

# 2020 Governance Outlook

**PROJECTIONS ON EMERGING BOARD MATTERS**



A publication of the National Association  
of Corporate Directors and Partners

Baker Tilly

Broadridge Financial Solutions

Ceres

Deloitte

Grant Thornton

Spencer Stuart

Weil, Gotshal & Manges

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Baker Tilly  
Broadridge Financial Solutions  
Ceres  
Deloitte  
Grant Thornton  
Spencer Stuart  
Weil, Gotshal & Manges

## ABOUT THIS REPORT

The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2020, and follows with eight partner contributions that provide distinct insights and projections on the following themes: preparing for the next recession, strategic business risks, regulatory changes, legal risks, board composition, the digital frontier, ESG and engagement, and water scarcity risk.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2019, and (3) relevant implications and questions for boards to consider. The *2020 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2020 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

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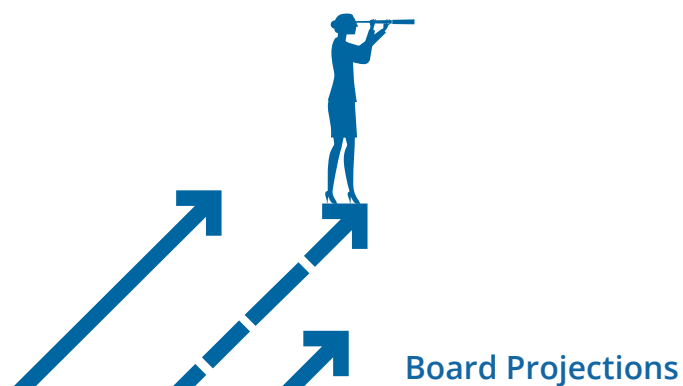
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# Executive Summary

## Key Projections

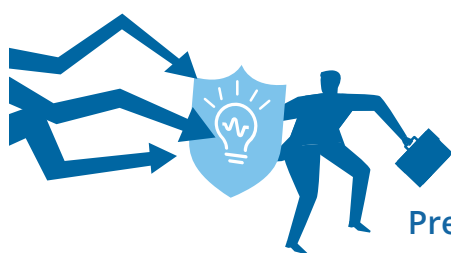


### Board Projections

#### NACD

- NACD's Blue Ribbon Commission Report, *Fit for the Future*, provides tactics to ensure that the board and the leadership within the boardroom are able to have the flexibility they need to be prepared for the changing needs of the boardroom going forward.
- Sixty-eight percent of directors responding to NACD's 2019–2020 Public Company Governance Survey indicate that over the next five years their existing strategies will become completely irrelevant, meaning board leaders need to work closely with management in order to ensure the company is able to adapt for the future.

"NACD's most recent Public Company Governance Survey found that looking forward to 2020, directors are most concerned about the impact of growing business-model disruptions, the slowing global economy, increased competition for talent, changing cybersecurity threats, and rapid technology changes. Each of these trends alone could drive companies out of business."



### Preparing for the Next Recession

#### GRANT THORNTON

- US companies are bracing for a recession in 2020, with economic warning signs mounting. While it remains unclear whether a recession will indeed occur and, if so, how significantly economic conditions will deteriorate, businesses are preparing for a potential downturn in the next 12 months.
- The analysis performed by Grant Thornton offers boards guidance on how to assess management's thinking about and preparedness for a potential recession and how to continue successful innovation in a slowing economy.

"Companies that make the earliest and wisest investments in innovation during the downturn will be those best positioned to seize market share and competitive advantage coming out of it."



## Strategic Business Risks

### BAKER TILLY

- “Resilience” is key to defining how effective boards operate. Merger and acquisition (M&A) transactions, trade compliance, tax issues, and data privacy are key risks boards should prepare for in 2020.
- Boards must understand how both their own companies and their acquisition targets are dealing with the pace of change, innovation, and disruption in these key risk areas. A business model that is on strategy today may be off strategy tomorrow.

“Boards should confirm that company leaders adopt a comprehensive data-privacy program that embraces the key principles of global privacy laws, and use that program as a corporate umbrella of protection against fallout from an inevitable data incident.”



## Regulatory Changes

### DELOITTE

- The US Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the Financial Accounting Standards Board (FASB), have put forward agendas they are aiming to take action on in 2020, impacting financial reporting, accounting, auditing, and associated governance matters for companies.
- Boards should remain vigilant in their oversight role, staying informed of regulatory developments in a timely manner and understanding how their companies are monitoring and adjusting to regulatory changes.

“Given the rule making initiatives at the SEC, PCAOB, and FASB, it is likely that 2020 may bring continued regulatory change and possibly more risk to public companies.”





## Legal Risks

### WEIL, GOTSHAL & MANGES

- The *Caremark* case set a very high bar for holding directors personally liable for failing to properly oversee their company's affairs. As boards refresh their oversight agendas for 2020, there are useful lessons to be drawn from two decisions of the Delaware courts issued earlier this year that allowed *Caremark* claims to proceed beyond the motion to dismiss stage.
- Directors should identify their company's "mission critical" risks and ensure that information about these risks is elevated not only to management but also to the board itself.

"Boards will start to take a closer look at the role of their own board committees and either expand the mandate of an existing committee or, where appropriate, establish a new board committee to oversee a 'mission critical' risk to the company."



## Digital Frontier

### DELOITTE

- Boards should consider the need for technology skills as part of their board composition and refreshment activities, making technology acumen a part of the selection criteria, in addition to other skills and experiences needed to support the business's strategy.
- As macro technology forces collide and companies push beyond the digital frontier, curiosity about tech advances alone will no longer be sufficient, and directors may need to go the extra mile in becoming tech-savvy.

"Boards are shifting the focus to understand how technology can also be leveraged offensively to create and enable new opportunities, business models, and revenue sources. As a result, many board members are seeking to understand the business impact of emerging technology trends to better exercise oversight without stepping into management's role—in other words, keeping their 'fingers in and noses out.'"



## Board Composition

### SPENCER STUART

- Responding to the evolving demands on boards and a growing investor focus on board composition, many boards are diversifying perspectives in the boardroom. As a result, the profile and skill set of the director continues to shift.
- To remain an asset to the company and to be prepared to make a meaningful contribution to enterprise strategy and able to challenge management effectively, boards need to continually consider refreshment and seek out directors who can bring in much-needed knowledge and experience from the front line.

"The most effective boards use the results of board and individual-director assessments as a fundamental element of strategic board-succession planning. They also consider whether the skill sets and profiles of current directors are still relevant in light of changing business needs and the future of the business."



## ESG Engagement

### BROADRIDGE FINANCIAL SOLUTIONS

- Broad groups of stakeholders will likely continue to make ESG demands of management and director “mindshare” in 2020 and immediately beyond. Developing new and robust ways of engaging all stakeholders is key to addressing growing expectations for corporate societal impact.
- Boards should ensure that their companies have identified the most relevant stakeholder groups and have a robust strategy to engage with them. Companies may want to give a higher profile to communications on their progress in ESG areas.

“Heading into 2020, boards need to develop new and robust means of engaging all stakeholders on companies’ ESG policies and progress.”



## Water Scarcity Risk

### CERES

- Water risks are already impacting the corporate bottom line and affecting corporate operations and supply-chain performance. In 2018 alone, companies reported water-related financial losses to the tune of \$36 billion.
- Directors should encourage management to assess whether water risks have a material impact on the unique circumstances of their businesses, and, if so, consider how these potential impacts should be integrated into corporate strategy.

“As boards expand their work on environmental, social, and governance issues, boards of companies in key sectors should work with management to assess and address their exposure to water risks.”

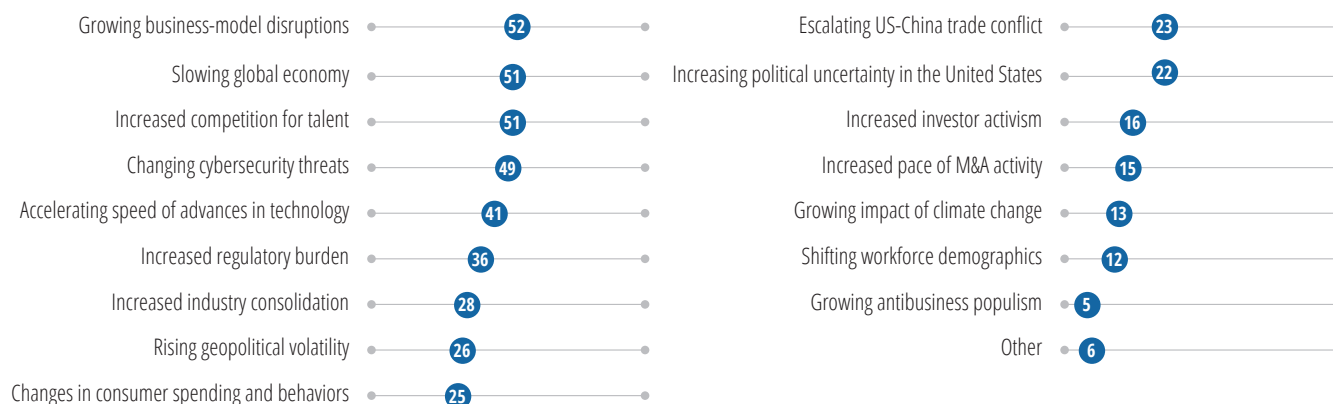
# Preparing for the 2020s:

## Five Shifts That Fit-for-the-Future Boards Must Make

By Friso van der Oord and Reaa Chadha, NACD

Today, the accelerating pace and intensifying complexity of change are creating a fundamentally different operating reality that is putting the competitiveness and governance of many businesses to the test. NACD's most recent Public Company Governance Survey found that looking forward to 2020, directors are most concerned about the impact of growing business-model disruptions, the slowing global economy, increased competition for talent, changing cybersecurity threats, and rapid technology changes.<sup>1</sup> Each of these trends alone could drive companies out of business. But, as we reveal in this year's NACD Blue Ribbon Commission Report, *Fit for the Future: An Urgent Imperative for Board Leadership*, "what makes the current epoch uniquely unpredictable and hard to navigate is the fact that these changes are happening concurrently, interacting with and amplifying each other. . . ."<sup>2</sup> For example, the exponential changes in digital capabilities have increased vulnerabilities to cyber threats and unleashed a war for talent, while worsening geopolitical turbulence, including concerns about increasing trade protectionism, is casting a dark cloud over global economic growth in 2020.

