companies you serve have robust D&O insurance programs that protect both corporate and personal assets against these, and other, potential threats.

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MARSH & McLENNAN INSIGHTS | NACD NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

WHAT YOU NEED TO KNOW ABOUT CYBER INSURANCE AND REGULATORY CHANGE

PUBLISHED BY
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As recent events have shown, the pace and scale of cyberattacks continue to grow, as do the financial stakes—revenue losses, recovery expenses, liability costs, and potentially severe regulatory fines are all consequences facing companies. The specter of 2017's NotPetya event, the most devastating cyber event in history, continues to haunt business leaders: the malware caused more than $10 billion in economic damages and disrupted business operations, production, and logistics for major global firms. The insured losses from that attack alone have been estimated at more than $3 billion.

Incidents such as these are forcing companies to make cyber risk a corporate priority. In the recently released *Global Risks Report 2019*, those in advanced economies again rank cyberattacks among their top risk concerns. That recognition has evolved from viewing cyber risk as a problem to be solved by spending more on technology to seeing it as a risk that must be actively managed across many areas of the company. That shift in mindset has brought cyber insurance into the overall equation of how a firm manages its technology risk.

But cyber risk is an increasing concern not just for c-suites and boards: regulators also are more actively looking at how organizations address cyber risks and how they manage their responsibilities to key stakeholders. So even as the financial costs of cyber threats grow, the regulatory stakes are likewise poised to rise as more regulators—and particularly the US Securities and Exchange Commission (SEC)—begin to impose stricter requirements on businesses.

These two trends—the increasing adoption of insurance to transfer cyber risk and a more rigorous regulatory approach to cyber-risk management—dovetail in numerous ways. Many of the new regulatory requirements and guidance around cyber-risk assessment, prevention, and management, executive and board-level ownership, and event disclosure and response, are the same practices that should inform an organization's decision-making around cyber insurance investment. These same best practices are what underwriters increasingly expect and value.

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THE SEC STRENGTHENS ITS STANCE

Cybersecurity has been on the SEC's agenda for several years. In 2011, the commission's Division of Corporation Finance issued guidance calling on companies to assess their disclosure obligations regarding their cybersecurity risks and cyber incidents.

While a good starting point, the guidance did not go far enough in setting clear expectations for both proactive and reactive cyber-risk management and oversight. The SEC's 2018 interpretative guidance outlines requirements for publicly traded companies to disclose cybersecurity risks and material incidents.

THE SEC GUIDANCE FOCUSES ON FIVE MAIN AREAS:

- **Pre-incident disclosure.** The guidance calls for transparency around the identification, quantification, and management of cyber risks by the C-suite and oversight by the board of directors. Often, growth in technology and the global operating environment impede 360-degree visibility into a company's vulnerable spots, with lack of data contributing to compromised security.
- **Board oversight.** The board is expected to understand, quantify, and oversee cyber risk. The SEC advises companies to disclose in their proxy statement the board's role and engagement in cyber-risk oversight. Board members have to be privy to and understand the company's overall cybersecurity exposure, with a particular focus on the impact on the company's financial condition, integrating this insight into their 360-degree view of the company's risks.
- **Incident disclosure.** Companies are required to "inform investors about material cybersecurity risks and incidents in a timely fashion." To do so, companies must have structures in place to identify and quantify cyber risk—tools that allow the organization to rapidly determine whether the impact of a compromised system was, in fact, material and requires disclosure to regulators and investors.
- **Controls and procedures.** The guidance also tasks companies with assessing whether their enterprise risk management (ERM) process is sufficient to safeguard the organization from cyberdisasters. This requires a step-by-step playbook for cyberevents, including identifying who needs to be contacted and how and with whom the business will share information about a breach. Given the evolving nature of cyber risk, ongoing due diligence exercises should occur to identify and manage new risks—especially during a merger or acquisition. Most companies have long done this for other perils such as natural disasters, and it is imperative they extend this process to cyber risk.
- **Insider trading.** New to the 2018 guidance is a reminder to companies, directors, officers, and other parties of insider trading prohibitions. In practice, this means that directors, officers, and other executives who are aware of a company's cybervulnerabilities or a breach could be liable if they sell company stock, or instruct anyone else to do so, before such a breach or vulnerability is divulged.