### What five trends do you foresee having the greatest effect on your company over the next 12 months?



As a result, companies can no longer rely on their historical strategies. In fact, 68 percent of directors responding to our recent Public Company Governance Survey indicate that over the next five years their existing strategies will become completely irrelevant, while 61 percent identify effective board engagement in strategy as the most important improvement priority for their boards in 2020. Similarly, the accumulated experience of both executives and board members in strategy setting, technology, and

<sup>1</sup> NACD, *2019–2020 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2019), p. 12.

<sup>2</sup> NACD, *Fit for the Future: An Urgent Imperative for Board Leadership* (Arlington, VA: NACD, 2019), p. 8.



even industry may be less relevant in the near future. These stark challenges suggest that boards will need to consider a new mind-set and a different modus operandi in order to become fit for a much different and more turbulent future.

## Implications for Boards

In NACD's most recent [Blue Ribbon Commission Report, \*Fit for the Future\*](#), we outline five key shifts that board leaders should orchestrate to make their boards fit for purpose. These shifts can help transform how the board is composed, how it operates and interacts with the business and stakeholders, and how it holds itself accountable.

### 1. Boards must engage more proactively, deeply, and frequently on entirely new and fast-changing drivers of strategy and risk.

**Why it Matters:** While 2020 is forecasted to aggravate already existing risks and projected to introduce new exposures, it will also offer new business opportunities as a result of accelerating climate change, fundamental geopolitical shifts, and major technology advancements. These rapidly changing drivers of both value creation and destruction demand a much more proactive and intense level of board engagement with management on critical matters.

#### Recommended Strategies

a. Adopt a consistent "trust but verify" mind-set in your engagement on fast-moving but critical issues such as strategy, risk, and digital transformation. While it remains important to extend trust to management, when management's answers are not satisfying, boards should have the confidence to ask tough questions and drill deeper into management's assumptions about new risks and less-certain opportunities.

b. Initiate an ongoing dialogue with the CEO to clarify where the board would like to seek deeper engagement and why this creates better governance. This will assist the board in establishing a framework for more frequent communication with management between formal meetings.

**Key Success Factor:** A transparent and trusting relationship between the board leader and the CEO will be critical to reach agreement on which boundaries need to be reset to allow for more proactive board involvement. Clear boundaries are still needed, with the board providing oversight and guidance.

### 2. Boards must review their composition through the lens of shifting strategic needs and approach their own renewal to ensure long-term competitive advantage.

**Why it Matters:** Today's shifting business realities demand new board skills, experiences, and expertise. However, even with the demand for new skill sets growing, NACD's recent Blue Ribbon Commission Report found that the majority of directors serving on boards in the Russell 3000 Index

While 2020 is forecasted to aggravate already existing risks and projected to introduce new exposures, it will also offer new business opportunities.

For board renewal to succeed and create value, board leaders must work to create an inclusive culture in order to amplify diverse voices in the boardroom.

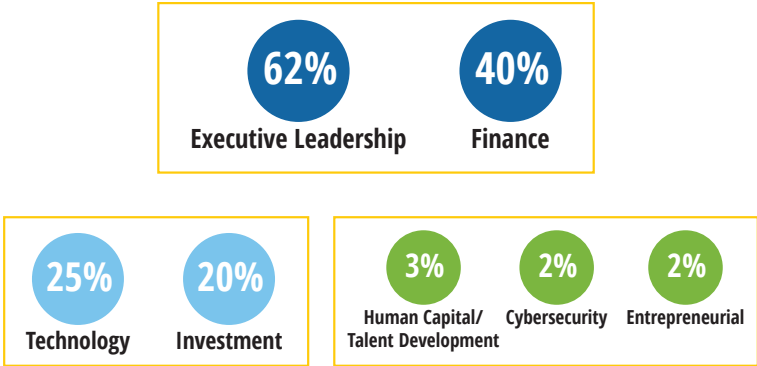
still have a background in finance (40%) and executive leadership (62%), indicating a potential mismatch between the types of director experiences that boards look for today and the types of experiences that will support the future needs of their companies.<sup>3</sup>

**Recommended Strategies**

- a. Boards should look at the company’s current and future strategic needs as well as at valid stakeholder expectations while creating their renewal process.
- b. When adding to the board, ensure that the director candidates are not only “experts” possessing proven, relevant, technical expertise but are also equipped with the capacity to learn, to add value in other areas, and to collaborate.

**Key Success Factors:** Building a diverse board that, at least on paper, is aligned with the shifting strategic direction of the business is not enough. For board renewal to succeed and create value, board leaders must work to create an inclusive culture in order to amplify diverse voices in the boardroom. Board leaders can help activate diversity by focusing on board renewal and understanding the importance of tenure. Having a mix of tenures on the board will help to maintain a diverse board composition.

**A Mismatch with Future Needs:** Director recruitment continues to prioritize classic skills and experiences (*prevalence of skills in new directors over the last 12 months.*)



**Board Renewal in the Russell 3000 Index (Since 2018)**

Data and company intelligence collected from MYLOGIQ - Multidimensional Public Company Intelligence, NACD analysis.

<sup>3</sup> NACD, *Fit for the Future: An Urgent Imperative for Board Leadership* (Arlington, VA: NACD, 2019), p. 14.

### 3. Boards must adopt a more dynamic operating model and structure.

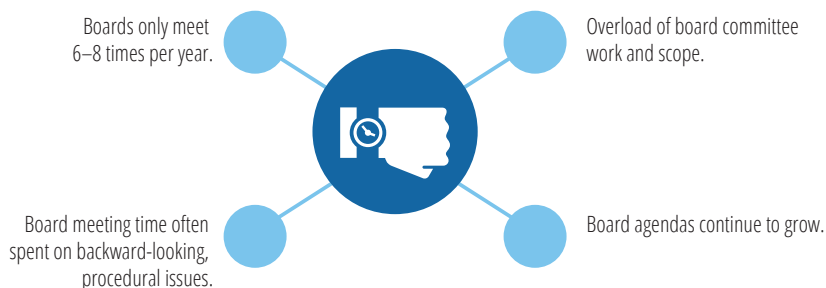
**Why it matters:** The rapidly shifting business environment also puts strains on the traditional board operating model, which struggles to keep up with new demands. The three traditional board committees suffer from mandate overload, while meeting agendas still allocate a disproportionate amount of time to procedural and compliance issues. A more fluid *modus operandi* for boards is needed to effectively oversee new issues and ensure productive discussions.

#### Recommended Strategies

- a. Have more frequent joint meetings of committees that have overlapping mandates, in addition to a strong relationship and interaction between committee chairs.
- b. Reviewing the agenda for its effectiveness and assessing how the board is spending its time ensures that the most critical issues receive appropriate attention.
- c. Boards should perform a rigorous governance review that dives into the board's governance guidelines, operations, structure, and charter(s) every year.

**Key Success Factor:** In order to build more agility into board operations and structure, the board leader needs to drive an ethos of continuous self-improvement among the board, especially the committee chairs.

A more fluid *modus operandi* for boards is needed to effectively oversee new issues and ensure productive discussions.



### 4. Boards must be much more transparent about how they govern.

**Why it Matters:** “Where was the board?” is one of the first questions asked after a governance failure or ethical issue. This implies a lack of visibility into how boards operate when confronted with major challenges. There is a constant call from stakeholders to make the board room’s inner workings less opaque. Investors in particular want to see explicit disclosure on how boards operate, make decisions, and hold themselves accountable.

When it comes to board performance, accountability starts with the rigor and candor of discussions in the boardroom.

#### **Recommended Strategies**

- a. Provide greater transparency internally and externally around boardroom operations and decision making.
- b. Prepare designated members of the board to engage directly with investors on selected governance matters.

**Key Success Factors:** To aid transparency, the board leader should engage directors and management on how to offer increased visibility into the workings of the board. At the same time, board members should seek to better understand their investors' shifting information needs on board operations.

#### **5. Boards must hold themselves more accountable for individual-director and collective performance.**

**Why it Matters:** Forty-six percent of respondents to NACD's Board Leadership Survey reported that their board leaders fail to remove directors who are no longer qualified to serve.<sup>4</sup> When it comes to board performance, accountability starts with the rigor and candor of discussions in the boardroom. External pressures such as investor, regulatory, and societal expectations compound the need to ensure accountability in the boardroom.

#### **Recommended Strategies**

- a. Define the board's annual objectives, and assess how the board delivers against them on a rolling and annual basis.
- b. Ensure board directors are engaged by maintaining a targeted, continuous, learning agenda for the board.
- c. Confirm that board evaluations are comprehensive, assess both individual-director and full-board performance, and are followed through with specific improvement actions.

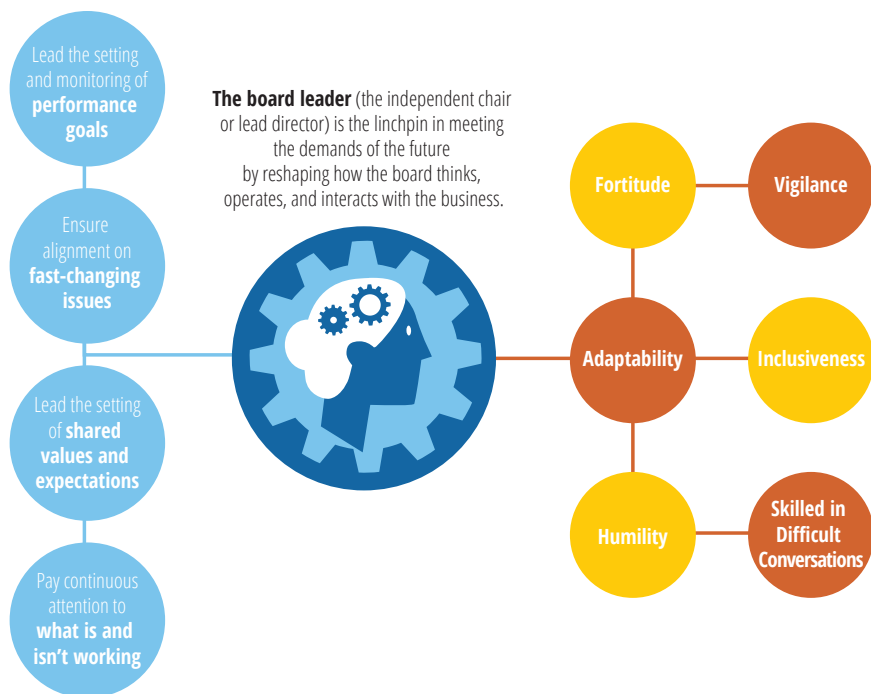
**Key Success Factors:** Board leaders should establish a behavioral framework to set expectations for director engagement and contribution. This will help clarify what the board's performance standards are and help to objectively evaluate the continued relevance of individual directors.