The cost of non-compliance can be substantial. Last year the SEC leveled a $35 million penalty against a large technology company it said misled investors when the company failed to disclose the theft of the personal data from hundreds of millions of user accounts.

Congress, which holds the SEC's purse strings, is placing mounting pressure on the agency to improve cybersecurity, and private investors are also pressing for more stringent cybersecurity controls at the companies they hold. It is, therefore, likely the SEC will start coming down

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on companies with more vigor, especially in the wake of recent—and, inevitably, future—major breaches.

RISK TRANSFER AS A CORE CYBER-RISK MANAGEMENT TOOL

Given the nature of the majority of risks, businesses recognize that technology and other solutions alone can't respond to the full spectrum of risks they face. Insurance has historically stepped in to provide the financial backstop for that residual risk that cannot be managed to zero through process, procedure, and mitigation.

Cyber risk is no different in this sense, and organizations are now recognizing that cyber risk also cannot be managed through technology alone. It is an operational risk that needs to be incorporated into the firm's overall ERM processes—one that includes risk transfer, as well as mitigation and resilience planning.

The insurance market now offers risk transfer solutions for cyber risk that address both ever-evolving technology risk and the recent retreat of traditional insurance products from adequately addressing firms' evolving cyber-risk profile.

Cyber insurance starts with the premise that all of a firm's technology-driven risk should be insurable. These risks include both the direct loss that a firm can suffer in terms of lost revenue or assets, as well as the liability that can arise from a data breach or failure to comply with myriad new domestic and international regulations.

Cyber insurance has also been at the forefront of pushing for better understanding of this risk's financial implications to help the industry improve modeling of potential loss scenarios. That financial assessment is a critical foundation for businesses' risk management planning as well: Cyber-risk quantification helps the firm assess the economic impact of a range of cyberevents, and on that basis, make informed investments in technology, insurance, and response resources. Quantification of cyber risk also allows for cyber risk to be analyzed within the firm's overall risk framework and integrated into its overall risk management planning.

The assessment, evaluation, and modeling processes that are essential foundations for purchasing cyber insurance are, in many ways, aligned with the practices called for by the SEC in its recent guidance. Given the likelihood of an increasingly active regulatory agenda, organizations are advised to align their policies and practices to abide by the SEC's recommendations and to consider insurance market coverage that can help protect against cyberevent-related losses and regulatory liabilities.

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FROM CARS TO CORNFLAKES, LIBOR'S DEPARTURE WILL RIPPLE THROUGH CORPORATE AMERICA

PUBLISHED BY
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The phrase "LIBOR transition" doesn't elicit more than a yawn from most corporate treasurers.

But how about this: "the terms on your debt maturing after 2021 are going to change, whether you like it or not."

That is precisely the scenario in view as regulators phase out the London Interbank Offered Rate, or LIBOR, by the end of 2021.

Known as the "world's most important number," LIBOR has more than $240 trillion linked to its daily fluctuations according to Oliver Wyman estimates. LIBOR is tied to all sorts of financial products; you may have a mortgage, student or auto loan tied to it, and your company probably borrows based on it. In other words, it drives your corporate interest expense.

Board directors need to ensure management starts thinking through the transition now. The good news is that companies still have time to get ready. The bad news? The transition will require a fundamental repricing of debt and might have a large market impact.

The largest banks are already preparing, pushed ahead by regulators on both sides of the Atlantic. UK regulators in September sent classically understated "Dear CEO" letters to the largest financial institutions in Britain, politely demanding they develop and submit by December a board-approved plan for LIBOR transition. Regional and community banks, meanwhile, are just starting their efforts.

Beyond banks, the transition affects almost all large corporations, given that trillions of dollars of debt or hedges of debt is tied to LIBOR. Yet in our conversations with treasurers, financial officers, and yes, board members of non-financial companies, we have come across few who recognize the looming issue—or are even aware of it.

Consider this an early warning.

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Corporate loan and debt agreements generally contain language that defines what happens if LIBOR is unavailable—but is designed for a short-term contingency like a systems outage, not permanent cessation. Typical terms vary, ranging from "use the last rate," meaning that your floating debt is now fixed, to "use prime," meaning that your rate is now very different.

There are no criteria for what constitutes a LIBOR discontinuance, leaving companies exposed to language buried in contracts. Firms might be entitled to something better, or something worse. Does management know, or are they depending on the financial system to offer a reworked deal? That isn't always possible; perhaps a bank will renegotiate, but bondholders might be unwilling to give back an unexpected gain.

Companies are likely to feel a financial impact not only from the changing terms of the debt itself but also from changes rippling through hedges and derivatives linked to debt. That's because almost all these changes break the "hedge accounting" that firms use on their balance sheet, potentially increasing balance sheet volatility.

WHAT WILL REPLACE LIBOR?

In the end, transactions in the market won't be defined by the regulators who are taking LIBOR off the table. Regulators indicate the transition is "market led," so it is up to the banks and customers to define a path forward. That's why corporations need to focus: This is a fundamental repricing of the more than 100 financial products tied to LIBOR, and the market impact is still murky.

While the regulators have not defined how economic changes will work, they have created potential replacement rates. Each of the five existing LIBOR rates will be replaced by country or region specific rates. For example, the Federal Reserve has created the Secured Overnight Financing Rate, or SOFR, and the UK Working Group recommended the Sterling Overnight Interbank Average rate, or SONIA. These are structurally very close to true "risk free" rates and therefore act differently than LIBOR. They should average lower than LIBOR as LIBOR contains features that are good for the banking system. For example, LIBOR will increase during a bank crisis like we had in 2008—and this is not in the new rates. Look for the industry to seek to replicate these features in new non-LIBOR products, which are still under development, and to seek to sell them to corporate borrowers.

All of this points to a mountain of work for corporations and their finance teams. They must inventory existing LIBOR-based obligations, determine exposures past the likely end of LIBOR in 2021, work down those exposures if possible, and get ready for a slew of new products to be evaluated.

WHAT TO DO: A CHECKLIST FOR BOARDS

How can boards monitor this? In short, by following the script already laid out for banks by the UK regulators in September.

First, they should ensure there is leadership accountable for managing the transition. This might well be the chief financial officer or corporate treasurer, but it will vary depending on the

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company's business model. And since this is a global problem, it needs to be considered and managed globally.

That leader (and team) should start by identifying exposures. These is no easy way to do this but to go through the financials and document those which are based on LIBOR, and project what will change when LIBOR goes away.

Once the exposures are understood, leaders should consider the big picture and report to the board about its implications. Companies and their bankers have a relationship that needs to survive what in the end is a technical hitch. What should be the response when a bank calls to refinance or renegotiate?

Next, board members should advise that their companies need to consider the details and build a work plan. LIBOR likely is present in more places than is obvious. For instance, systems will need to be updated. Some of these will be vendor systems, and companies need to show that they are on top of these vendors. That's the end of the UK regulatory request—a board-approved plan. Boards should be pushing for a similar outcome unless their LIBOR exposures are negligible.

Finally, if you are a board member, you should insist your company isn't the last to change. As LIBOR fades away it will likely get stale and products based on it could become illiquid. If your company is late to the table, it could prove costly.

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IT'S TIME TO FOCUS ON THE CHRO: THE HIDDEN INNOVATION HERO

PUBLISHED BY
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Patty Sung is a senior principal and innovation leader in Mercer's Global Digital Innovation Hub.

Innovation is top of mind for most C-suite executives and directors of companies, and both have every reason to prioritize innovation as part of the company's strategy. According to a study by Credit Suisse, the average lifespan of a S&P 500 company is now less than 20 years compared to 60 years in the 1950s. Additionally, Mercer's *2019 Talent Trends Survey* found that 73 percent of executives predict significant industry disruption in the next three years, up sharply from 26 percent in 2018. In many industries, continued innovation is critical to a company's ability to survive and thrive.