#### **The Board Leader as a Catalyst for Change**

The board leader (the lead director or independent chair) will need to act as a catalyst of these five shifts to build "fit-for-the-future" boards, but they cannot command and dictate change as management leaders often do. As the first among equals, they must use their influence to build consensus for adopting new governance practices and approaches and for establishing new behavioral norms. Productive dialogue with the full board and each individual director will be critical.

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<sup>4</sup> NACD, *Data Snapshot: The Voice of NACD Members on the Future of Board Leadership* (Arlington, VA: NACD, 2019), p. 2.



This new change mandate requires the board leader to reflect on both their skill set and their mind-set. Are they adaptable in light of the shifting operating realities for business? Do they effectively communicate both within the board room and with management and external stakeholders to build support for change? Can they overcome resistance to changing the board's composition, structure, and operations? Above all, as change agents at such a critical juncture for good governance of companies, they will need to show fortitude, courage, perseverance, and strength of mind to help their board evolve rapidly.



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# How to Win in the Next Recession:

## What Boards Should Know About Preparing for and Innovating Through the Next Downturn

By Chris Smith, Grant Thornton

With each passing month, the current US economic expansion, already the longest in the post-war era, sets a new record. But economic warning signs are mounting. The ongoing trade war with China continues to be a drag on the global economy. Construction spending in the US was down more than 2 percent for the first eight months of 2019.<sup>1</sup> The manufacturing sector shows continuing signs of weakness. The September 2019 Institute for Supply Management (ISM) index hit its lowest reading since June 2009.<sup>2</sup> Consumer spending continues to buoy the economy for now, but for how long?

In the summer of 2019, Grant Thornton surveyed more than 250 business owners and C-level executives at companies with between \$250 million and \$3.5 billion in annual revenues on recession-related topics ranging from when they expect a recession to how they are preparing for it and how they plan to respond once it arrives. One key finding? Most think the current expansion is nearing its end.

Of the majority of respondents, 62 percent expect a recession within the next 18 months. Delving deeper, private companies are somewhat more pessimistic, with 39 percent seeing a recession in the next 12 months, while public companies' respondents were more likely to see the recession starting in 12 to 18 months. Only one-quarter of respondents do not expect a recession within the next two years. Most companies, however, see continued investment in innovation as a key to succeeding through the next recession.<sup>3</sup> The challenge for boards? Helping to ensure companies accurately understand the challenges of doing so.

When asked what is most likely to trigger a recession within the next year, the most common answer was Regulation/Trade/Tariffs at 17 percent, followed by Interest Rate Hikes (14%), US Policy Uncertainty (13%), and Slower Global Growth (12%). There were, however, some significant differences in trigger rankings between public and private company respondents.<sup>4</sup> Boards can help management understand, anticipate, and prepare for the links among these triggers.

Tariffs and policy uncertainty currently are a drag on global growth and, while federal policy in the United States is currently leaning more toward cuts than rate hikes, already low interest rates leave limited room for central banks to maneuver.

Public-company respondents were more than twice as likely as their private-company counterparts to choose interest rate hikes as the most likely trigger (20% to 9%), and they are significantly more concerned

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<sup>1</sup> Yelena Maleyev, "Construction and Manufacturing Showing Signs of Weakness," posted on Grant Thornton's *Economic Insights & Analysis Blog*, September 3, 2019.

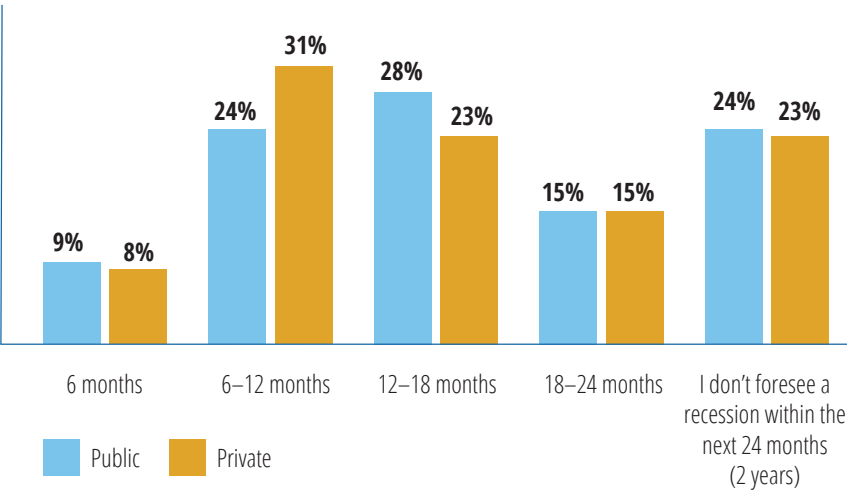
<sup>2</sup> Ibid.

<sup>3</sup> Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 4.

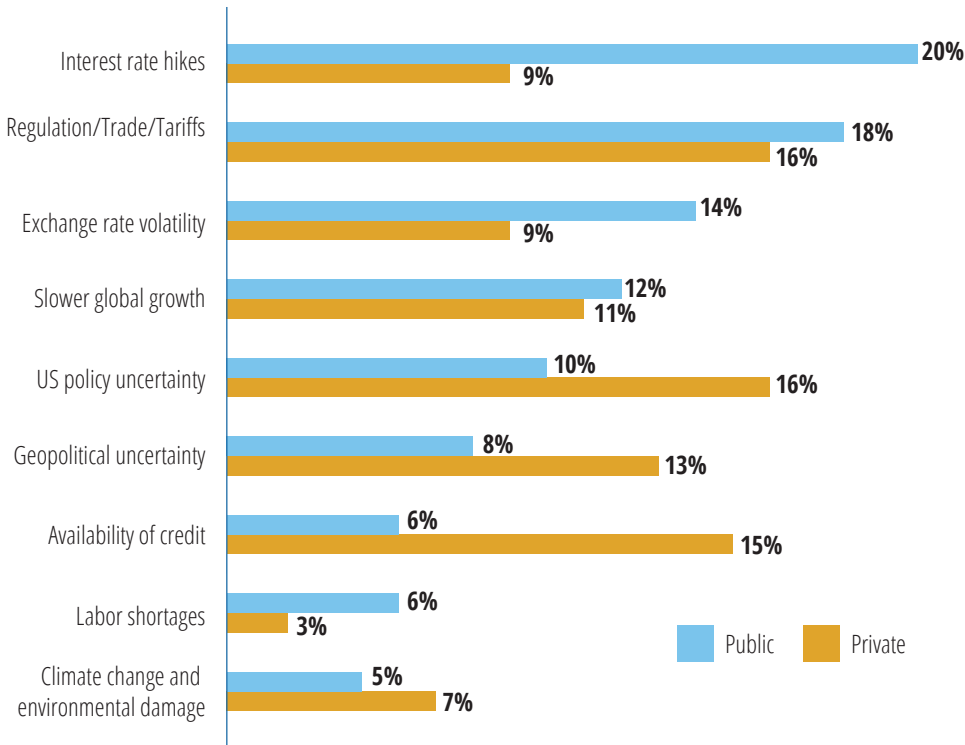
<sup>4</sup> Ibid., p. 5.



### Recession expectations by public/private companies



### What is most likely to trigger a recession?



about exchange-rate volatility (14% to 9%). Meanwhile, private-company executives were almost three times as likely to cite availability of credit (15% to 6%) as the primary cause for a recession, and they are 50 percent more concerned about US policy uncertainty (16% to 10%) than their public counterparts.<sup>5</sup>

Tariffs and their impact on global growth have been a growing concern for businesses and economists alike. Among respondents to the survey, 42 percent report that tariffs have had a negative effect on their business, while 27 percent report a positive impact, reflecting the overall view that tariffs are a drag on the global economy.<sup>6</sup>

Diane Swonk, Grant Thornton's chief economist, offers a warning on shifting international political trends. "Older electorates with atavistic tendencies—a longing for a return to the past—are voting in autocratic

<sup>5</sup> Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 5

<sup>6</sup> Ibid., p. 6.

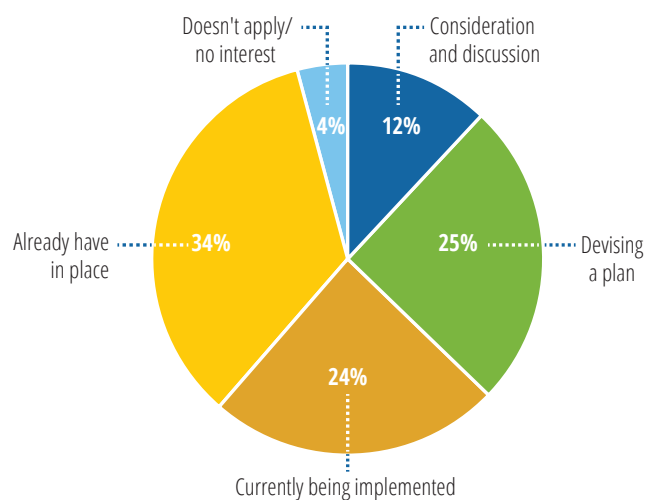


## How prepared is your company for a downturn?

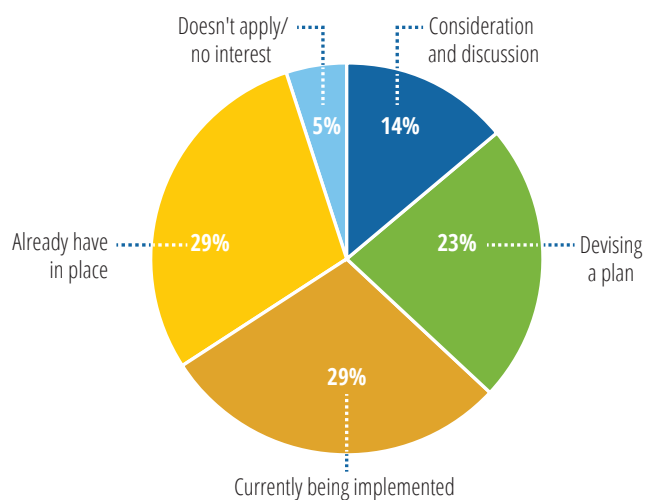
### Four Starting Questions for Boards.

1. **Are you focused on your core?** During the long recovery, it's not unusual for businesses to have diversified into new areas—a rising tide lifts all boats. But which are likely to run aground first in a downturn? By identifying underperforming or non-core assets now, you can sell them while conditions are strong and you are likely to secure a better return. You can then use that capital to pay down debt, provide a financial cushion, and build a war chest to seize opportunities once the recession hits.
2. **Are you watching long-term commitments?** Think carefully about any long-term commitments, from new leases to capital expenditures to new supplier and customer relationships. In order to maintain flexibility, consider them through the filter of how they would impact your business should conditions tighten.
3. **Have you planned your debt?** If you need capital or have a refinancing coming up in the next 24 months, act on it now while you can secure financing on relatively easy terms with very few covenants. Once conditions tighten, the cost of debt shoots up, covenants get restrictive, and there is less capital available.
4. **Are you optimizing your supply chain?** Now is a good time to evaluate what you need, where it is sourced, and how much you really require. What are you long in today that you may not want to be? What don't you want to get longer in? This is also a good time to consider the long-term viability of key suppliers and develop back-up plans should any fail. Ongoing and expanding trade wars may also make this a good time to explore new supply chain locations.

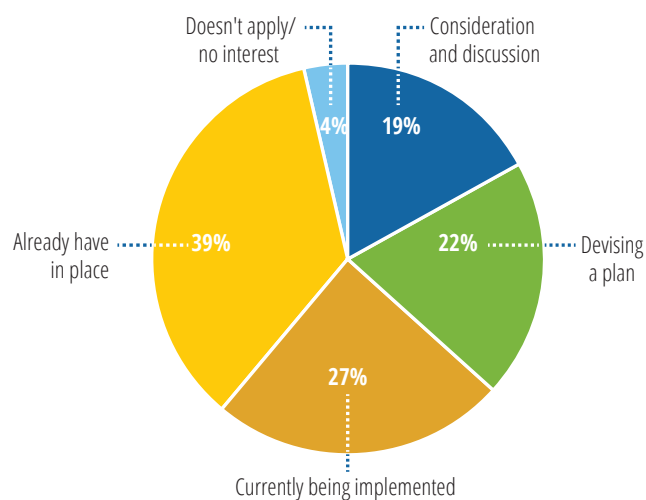
### Crisis management planning



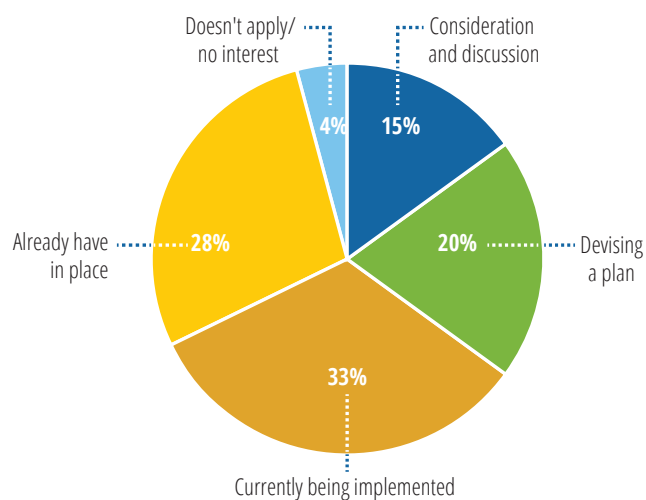
### Stress testing



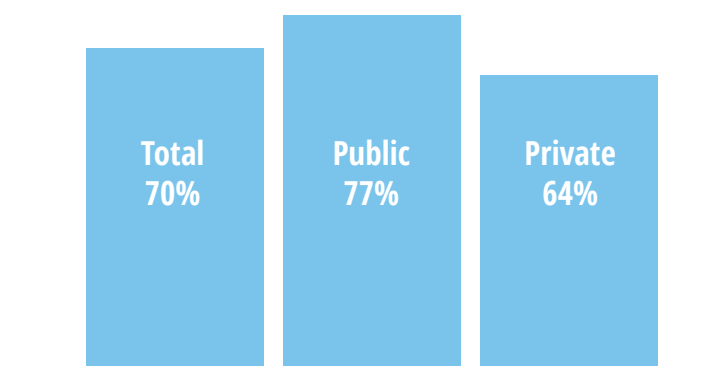
### Supply chain resilience



### Cash flow modeling



#### Percentage of respondents planning to increase investment if recession is imminent



leaders who are ushering in a new era of nationalism, harder borders, and a backlash to anything foreign, like immigrants and trade,” said Swonk. “The result is a cascade of policies that tend to curb growth, or worse. Countries led by autocrats tend to trigger negative economic outcomes.”<sup>7</sup>

#### How companies are preparing for recession

The question for boards? How to help your company prepare and shape the right strategy to navigate the next downturn. Benchmarking your company’s strategy against its peers is a good place to start.

Well over half of the companies we surveyed not only believe a recession is coming, they are actively planning for one.<sup>8</sup>

We asked respondents about four common strategies that companies could implement to prepare for a recession:

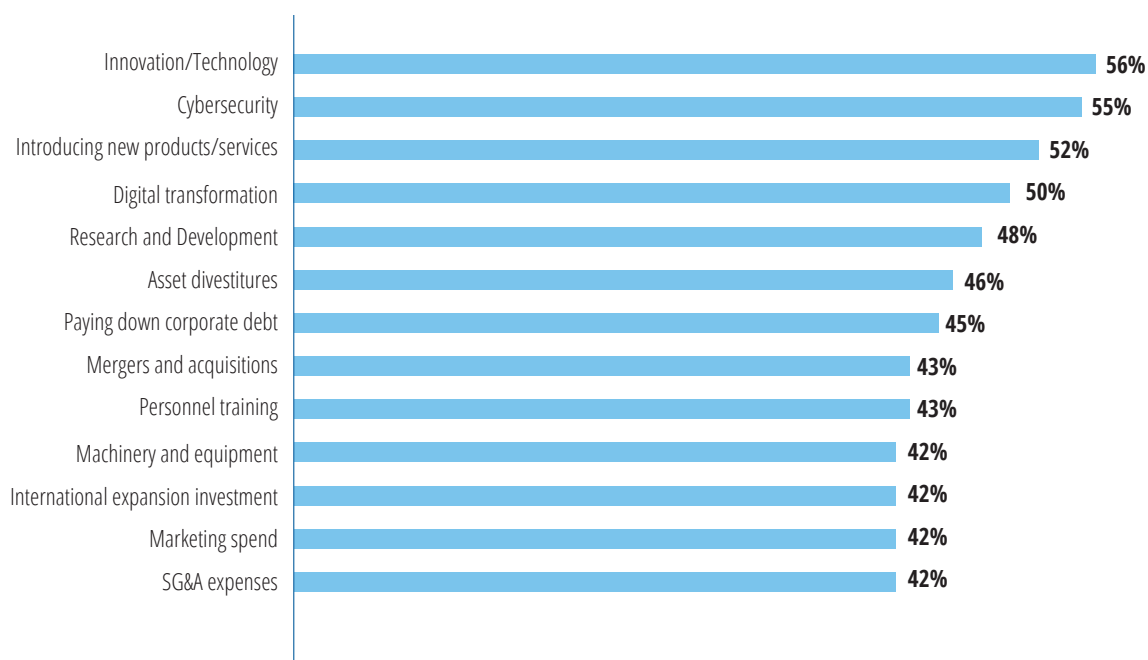
- Crisis management planning to frame likely recession-based scenarios and the company’s response to them
- Stress testing to determine how well the company can weather issues like decreased revenue, increased interest rates, or lack of available lending resources
- Supply chain resilience strategies that can reduce costs and offer alternatives in the event of supplier failures or ongoing trade-war issues
- Cash flow modeling to accurately forecast cash flow and offer alternate options to maintain a healthy cash position

<sup>7</sup> Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 17.

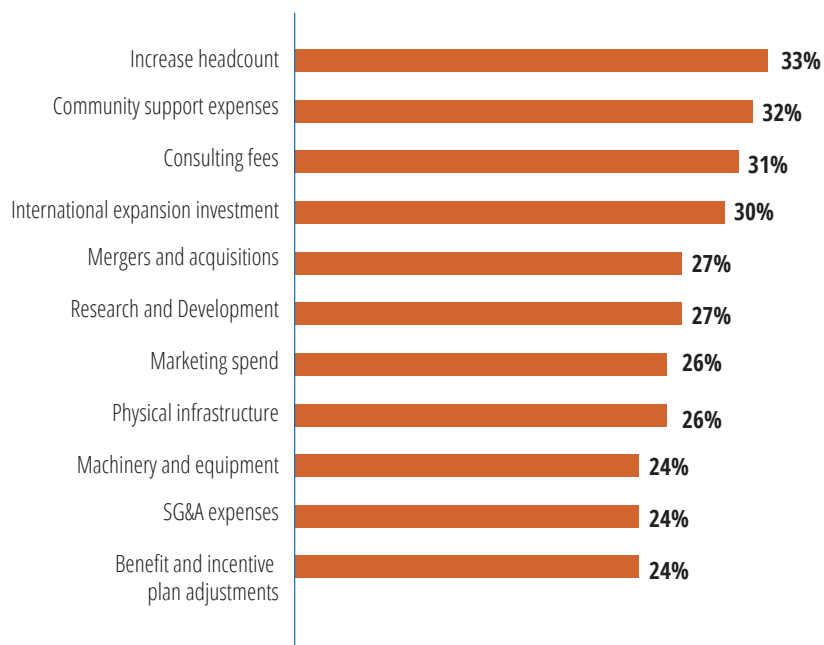
<sup>8</sup> Ibid., p. 7.

## Company investment plans if a recession is imminent

### Ramp up investment



### Ramp down investment



“The fact that companies want to keep innovating through a recession is great, but in a recession cash is king. If you run out of cash, you run out of options.”

— Scott Davis

Across the board, the majority of companies either already had plans in place or were currently implementing plans in each category.<sup>9</sup>

Whether or not you see a recession as imminent, it makes sense to be prepared for one. Boards should check where their management stands with their recession planning and reality check the nature and extent of those plans against their company’s unique strategy, industry concerns, market conditions, and exposure to specific risks. Boards of smaller enterprises should be especially diligent. Our survey finds that companies with revenues between \$250 million and \$500 million are less likely to have plans in place than their larger competitors.<sup>10</sup>

The board should be checking what areas of potential stress management is actually testing and they should be ensuring that management has sufficient forecasting and other cash-flow modeling processes in place to provide early warning of cash issues in the event of a downturn. Scott Davis, a partner in Grant Thornton’s strategic solutions practice, explains: “The fact that companies want to keep innovating through a recession is great, but in a recession cash is king. If you run out of cash, you run out of options. Smaller companies in particular should be stepping up their forecasting efforts. They often have less cushion to begin with, so disciplined cash management is even more vital.”<sup>11</sup>

Interest rate and debt are other areas boards should ensure are receiving sufficient focus. Grant Thornton’s survey shows a relative lack of concern about interest rate increases, which may be a sign of short institutional memories when it comes to recessions. “During the Great Recession, lack of available credit was one of the major factors in many business failures,” said Davis. “Yet in this survey, while 65 percent of respondents view access to capital as a key risk in the event of a recession, only 27 percent have indicated plans to increase credit lines as a strategy.” Davis recommends that boards push management to take a close look at their current and projected credit needs now, while rates remain low and restrictive covenants are uncommon. “Once a recession hits, credit can be very hard to come by,” said Davis.<sup>12</sup>

### Innovating through the downturn

One surprising finding of the survey? While companies have traditionally pulled back on investment to conserve resources during a recession, 70 percent of respondents plan to increase investment in either innovation/technology, digital transformation, or cybersecurity during the next

<sup>9</sup>. Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 7.