In the recent past, having a dedicated, centralized innovation team seemed like the obvious answer to this corporate imperative, and companies made the move to create such teams—the number of corporate innovation centers has grown from over 300 to 580 from 2015 to 2017. Unfortunately, the success of these innovation centers has been mixed. Centers that tend to lag in performance usually have unclear strategic goals, suboptimal set-up, and vaguely defined success metrics.

Developing a culture of innovation requires commitment from the top, starting with the CEO. The company's CEO needs to define what innovation means to the firm, be its biggest advocate, and get the entire leadership team's buy-in and support—including the backing of the board. Boards should make sure that the innovation strategy is forward looking with a balance of incremental and disruptive goals. Once the vision is defined, leaders need to infuse innovation into the company's DNA by cultivating an open-minded and intellectually curious culture that is ready for change.

To truly embrace a culture that is open and prone to innovation, CEOs are also looking to their chief human resources officers (CHROs) to help lead this cultural change and drive innovation.

THE CHRO AS INNOVATION CATALYST

The role of the CHRO has evolved, and it has never been more critical for the board to focus on this role's ability to drive a culture of innovation throughout the organization. To enable innovation at scale, having a sound people strategy is equally important as having the right infrastructure, processes, and tools.

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When considering the CHRO's role in setting the framework to build a workforce that drives innovation, the board should consider how the CHRO is leveraging the following four building blocks.

TALENT IDENTIFICATION

- The most important building block for the CHRO's talent strategy is identifying the right people. One could argue that innovation is an innate skill, and not a skill that is developed. In reality, the answer is, "it depends." The company's definition of innovation drives the types of talent needed, whether the talent can be developed from within, and if recruitment from outside needs to happen. People also have varying degrees of innovative talent. Organizations may have a limited number of innovation whizzes available to create transformative ideas, but many are capable of developing incremental innovations to improve existing solutions or modernize core businesses with the right training, support, and tools.
- The board and management need to think beyond traditional approaches to identify the right talent and teams to lead innovation initiatives. Depending on the level of disruption required, the board and management may need to urge the CHRO to consider external talent such as seasoned entrepreneurs to get an injection of fresh ideas. The CHRO should keep a close pulse on innovation talent across the firm, meet with innovation teams on a regular basis, and report back to the CEO and board to ensure the firm has a strong pipeline of talent suited for innovation.

DIVERSITY AND INCLUSION

- It is no secret that diversity drives innovation. Diversity in this context extends beyond gender, race, and ethnicity, and includes experiences, expertise, perspectives, and even working styles. Individuals with differing thoughts can result in dissent and conflict, but this should be viewed as the gateway towards developing breakthrough ideas. Inclusion must come hand-in-hand with diversity. One can only maximize the potential of a diverse team when each individual's differences are respected and valued. In addition, a diverse and inclusive workforce ensures that the innovations created are reflective of the organization's diverse customer base. The board should embrace and work with the CEO and CHRO to measure how diversity and inclusion impacts innovation and the company's people strategy on an ongoing basis.

PERFORMANCE MANAGEMENT

- Since innovation development processes are agile in nature, workforce performance management and metrics should align with "test and learn" principles. The "test and learn" approach ensures that projects can fail fast and pivot as needed. To encourage such behavior, performance management also needs to allow continuous and open feedback to enable individuals to adapt according to project needs. The board and CEO can make this feedback loop a priority by measuring how the CHRO structures performance reviews at the firm.
- Disruptive innovation initiatives require a longer time horizon to realize their potential and impact. As such, these initiatives should not be measured on a quarterly basis. Setting key milestones that could be an early indicator of success will help boards monitor progress. Although driving revenue, profit, and return on investment growth are the ultimate goals of innovation, non-financial metrics are not to be ignored and are arguably equally important. These metrics include, but not limited to, enhanced company brand, increased ability to attract top talent, improved customer satisfaction, speed to decision making and execution, ability to break down silos, the number of ideas in the pipeline, and increased digital presence and digitization across the firm.

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LEARNING AND DEVELOPMENT

- In this rapidly changing environment, it is critical for all employees to be on top of key trends and develop new skills—the board included. Besides formal training courses, entrepreneurs and start-ups are excellent channels for corporate "intrapreneur" learning. Including exposure to these resources as part of a corporate people strategy could yield measurable benefits that the board could use to assess efficacy of the program. As an example, Mercer piloted a learning program with NewCampus, a startup that invites entrepreneurs around the world to share their expertise and experiences with Mercer colleagues. This type of alternative learning is a great source of inspiration for new ideas. For companies with dedicated innovation centers, having rotational programs will enable organizations to build stronger innovation muscle, share what has been learned, and develop skills with broader employee populations to achieve greater impact.

For CHROs to drive innovation, they need to innovate and reimagine the HR function they lead. The CHRO and his or her team at entrepreneurial companies are more progressive in their thinking, willing to experiment, and thrive on setting new industry standards. If companies believe that their people are the ultimate sustainable competitive advantage—the power for creating innovations for the firm—the CHRO and that person's entire team should be the key to unlocking human capital potential at the firm. The board and CEO need to empower the CHRO to experiment, and that could be as simple as trying out new technologies and policies. The time to do so is now.

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TOXIC CORPORATE CULTURES—AND HOW TO DEAL WITH THEM

PUBLISHED BY
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Over the last year, the media have been full of stories about organizations' cultural missteps or toxic cultures, with almost weekly reports of executives being dismissed for infractions. And boards are asking themselves—does our organization have cultural problems, and if so, how do we detect them and respond?

An organization's culture is a critical element for success and differentiation, and it can be the rocket fuel for delivering value to stakeholders. But a dysfunctional or toxic culture creates inefficiencies and underperformance across the organization. At worst, cultural blowups can damage a company's reputation with negative media coverage, put the organization in breach of laws and regulations, trigger lower productivity, and be very costly to resolve.

HOW HEALTHY IS YOUR ORGANIZATION'S CULTURE?

There is a significant body of research on the importance of culture in driving organizational success as well as guidance for boards in their role in oversight of organizational culture. Despite this, culture is not yet a regularly scheduled agenda item in many boardrooms, or there may only be limited updates on the organization's culture or the process to drive the desired culture.

This needs to change. As organizations and boards face growing questions on culture from investors, regulators and employees, it's critical that directors have regular, detailed updates on the health of the organization's culture.

Directors need to prioritize scheduled discussions on culture. Typically, the role of a board director is summed up as: "nose in, fingers out" (i.e., oversight but not management). With culture issues, the role of the board is now to "nose in, nose in, nose in"—to look deeper, ask questions, and probe for details when something seems amiss.

A BOARD CANNOT CREATE AN ORGANIZATION'S CULTURE—BUT IT CAN INFLUENCE IT

While boards have an oversight role for culture, the reality is that boards cannot lead or set the organization's culture. Rather, the organization and the executives create the culture; they are the ones living and breathing it every day.

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However, the mechanisms by which boards capture insights on culture—either in their committees or as a full board, how directors engage on the issue, and how the board engages management—all serve as levers that influence culture and how management prioritizes culture.

Research by Marsh & McLennan Insights, which included interviews with members of WomenCorporateDirectors, has developed a number of recommendations on how boards can detect and respond to dysfunctional or toxic corporate cultures.

THE CEO AS THE CHIEF CULTURE OFFICER

For boards, the primary instrument by which they can influence culture is through the selection of the CEO.

The CEO serves as the "Chief Culture Officer," and boards should capture insights, such as 360-degree evaluations, on the CEO as a cultural leader. Further, boards should formally consider cultural leadership factors in CEO and executive team succession and planning.

The executive team that the CEO develops is also a critical indicator of the expected organizational culture. The CEO should be able to indicate the leadership qualities of the individuals in the management team and how they align with the goals and culture of the organization.