<sup>10</sup>. Ibid.

<sup>11</sup>. Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 9.

<sup>12</sup>. Ibid.



recession. Public companies were more likely than their private counterparts to plan on increases, but a sizeable plurality of both sectors plan to ramp up investment in one or more of those areas.

No matter when it starts, this recession will be different, says Chris Stephenson, a principal in Grant Thornton's financial management practice. "It's been more than a decade since the last recession. Companies' recession memories and capabilities have atrophied. Few executives are in the same jobs they were 10 years ago. Some haven't been through a downturn at all. And business models have changed significantly. Some companies will have to relearn some hard lessons, but what's clear is that they don't intend to just retrench and try to ride it out. Most are counting on continued investment in technology and innovation to push them through."<sup>13</sup> Since board members often do have experience in prior recessions, they can serve as a valuable resource for management teams that do not. This would also be a good time for boards to revisit their succession plans. Finding the right CEO during a recession is particularly challenging.

Technology and digital transformation have revolutionized the business landscape since the last recession ended more than a ten years ago. Respondents clearly view ongoing innovation as vital to their success no matter the business climate. When asked how they would approach a wide variety of investment decisions if a downturn were imminent, half or more of respondents picked innovation and innovation-related activities as their top-four choices for increasing spending. Additionally, almost half chose R&D, which also drives innovation. While these investment categories were a top focus for both public and private companies, public company investment plans are more aggressive across the board when compared with those of private company respondents.<sup>14</sup>

The areas where respondents are most likely to make cuts when it comes to investment? Headcount, community support, consulting fees, and international expansion.

"Companies that make the earliest and wisest investments in innovation during the downturn will be those best positioned to seize market share and competitive advantage coming out of it," said Stephenson. "But that won't be easy. Cash will be tight. It will take real insight into your business and your market to zero in on the core business functions that will build the innovative foundation that will drive you ahead during the recovery."<sup>15</sup>

Investment doesn't just have to drive innovation in products and services; it can also drive innovation in the financial discipline companies need during a downturn. "Consider the vast advances made in data gathering

Technology and digital transformation have revolutionized the business landscape since the last recession ended more than ten years ago. Respondents clearly view ongoing innovation as vital to their success no matter the business climate.

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<sup>13</sup> Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 4.

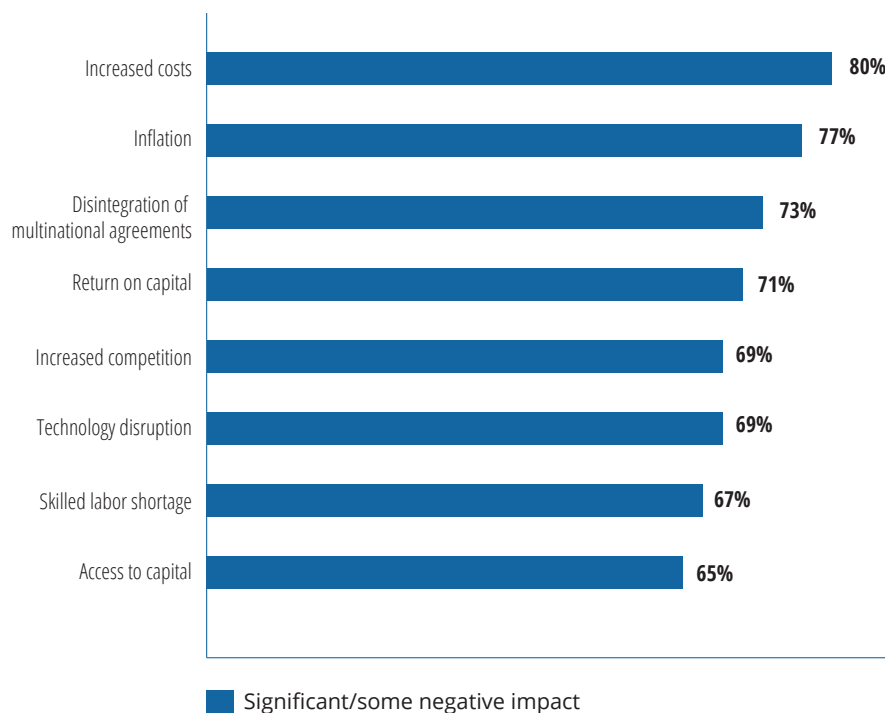
<sup>14</sup> Ibid. p. 10.

<sup>15</sup> Ibid.

“A recession is no time to have to deal with the economic and reputational ramifications of a major breach. Strengthen your cyber defenses and be vocal about it. Cybercriminals look for weak targets. Let them know your defenses are strong.”

— Chris Stephenson

### Which risks will have the greatest short-term impact on growth in a recession?



and analytics,” said Davis. “Those tools can also significantly improve the timeliness and accuracy of your cash forecasting and management, which are vital during a recession.”<sup>16</sup>

Stephenson encourages boards to remember that companies aren’t the only ones innovating. So are cybercriminals. Fraud of all kinds often increases during a downturn—cybercrime is no exception. Cybercriminals know resources will be tight and are hoping that many companies will cut back when it comes to cybersecurity. “Don’t be one of them,” said Stephenson. “A recession is no time to have to deal with the economic and reputational ramifications of a major breach. Strengthen your cyber defenses and be vocal about it. Cybercriminals look for weak targets. Let them know your defenses are strong.”<sup>17</sup>

<sup>16</sup>. Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 10.

<sup>17</sup>. Ibid., p. 12.

## Focusing on the human factor

Layoffs are one of the most unpleasant aspects of a recession, and that's reflected in Grant Thornton's survey results. Overall, respondents were almost evenly split, with 35 percent saying they would ramp up investment in headcount, 33 percent saying they would ramp down, and 32 percent not planning on a change.<sup>18</sup> However, smaller companies, those with between \$250 million and \$500 million in annual revenue, were far more likely to ramp up investment on both headcount, at 42 percent, and retention, at 47 percent. In comparison, larger companies came in at 33 percent and 36 percent, respectively.<sup>19</sup>

Nicole Blythe, Grant Thornton's national managing partner for people experience, offers these thoughts on workforce issues for boards to consider.

"Your workforce plan should anticipate how you will react to a recession," said Blythe. "That means addressing supply and demand issues. What capabilities does your company need? With most companies recognizing that continued innovation is the key to thriving through a recession, it's vital to identify the key skills and key players necessary to support those efforts. There is always a limited supply of top performers."<sup>20</sup>

Blythe also pointed out that, during the last recession, companies found new ways to leverage flexible or contingent workforces—and that many continued to use those options even after the recession was over. "Flexibility is increasingly important in a downturn," said Blythe.<sup>21</sup>

Blythe is not surprised that respondents from smaller companies are more focused on retention and less on cutting headcount. "Smaller companies often offer products and services at lower price points than larger competitors, so they can become an attractive option to new customers during a downturn. They need to maintain their capacity to capitalize on those opportunities. Also, smaller employers are more likely to have no or little redundancy in certain key positions, which makes retaining their key players especially important."<sup>22</sup>

## Understanding and mitigating recession risks

Successfully navigating a recession hinges largely on identifying, understanding and mitigating risks—a key focus for every board. Respondents to Grant Thornton's survey offered some interesting perspectives on the risks they see in the next recession.

"Smaller employers are more likely to have no or little redundancy in certain key positions, which makes retaining their key players especially important."

— Nicole Blythe

<sup>18</sup> Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 11.

<sup>19</sup> Ibid., p. 14.

<sup>20</sup> Ibid., p. 15.

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

“Ongoing trade disputes are driving up costs for many companies. Looking forward, companies are anticipating a recession where, instead of costs going down, tariffs and trade wars may keep driving them up. That’s a significant problem.”

— Yvette Connor

When respondents were asked about the greatest risk to near-term performance in the event of a recession, increased costs, inflation, and the disintegration of international agreements topped the list.<sup>23</sup> A few years ago, it was highly unlikely that the weakening of international agreements would have made the list, much less finished near the top, and inflation and increased costs are not usually concerns during recessions, when costs historically have gone down.

“On the surface, these results suggest respondent fears that are the opposite of deflation and reduced costs, which are typical during a recession,” said Yvette Connor, Principal in Grant Thornton’s regulatory and compliance solutions practice. But, when the third-highest ranked risk, disintegration of international agreements, is factored in, the reason for those concerns emerges. “When we add global instability and tariffs into the equation, escalating supply chain and delivery costs and inflationary concerns make more sense. Ongoing trade disputes are driving up costs for many companies. Looking forward, companies are anticipating a recession where, instead of costs going down, tariffs and trade wars may keep driving them up. That’s a significant problem.”<sup>24</sup>

Connor points out that businesses continue to see technology disruption as a major risk, even during a recession, which is one of the reasons so many companies plan to continue investments in innovation even during a downturn. “Digital transformation will be the best way to offset their risks,” says Connor. “It decreases costs, increases efficiency, increases the quality and quantity of information available to them, and improves their resilience.”<sup>25</sup>

Connor is also not surprised that access to capital is a key concern. She noted that smaller companies are more focused on paying down debt. “The private-equity market is still hot, so smaller companies can still sell off underperforming assets at good multiples and use that money to pay down debt and build up a bankroll so they can respond to M&A and other opportunities as a recession deepens. Credit will get tighter. All companies should be taking a close look at their debt and should be exploring their options now while conditions are still favorable.”<sup>26</sup>

### **Innovate through the recession**

Most companies believe a recession is coming, and most don’t plan to just retrench and ride it out. They intend to leverage ongoing innovation and investment in order to emerge stronger and better positioned on the other side.