ORGANIZATIONAL CULTURE AS A REGULAR BOARD AGENDA ITEM

The second most important action boards can take is to include culture as a standing and consistent board agenda item.

In most boardrooms, few directors have a deep background in talent management or human resource factors. It is probably not ingrained in a board's psyche to discuss culture regularly. But by prioritizing culture discussions, directors can help the CEO and management team uncover issues across the organization.

A culture dashboard, with regular tracking of key cultural performance indicators, shifts the discussion from episodic, one-off discussions—that, when introduced by the board, could make management feel blindsided—to a natural standing topic of discussion.

Organizations can examine data points, such as whistleblower hotline data, compliance data and employee data, such as employee engagement surveys, data on hiring, performance ratings curves, pay increases, promotions, and turnover reports to get insights into the organizational culture.

HUNT FOR THE DISCREPANCIES IN THE DATA

It is important that boards do a deep dive into the data and consider the indicators by gender, race, age, geography, business unit, tenure, and employment level.

Discrepancies in the data can indicate areas or departments within the organization that are at risk for dysfunctional or toxic behaviors. For example, high staff turnover rates in one business unit

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might indicate a local management problem; or limited career growth of female staff may indicate that the day-to-day operating environment is not aligned with the desired organizational culture.

"Nosing into" data by these different aspects can also help the board determine if the "tone at the top" is also the "tone from above" throughout the organization—that is, the culture set by a manager or supervisor. Middle management is a powerful layer in setting organizational subcultures, especially in large global organizations, enabling culture to trickle down organizations.

DOES THE BOARD HAVE ITS OWN TOXIC CULTURE?

The board must also turn the mirror on itself. Directors should consider potential culture indicators within the boardroom and how effectively the board can respond to cultural issues.

If the board's own culture aligns with the organization's culture, it may be particularly difficult to spot indicators of cultural dysfunction, as doing so would take a sense of self-awareness that not all organizations have.

If the board has a toxic culture, how can it spot a toxic culture within the management team?

A lack of diversity in the boardroom is also a cause for concern. Data shows that, over the past two years, only 37 percent of boards have discussed how diversity, or the lack thereof, impacts company culture.

Can a board without women address #MeToo-related complaints and issues?

Can boards with limited racial diversity be effectively attuned to diversity issues?

If there are only one or two directors in the boardroom who can contribute diverse perspectives, as is the case in most boardrooms, it can be difficult to push conversations on challenging topics.

By tracking cultural indicators, increasing cultural awareness in the company, and applying levers of change where necessary, boards can help steer the culture—creating a greater alignment of the entire workforce to the vision of the organization.

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METRICS FOR GENDER INCLUSION THAT EVERY BOARD SHOULD MONITOR

PUBLISHED BY
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For some time, the presence of women in leadership positions has been positively linked to share price and profitability, to employee retention and engagement, and even to the company's capacity to innovate. Leaders of companies understand the business imperative to improve the retention and promotion of women at every level. Meanwhile, many board members have held their breath, each hoping their organization won't be the next one swept up in a scandal. They're hoping that practices in hiring, promoting, and paying women are equitable and unbiased; that women are being valued and treated with respect; and that their companies are not vulnerable to a female talent drain.

Hoping simply isn't enough. Action must be taken to ensure that women, including women of color, are being represented and treated equitably. But many board members still feel like they lack the right insight to track gender advancement for women—or even to predict and prevent potential scandals before they occur. Mercer's When Women Thrive practice assembled a dashboard of seven metrics our consultants believe every board should be tracking to provide oversight on the progress of women in the organization. These metrics will help you to understand the progress you are making (or losing) in your efforts, and where your best opportunities and worst vulnerabilities lie.

Representation by gender, race, and career level. This is probably the most critical snapshot on this dashboard. One Mercer uses these points to create what we call internal labor maps. How many women are in your organization? How many are non-white women? Are they over-represented at lower levels, with ratios falling off dramatically at promotional choke points? These are patterns that need to be investigated and reported on to the board.

Hiring, promotion, and turnover rates by gender, race and career level. This metric tells you not only where women currently are in your organization, but how they are progressing. Are they being brought in at rates that equate with your market or is there more you can do as you seek diverse, qualified candidates? How are women being promoted or exiting the organization compared to men? Take a hard look at these numbers to understand where opportunities exist for women and where they are stagnant.

Pay data by gender, race, and role. This number should look not only at salary, but at total compensation. It should also include 401k and other financial opt-in patterns. Financial wellness

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and investment behaviors are representative of employee confidence, which in turn correlate strongly with tenure.

Health data by gender. Here again, equal is not always equitable. Look at health data in your organization by gender. Women have different needs and are less likely than men to receive the preventative treatment they ask for. Explore healthcare benefits that are proven to support women's needs.

Employee engagement data by gender. Employee engagement surveys that are anonymous save for gender can hold a wealth of information. Pulse surveys can even alert you to abuse in the system. If you see patterns consistently showing a disconnect between men and omen's responses on engagement data, you may have a culture of inequality, bias, or harassment.

Number of sexual harassment claims. Are trends going up or down? How many claims have been filed with the Equal Employment Opportunity Commission? Keep an eye on this number.

Organizational climate data by gender. Ask the company to put together an organizational climate study to assess risk in the following areas: leadership practices, work climate, employee experience, and employee voice. This data will give you actionable data about the culture that is driving the numbers above.

When sorted by gender and analysed in a regular dashboard, these stats will give your board deep insights into where your company stands on gender equity—and where you are headed.

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MARSH & McLENNAN INSIGHTS | NACD NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

EMBRACING BOARD DIVERSITY: GO BEYOND THE NUMBERS

PUBLISHED BY
SARAH ROBSON

Sarah Robson is president and CEO of Marsh Canada Limited. Sarah has more than 30 years of experience in the insurance industry, with specialized expertise in directors and officers liability issues.

Despite the media attention on issues of diversity, the pace of progress around diversity in corporate boardrooms remains challenging. Half—49.5 percent—of United States boards in the U.S. Russell 3000 Index currently have two or more female directors, but only 17 percent of the total of boardroom seats on the Index are held by women.

The data is similar in Canada, where one-third of corporate boards are still all-male, and just 15 percent of board seats of disclosing Toronto Stock Exchange companies are held by women, rising to 27 percent in S&P/TSX60 companies, which reflects a generally higher female representation in larger organizations.

THE RISE OF MANDATING

In response to the slow pace of gender diversity, some countries and states have set quotas for women on boards. Norway mandated quotas of 40 percent female representation 10 years ago; Belgium, Italy and France have quotas and the Netherlands mandates companies to "comply or explain" around a 30 percent target.

Gender diversity on boards in these countries has increased in response. For example, a recent study of large European companies shows that France has 44 percent female representation on boards, Italy has 36 percent representation and Belgium has 32 percent representation.

In October 2018, California became the first U.S. state to mandate that companies incorporated in California, as well as foreign corporations headquartered in California listed on major U.S. stock exchanges, have at least one female director by the end of 2019 and at least three female directors by the close of 2021.

Institutional investors are also taking action. For example, State Street Global Advisors will take voting action against companies without at least one woman on the board from 2020 in the U.S., UK and Australia, and in 2021 in Canada, Europe and Japan. Similarly, the Canada Pension Plan Investment Board recently announced its policy to take voting action at its investee public companies if the board has no women directors.

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QUESTIONABLE ENTHUSIASM

On their part, many directors report that they are keen to increase gender diversity. More than 50 percent of U.S. and Canadian boards have goals for board diversity and 89 percent have had conversations about diversifying board composition during the past two years. But other surveys suggest some of the mixed feelings about these discussions. In a 2018 PwC survey (with 81 percent male respondents), more than half of the respondents said that board diversity efforts are driven by political correctness, and nearly half think shareholders are too preoccupied with the topic.

All these efforts raise the question: Does gender diversity matter, and are we pushing the wrong solution to the problem? The answer would seem to be: It depends—and it may depend on the problem being tackled.