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<sup>23</sup> Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 18.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

“Plan now. Then invest in, innovate, and execute your core business during the downturn. That will position you to dominate the recovery,” said Stephenson. “Companies that approach a recession with the discipline to control expenses and manage cash, but with a matching vision to align ongoing investment with strategy and opportunity can win the recession instead of just surviving it.”<sup>27</sup>



## QUESTIONS FOR DIRECTORS TO ASK

While the idea of continuing to innovate through a recession sounds attractive, it won't be easy. Stephenson suggests boards consider the following questions when reviewing management's innovation plans:

- **Where will the money come from?** “Cash is king in a recession, so financial discipline is vital. Be sure the investment isn't going to strain the cash flow necessary for ongoing core business operations,” said Stephenson.
- **Does this innovation help drive a core business need?** “This is the time to focus on core business functions, not the time for big-ticket whitespace projects,” Stephenson said.
- **What is the project time line?** “The faster the better,” said Stephenson. “The best projects will have very clear goals and quick, realistic time lines.”
- **How fast is the ROI?** “A recession is the time to focus on projects with immediate returns, not those that will take months or years to ramp up,” said Stephenson.



Chris Smith is the national leader of Grant Thornton's Growth & Transformation services and a member of the firm's partnership board.

<sup>27</sup> Grant Thornton, *The Innovation Recession: Why This Downturn Will Be Different and How to Prepare* (2019), p. 19.

# 2020 Strategic Risks for Boards:

By Jim Alajbegu, William Chapman, Jeff Jorge, Gary Peric, Raina Rose Tagle, and David Ross, Baker Tilly

US companies face a variety of risks—both domestically and internationally—that are reshaping the world in which they do business. The board’s role in responsibly overseeing executive leaders’ management of the most significant risks has become increasingly complex.

“Resiliently” describes the way in which effective boards operate now. Rapid changes in the political and market environments require boards to clearly understand their organizations’ enterprise risks and opportunities. Boards should also consider reputational risk as a more significant risk than it has been in the past. A reputational risk is any risk that has the potential to produce negative publicity, change the public’s perception of the organization, or result in uncontrollable events that adversely impact a company’s reputation, thereby affecting its revenue.

When significant risks have been identified, the knowledge, skills, and abilities already present among board members can be matched to those risks and the board can attempt to fill any gaps in expertise. Having the right people, structure, and information in place enables boards to understand the risk profile and the risk appetite of the organization and allows them to ask probing questions of executive leaders.

This viewpoint focuses on four key risks—mergers and acquisition (M&A), trade compliance, tax issues, and data privacy—as well as on how boards can provide effective guidance and oversight related to each risk.

## Managing risk to improve the chances of an M&A transaction’s success

According to the [Harvard Business Review](#), 70–90 percent of M&A transactions fail.<sup>1</sup> This can usually be traced to insufficient due diligence in three areas:

### M&A Transaction Failure and Due Diligence

Was the strategic approach sound?



Was the process of validating the investment sound and thorough?



Was the post-transaction plan in place before the deal closed?



Source: Baker Tilly.

<sup>1</sup> Roger L. Martin, “M&A: The One Thing You Need to Get Right,” the *Harvard Business Review*, June 2016.



Boards are taking their fiduciary obligations more seriously than ever and collaborating with management to oversee all aspects of a transaction. The board must monitor the work of the due diligence team to confirm that appropriate diligence is conducted and that the risks in the transaction are identified and communicated to the board.

The board should support the executive team by ensuring that it has the resources necessary to execute and successfully integrate any transaction.

### **Sustainable free cash flows**

Deals are carefully priced in the current market. The focus used to be on earnings before income tax, depreciation, and amortization (EBITDA), but EBITDA is not a perfect metric because it ignores the investment in net working capital, net replacement capital expenditures, and cash taxes paid. Companies are trying to validate the sustainability of the free cash flows—the economic earnings available to the stakeholders of the business (the debt and equity owners).

Companies and boards are also looking closely at the risk profile of a subject company—customer concentrations, products and services concentrations, vendor and supply chain concentrations, distribution channel concentration, intellectual property (IP) concentrations, key person issues, and commodity risks—as they all relate to the sustainability of free cash flows.

The reputational risk in any transaction today could outweigh the tangible benefits of the transaction itself. A company's assets generally are not only people, products and services, and proprietary technology, but also brand and reputation. If a transaction puts a company's reputation at risk, it may not be worth it.

### **Looking ahead to 2020**

In 2020, boards will be focusing on how disruption, tariffs, labor, and taxes will affect M&A activity.

Boards must understand how both their own companies and their acquisition targets are dealing with the pace of change, innovation, and disruption. A business model that aligns with strategy today may be off strategy tomorrow. (Think Blockbuster before Netflix or the local cab company or car dealership before Uber and Lyft.)

If the target company has a significant direct labor force, boards should understand the manner in which executive leaders have determined that all employees have proper documentation.

Boards are taking their fiduciary obligations more seriously than ever and collaborating with management to oversee all aspects of a transaction.

Boards should challenge their executive teams on the soundness of their global trade strategies, not only with China but with every country with which the company conducts trade.

### **Addressing increased complexity of trade regulations and risk of noncompliance**

International trade compliance has far outpaced past levels of complexity. High tariffs on finished goods, components, or commodities imported from China, coupled with increased scrutiny by US customs officials, give a wake-up call to boards to ensure that their companies are pursuing solid trade strategies while mitigating trade-related risks.

Boards should challenge their executive teams on the soundness of their global trade strategies, not only with China but with every country with which the company conducts trade. Boards also must understand the risk in concluding that senior leaders are equipped to handle trade compliance issues without guidance from outside the company.

### **New world of tariffs**

Business leaders in the US have not faced significant tariff issues for three generations. Prior to 2019, US companies may have paid low, single-digit tariffs on items imported from China and considered the cost a small part of their overall cost structure. The 10–25 percent tariffs on goods and components from China levied in 2019, however, are causing companies to rethink the amount of business they do there.<sup>2</sup> In addition, companies doing business with China, irrespective of their industry sector, are facing more scrutiny by federal agencies.

The US Customs and Border Patrol (CBP), the primary federal agency overseeing international trade, increased its tariff-audit activity by almost 100 percent over the past year; the volume of penalties issued as a result of these audits increased by 40 percent. Total trade seizures for violations of trade compliance regulations totaled more than 50,000 individual cases over the last year.<sup>3</sup> CBP audits can target any importer, of any size, on any issue.

Unbeknownst to most boards and executive teams, the penalties for trade violations are significant. For example, if the CPB deems that a company deliberately used the wrong Harmonized Tariff Schedule (HTS) code on 10 items, the CBP can fine the company for

1. negligence (twice the loss of duties, taxes, and fees or the domestic value of the goods, whichever is less; or, if the violation caused no duty loss, then 20% of the dutiable value);
2. gross negligence (four times the loss of duties, taxes, and fees or the domestic value of the goods, whichever is less; or, if the violation caused no duty loss, then 40% of the dutiable value of the goods); or
3. fraud (an amount not greater than domestic value (1x) of the goods).<sup>4</sup>

<sup>2</sup>Maggie Fitzgerald, “[Here’s a list of American products targeted by China’s new tariffs](#),” posted on CNBC August 23, 2019, and updated August 24, 2019.

<sup>3</sup>US Customs and Border Protection, “Trade Statistics,” posted on [cbp.gov](https://cbp.gov).

<sup>4</sup>USC §1592, <https://www.law.cornell.edu/uscode/text/19/1592>.

In addition, if the CBP determines that individuals in the company operated in bad faith to evade tariffs, they may face up to two years in prison.<sup>5</sup> Senior executives are often unaware of these risks, because it is likely they have never faced a CBP audit.

### **Other US trading partners require the board's attention**

China, Canada, and Mexico constitute the top three US trading partners.<sup>6</sup> It is likely that companies engaged in global trade presently conduct meaningful cross-border shipments with both Mexico and Canada. While the United States-Mexico-Canada Trade Agreement (USMCA) remains unratified, the prevailing parameters of the North American Free Trade Act (NAFTA) remain in force with one major change: increased scrutiny, analytics, and inspection pressure on companies large and small.

Further, as USMCA is ratified, there will be a substantial increase in compliance requirements ranging from rules of origin (i.e., establishing proof of where goods are made, who makes them, and the local content in each) to labor allocation thresholds. At present, most companies are ill-equipped at the process, people, and technology levels to handle such an increase in compliance requirements. Forward-thinking companies need to take the necessary steps now to prepare for heightened scrutiny after USMCA is ratified.

### **Looking ahead to 2020**

In 2020, boards will consider adding directors to their rosters who bring the global trade expertise necessary to ask astute questions of management in order to ensure trade compliance and minimize risk exposure. Further, as boards monitor whether the US/China trade rift will ease or go away, they will also confirm that the company's trade compliance program is robust by leveraging the skills of newly added directors as well as by engaging external advisors to assist in identifying gaps and closing them. Finally, they will be thinking about how to handle long-term capital investments both in the United States and in other markets, trying to weigh the cost-to-benefit ratio of launching an operation in certain countries versus others.

Given the recurring signs of an imminent economic slowdown in the United States, boards should examine whether their companies are overly exposed to the domestic market. If so, top-line growth and diversification into international markets may be in order.

Forward-thinking companies need to take the necessary steps now to prepare for heightened scrutiny after USMCA is ratified.

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<sup>5</sup>FUSC S541, <https://www.law.cornell.edu/uscode/text/18/541>.

<sup>6</sup>Office of the US Trade Representative, "Countries & Regions," posted on [ustr.gov](https://ustr.gov).

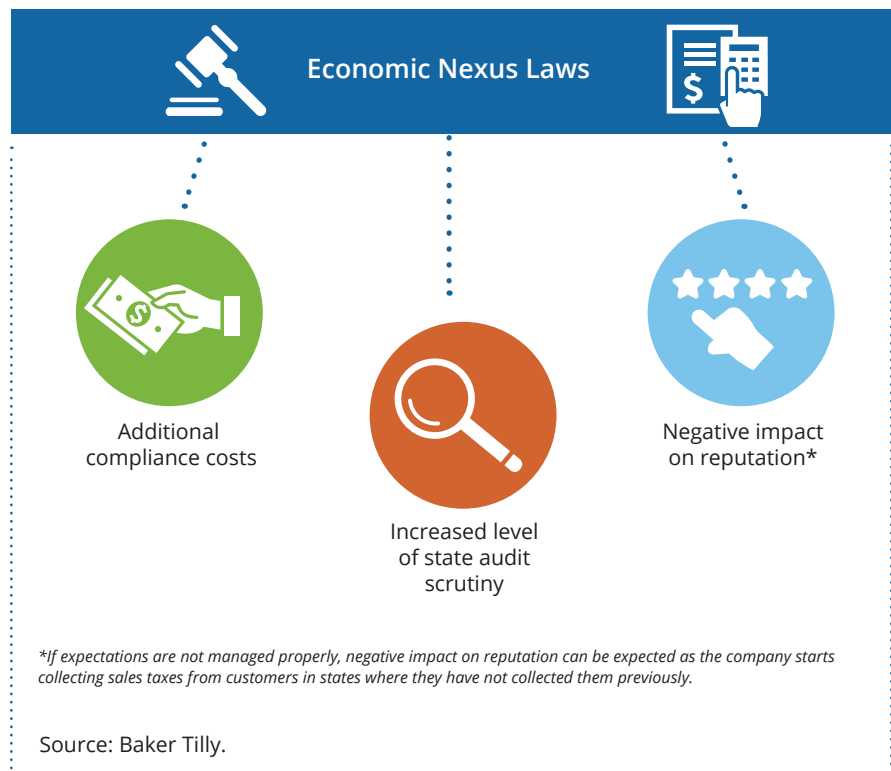
Most of the new economic nexus imposition statutes are similar. The laws are not retroactive and typically they provide a safe harbor.

### Shifting domestic and international tax risks

Since the US Supreme Court's 2018 *Wayfair* decision,<sup>7</sup> virtually all states with a sales tax have enacted an economic nexus imposition statute. Sellers are liable for the collection of sales taxes on sales destined to those states (under certain conditions), even if they do not have a physical presence in them. This tax liability creates a new tax risk for companies in many states. Boards should be aware of this.

Most of the new economic nexus imposition statutes are similar. The laws are not retroactive and typically they provide a safe harbor—a seller must generate approximately \$100,000 of revenue or more in the jurisdiction or have 200 separate transactions per year to be required to register and collect sales tax. Some states have slight variations—Tennessee and Texas have a \$500,000 limit and no transaction threshold. Kansas is an outlier—in October 2019, its economic nexus law went into effect with no threshold, so a seller with *any* sales in that state will have to register and collect sales taxes.<sup>8</sup>

A remote seller may need to register for and start collecting sales tax in many jurisdictions. Boards must be aware of the consequences of these economic nexus laws, including consequences such as these:



<sup>7</sup> *South Dakota v. Wayfair, Inc. et al.*

<sup>8</sup> Sales Tax Institute, "Economic Nexus State Guide," posted on [salestaxinstitute.com](https://www.salestaxinstitute.com).

## Taxing digital services

Government authorities are increasingly looking at ways to tax digital services. In July 2019, France enacted a 3 percent tax on revenue from digital services (such as collecting user data or selling targeted advertising) sold by large technology companies.<sup>9</sup> The exact impact of the tax on US companies like Google and Facebook is still uncertain, but clearly, other governments will be looking at a digital services tax for revenue.

Many states are starting to tax software as a service (SaaS). Tech companies that license remotely accessed software via a server need to be more vigilant. In the post-*Wayfair* world, an SaaS provider may have licenses all over the country and will need to monitor if it is liable for registration and collection of sales taxes and who is paying them (the SaaS provider or the licensee) to ensure that the revenue streams from the license are not taxed twice.

## International tax considerations

In addition to the new domestic tax risk related to *Wayfair*, boards of US companies doing business abroad should be aware of their companies' exposure to "global intangible low taxed income" (GILTI), part of the Tax Cuts and Jobs Act (TCJA).<sup>10</sup> GILTI is a new category of foreign income added to taxable income each year for certain US shareholders of foreign corporations. GILTI is generally defined as the excess of a US shareholder's aggregated "net tested income" from controlled foreign corporations over a routine return on certain qualified tangible assets.<sup>11</sup>

Throughout 2019, the IRS issued regulations, notices, and revenue procedures related to GILTI. Boards should ask senior management about steps taken to mitigate GILTI exposure with respect to foreign earnings.

Boards also need to be aware of their companies' exposure to indirect taxes such as the value-added tax, tariffs, and customs duties. Tax authorities in every jurisdiction are being much more aggressive in pursuing those dollars and increasing audits.<sup>12</sup>

Many states are starting to tax software as a service (SaaS). Tech companies that license remotely accessed software via a server need to be more vigilant.

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<sup>9</sup> Daniel Bunn, "France's Digital Services Tax: Facts and Analysis," appearing on [taxfoundation.org](https://taxfoundation.org).

<sup>10</sup> "IRS and Treasury issue guidance related to global intangible low-taxed income (GILTI)," posted on [irs.gov](https://irs.gov).

<sup>11</sup> US Department of the Treasury, Internal Revenue Service, *Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits*.

<sup>12</sup> This is an observation from the Baker Tilly experts we interviewed reflecting what they hear from clients on a regular basis.

Boards should be prepared for more state audits of sales taxes as enforcement of *Wayfair*-enabled economic nexus legislation goes into full swing

### Looking ahead to 2020

Boards should be prepared for more state audits of sales taxes as enforcement of *Wayfair*-enabled economic nexus legislation goes into full swing. Audits will be wide ranging, including a business's economic nexus start period in a state; the classification of items as nontaxable, taxable, or exempt on tax returns; and correct sourcing of revenue to the appropriate state.

In the wake of TCJA, there is a more favorable environment for companies with large amounts of cash saved offshore to repatriate that revenue. Boards need to know how much cash their companies have offshore and how they can bring it back with minimal tax impact.

### Responding responsibly to new data-privacy laws

Data-privacy regulation affects US companies operating domestically and around the world. The European Union has started assessing fines related to the General Data Protection Regulation (GDPR). The California Consumer Privacy Act (CCPA) goes into effect January 1, 2020.<sup>13</sup> Other states and even some cities are considering data-privacy laws. Boards must understand in what jurisdictions their organizations do business and collect personal data. This knowledge helps to determine which regulations apply and a company's data-privacy risk exposure.

Boards are closely watching the footprint of the organizations with which they do business. Even if a company does not have a physical presence in Europe and does not sell directly to European citizens, it may still need to be compliant with the GDPR based upon the data-processing agreements of the companies with which it does business.

### Reputational risk

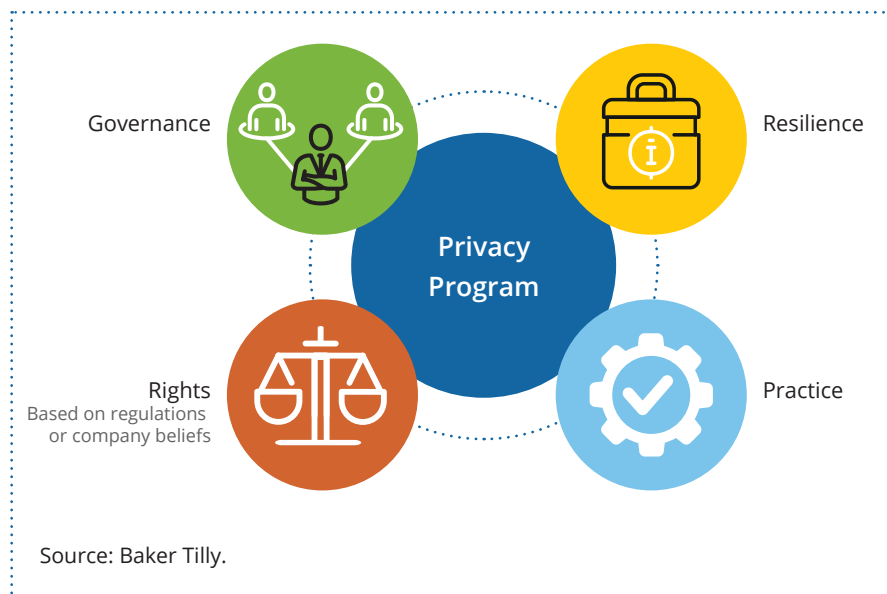
In addition to compliance risk, boards are increasingly aware of the reputational risk of a data incident—if a company has a big data spill, would they lose customers in different geographies?

Because the number of jurisdictions with privacy laws and regulations is growing, a board likely will depend on outside professionals to stay compliant. The International Association of Privacy Professionals is the main clearinghouse for information about privacy laws worldwide. In addition, companies likely will find it invaluable to have a trusted advisor who both knows the company's business and the relevant privacy laws where the company does business, to keep the company informed about its privacy obligations.

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<sup>13</sup> SB-1121 California Consumer Privacy Act of 2018.





### Risk registry and the privacy impact assessment (PIA)

Two things companies should have in place to help navigate the ever-changing landscape of data-privacy laws and regulations are a risk registry and a privacy impact assessment (PIA). These tools allow a company to evaluate specific data-privacy risks, whether the company has proper safeguards in place, how it can mitigate the risk, and whether it wants to accept the risk. If the company then has a data-privacy event and is questioned by a regulator, it would have a record of its process for identifying and mitigating risk.

Two key elements of any company's privacy program are resilience and practice. A company's systems and processes should be segmented so that if a data incident should occur, the impact will be minimal. Senior management and the board also need to go through tabletop exercises to ensure that, in practice, systems and processes work as expected to limit the damage from a data incident and meet the regulatory requirements.

### Looking ahead to 2020

More jurisdictions will likely enact GDPR- or CCPA-type laws and regulations. Boards should confirm that company leaders adopt a comprehensive data-privacy program that embraces the key principles of these privacy laws, and use that program as a corporate umbrella of protection against fallout from an inevitable data incident.

## Conclusion

Corporate resilience will be key for organizations' ability to deal with macro- and microeconomic conditions, disruptive technology, weather incidents, and the changing regulatory landscape. Finding the right talent for both the board and the organization—people who are able to adjust strategically in an environment of change—is crucial.

If executive leaders have assessed and prioritized risks, and documented the mitigation of those risks, the board can best focus its energy to support the business. If the executive leadership team is not forward thinking and the board does not understand risks and opportunities, both quantitatively and qualitatively, then ultimately the organization will lose ground.

Boards must emphasize a continuous cadence of improvement related to governance, risk, and compliance. Boards cannot afford to wait until an adverse event occurs to ask tough questions about emerging and high-priority risks.



## QUESTIONS FOR DIRECTORS TO ASK

### M&A:

- Does the transaction fit with the company's strategy?
- If acquisition is part of the company's growth strategy, will M&A transactions be focused on geographies, new products or services, talent acquisition, or new markets?
- Is a possible transaction consistent with how the company is positioned in the marketplace?
- If the company is being positioned for a possible sale, has senior leadership undertaken sell-side due diligence?

### International Trade

- How diversified internationally is the revenue of the company?
- Is the company overly exposed to the US market?
- Is the company compliant with trade regulations to the extent that it will withstand scrutiny by the CBP?
- Has management conducted a health check on its trade compliance program?