In terms of company performance, meta analyses of gender studies have found virtually no relationship between the gender diversity on the board and company performance. As one researcher at Wharton noted: “There is no business case for putting women on the board.” Equally, the researcher also noted: “There is no business case for putting men on the board.”

BOARDS SHOULD REFLECT THE REAL WORLD

Board gender diversity can, however, have impacts in other areas, such as tapping into community, customer and employee engagement. Women comprise about half of the total U.S. workforce, hold half of all management positions and are responsible for almost 80 percent of all consumer spending.

Non-diverse boards must ask themselves: How effectively are they guiding the companies in engaging with these increasingly diverse constituencies? All-male boards may face hard questions in an era of “Me Too” or rising pressures on reporting gender gaps in pay.

The real benefits of gender diversity—and all diversity—is typically perceived in sometimes hard-to-measure factors such as more fulsome and rounded discussions in the boardroom that enhance strategy and risk oversight. It is in this benefit and for this reason that boards should focus on diversity. Directors overwhelmingly agree that one of the board’s key roles is to guide the organization’s strategic direction for the long term, and for that, diversity of thought in the boardroom is vital.

THE IMPERATIVE FOR COGNITIVE DIVERSITY

If we want better boards of directors that can really guide strategic direction, we need true cognitive diversity in the boardroom. Cognitive diversity can be defined as differences in perspective or information processing styles, and it is not predicted by factors such as gender, ethnicity or age. However, cognitive diversity is often revealed when individuals think about and engage with new, uncertain and complex situations.

The importance of increasing cognitive diversity is already recognized by many directors. Research by the National Association of Corporate Directors (NACD) found that the need to enhance cognitive diversity of the board was a key factor in setting diversity goals for the boardroom.

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An emphasis on cognitive diversity will require a greater focus on the diversity of input into the processes of identifying and recruiting new boards members. Boards and their nominating and governance committees will need to work with executive search firms, associations and other networks to access a wider and more diverse pool of potential candidates.

IS YOUR BOARD READY FOR FUTURE RISKS?

Currently, most directors are recruited from known networks of the current board members and the executive team, although there is a growing trend to use executive search firms. Given the limited number of women in the pipeline of corporations, if boards want to increase women or racial diversity on boards, they will likely need to break out of traditional recruiting grounds and processes. For example, women hold just 5 percent of S&P 500 CEO positions and just 26 percent of executive positions, and there are three African-American CEOs of Fortune 500 companies.

Boards will need to get comfortable with extending beyond the typical candidate profiles to secure cognitive diversity. Currently, the most desired candidate capabilities in recruiting board members are industry experience, financial expertise and past executive experience. Far lower down the desired capabilities are experience such as strategy, IT, international, cyber, marketing or digital media or human resources.

Contrast this recruitment list against the greatest challenges facing most organizations—including digital or technological disruption, talent shortages, and a turbulent geopolitical environment impacting business—and the need for cognitive diversity is starkly clear.

AVOID A BY-THE-NUMBERS APPROACH

Directors will also need to push against cognitive biases that can impact how qualified candidates are perceived. These biases can include affinity bias, intergroup bias and confirmation bias that can lead us to prefer “people like us” and confirm preconceptions about capabilities.

A “by-the-numbers” approach to board diversity will have limited benefits for the board and their organizations. It may slowly lead to apparent diversity but not true cognitive diversity.

Boards that seriously embrace their goal of serving as a strategic asset to their organization will need to assess what skills, insights and experience are needed to help guide, challenge and stimulate management teams in the face of external disruptive forces. Boardrooms need to be equipped to guide disruptions, opportunities and challenges—and that starts with the composition of the board.

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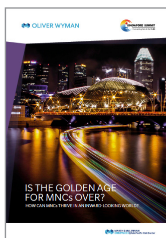

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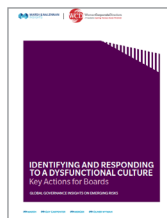

IDENTIFYING AND RESPONDING TO A DYSFUNCTIONAL CULTURE: KEY ACTIONS FOR BOARDS

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