### International and domestic tax consequences

- Is the company liable for corporate income taxes in states where previously there had been no liability?
- Who is responsible for communicating to executive leaders and the board about the company's domestic and international tax exposure?
- What is the plan, if any, for repatriating revenue sitting offshore?

### Data Privacy:

- Does the company have a comprehensive cybersecurity policy, including privacy considerations?
- In which jurisdictions (both in the US and internationally) does the company do business and collect personal data?
- When, as a company, should a privacy impact assessment be performed?
- How often should the company test the effectiveness of its cybersecurity plan in case of a data incident?



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# Governing Through Regulatory Change:

## A Focus on Financial Reporting, Accounting, Auditing, and Related Governance Matters

By Jennifer Burns, Maureen Bujno, and Andrew Hubacker, Deloitte & Touche LLP

Effective boards remain informed of regulatory priorities (whether directly or with the assistance of their committees) that impact financial reporting, accounting, auditing, and associated governance matters. Keeping these regulatory priorities top of mind is helpful to directors as they engage with management to understand how their companies are monitoring and adjusting to regulatory changes. The US Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the Financial Accounting Standards Board (FASB) have put forward agendas that they are aiming to take action on in 2020.<sup>1</sup> The SEC, PCAOB, and FASB are operating against the backdrop of broader legislative trends, a looming US presidential election, and potential changes in their leadership, which to varying degrees may impact the activities of each. Below we outline current and expected priorities for each agency, as well as how the board and respective committees should be thinking about the impact on the companies they serve.

### SEC Priorities

SEC chair Walter Joseph “Jay” Clayton has emphasized the need to give attention to all three prongs of the agency’s mission: “protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.” In 2020, we expect this focus to continue through initiatives related to the following:

#### Capital Formation and Disclosure Effectiveness

The SEC has several projects related to capital formation and disclosure effectiveness in process, including these:

- The SEC is considering changing the rules that govern which filers qualify as nonaccelerated, thereby expanding the number of filers that qualify as nonaccelerated. In doing so, the SEC is intending to reduce the compliance costs of smaller, less-complex public companies by reducing the number of companies required to obtain auditor attestation on their internal control over financial reporting.
- The SEC is working on the finalization of proposed rules intended to improve the information investors receive regarding acquired or disposed businesses, to reduce the complexity and costs of preparing the required disclosures, and to facilitate timely access to capital, through the following:
  - Significantly simplifying and streamlining the disclosure requirements related to registered debt securities
  - Amending the reporting requirements related to significant acquisitions and dispositions

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<sup>1</sup> The SEC’s [agenda](#) of its rulemaking actions is published twice a year pursuant to the Regulatory Flexibility Act. The [FASB technical agenda](#) and the [PCAOB standard-setting agenda](#) are updated on a real-time basis.

- The SEC is also working on the finalization of a [proposed rule](#) amending the reporting requirements of business disclosures, legal proceedings, and risk factors. Broadly, the amendments would move the reporting requirements toward a principles-based approach. However, the proposed amendments would add the following reporting requirements:
  - **Business disclosures:** Add human-capital disclosures, including any human-capital measures or objectives which are of focus in managing the business, to the extent such disclosures would be material.
  - **Risk factors:** Add a summary of risk factors if the disclosures exceed 15 pages and require the organization of risk factors under relevant headings.

While the timing and specific requirements of any final rule are uncertain, these proposals reflect the SEC's efforts to reassess current disclosure requirements and find opportunities to reduce the burden on registrants while maintaining appropriate investor protection.

Also, although the SEC issued a request for comment on quarterly reports and earnings releases<sup>2</sup> which closed in March 2019, this topic is not currently included in the SEC's near-term agenda. Chair Jay Clayton has stated in public remarks that he does not think the current frequency for interim reporting will change for the largest public companies, but perhaps more flexibility could be afforded for smaller companies. The SEC does remain concerned about short-termism by investors and companies focused on quarterly earnings and held a roundtable on this topic in July 2019.

### Risk Disclosures

The SEC's focus is expected to remain on risk disclosures such as cybersecurity, the transition from LIBOR,<sup>3</sup> and Brexit, as well as the board's risk oversight role on these issues.

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<sup>2</sup>The request asked for feedback regarding the frequency of periodic reporting, the extent of quarterly disclosures, the relationship between required Forms 10-Q and voluntary earnings releases, and the relationship between quarterly reporting and a focus on short-term results.

<sup>3</sup>LIBOR (or the London Interbank Offered Rate) is the basic rate of interest used in lending between banks on the London interbank market and is also used as a reference for setting the interest rate on other loans.

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- **Cybersecurity:** The focus on cybersecurity is expected to continue to be based on
  1. moving from a mind-set that focuses primarily on the prevention of cyberbreaches to a more forward-looking perspective that also takes into consideration whether the companies are collecting data in such a way that the data can be protected,
  2. companies taking steps to ensure they are informing investors about material cybersecurity risks on a timely basis,
  3. the importance of controls related to the identification and escalation of a cybersecurity incident to the appropriate levels within an organization,
  4. the need to address cybersecurity incidents in insider-trading policies, and
  5. the nature of board involvement in the management of cyber risk.
- **Transition from LIBOR:** Banks will likely stop reporting information used to set LIBOR after 2021 and the US Federal Reserve Bank's Alternative Reference Rate Committee has proposed the Secured Overnight Financing Rate (SOFR)<sup>4</sup> as an alternative rate to replace LIBOR. The SEC's focus on disclosures related to the transition from LIBOR is primarily related to companies' disclosures of risk exposure based on contracts indexed to LIBOR that go past 2021.<sup>5</sup>
- **Brexit:** Currently, there is significant uncertainty with respect to the nature and potential effects of Brexit, and the SEC has expressed concern that the effects may be underestimated in public markets. Companies should review their risk disclosures regarding Brexit, and consider whether those disclosures represent an accurate depiction of how management is considering risks related to Brexit and how those risks could affect the company's business.

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<sup>4</sup> SOFR uses data from the overnight Treasury repurchase market to calculate a rate published at approximately 8:00 a.m. New York time on the next business day by the US Federal Reserve Bank of New York.

<sup>5</sup> In July 2019, the staff issued a statement specifically related to matters companies should be actively monitoring and considering related to this topic, and it included matters such as appropriate identification of LIBOR exposure, analysis of existing fallback provisions or the need to engage with counterparties to appropriately identify an alternative rate, and hedging implications among other matters. Companies should review their existing risk disclosures and consider whether they faithfully depict where the company is in the process of assessing the transition from LIBOR and consider disclosing material, qualitative, and quantitative information that would be valuable to investors.

Separately, although disclosure regarding environmental, social, and governance matters is not on the SEC's 2019 Regulatory Flexibility Agenda, it is a topic that is making news headlines.<sup>6</sup> The Energy and Environment Legal Institute submitted a petition for rulemaking on climate disclosures, asking the SEC to clarify its 2010 guidance on environmental risk disclosures. In addition, various members of Congress have proposed more than 50 legislative bills, including H.R. 4329, the ESG Disclosure Simplification Act passed out of the US House of Representatives Financial Services Committee. Should the proposal become law, it would require public companies to disclose certain ESG matters in annual filings with the SEC.<sup>7</sup>

### Proxy Voting Responsibilities and Shareholder Proposals

On November 5, 2019, the SEC voted to propose [amendments](#) to its rules governing proxy solicitations. These proposed amendments would impact proxy advisory firms, requiring them to (1) disclose material conflicts of interest, (2) give issuers the opportunity to review and comment on advisory firm voting recommendations, and (3) provide a hyperlink to the issuer's response to the advisory firm's voting recommendation. Items (2) and (3) would be available only to issuers who file definitive proxy statements at least 25 days prior to their annual meetings, and the review period would depend upon the length of the period between the definitive filing and the meeting date. The proposal would also amend the definition of "solicitation" and provide for confidentiality of communications between issuers and advisory firms.

Also on November 5, 2019, the SEC proposed [rule amendments](#) which would impact shareholder proposals, including (1) changing the holding period (but not the minimum amount of ownership) needed to be eligible to submit proposals, (2) limiting the number of proposals a holder can submit, and (3) increasing the levels of support a proposal must obtain to be resubmitted at subsequent meetings.<sup>8</sup>

Both of the above proposed amendments are subject to a 60-day comment period, and because the proposals cannot be acted upon until at least January, they will not be effective for the peak proxy season in 2020.

Currently, there is significant uncertainty with respect to the nature and potential effects of Brexit, and the SEC has expressed concern that the effects may be underestimated in public markets.

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<sup>6</sup> See [speech](#) by William Hinman, Director SEC Division of Corporation Finance, "Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks," March 15, 2019.

<sup>7</sup> For a review of pending congressional bills on this and other governance topics, see [NACD Washington Review Q3 2019](#).

<sup>8</sup> Under the proposed rule, for example, a proposal would need to achieve support by at least 5 percent of the voting shareholders in its first submission in order to be eligible for resubmission in the following three years. Proposals submitted two and three times in the prior five years would need to achieve 15 percent and 25 percent support, respectively, in order to be eligible for resubmission in the following three years. Congress is also considering [H.R.3088](#), The Shareholder Protection Act of 2019, which addresses this issue.



In 2020, the PCAOB is expected to continue to focus on enhancing its processes—including all programmatic areas.

### **New Accounting Standard for Estimating Credit Losses (CECL)**

Companies and the SEC are focused on the adoption of new accounting requirements under [ASC 326](#) related to current expected credit loss (CECL), which for many public companies will go into effect in 2020.<sup>9</sup> While the requirements will have their greatest impact on banks and other lenders, any business that holds trade receivables, contract assets, loans, debt securities, off-balance-sheet credit exposures, reinsurance receivables, or net investments in leases will need to comply with CECL. The SEC staff has publicly discussed its views on key adoption activities related to CECL, such as the need to focus on internal control considerations and disclosures, including disclosures about how the company will transition to the new requirements. Specifically, the SEC has discussed the importance of companies appropriately assessing their data controls in light of the amount of data required to execute the estimation process in the CECL standard and to adhere to the new disclosure requirements in the standard.

### **PCAOB Priorities**

The PCAOB's current chair and three board members have been in place since early 2018, with another board member joining in November 2019. As a new board they have had the opportunity to take a "fresh look" to enhance the organization and its activities. In 2020, the PCAOB is expected to continue to focus on enhancing its processes—including all programmatic areas (standard setting, registration and inspections, and enforcement). In doing so, the board will likely consider how to further enhance its transparency and outreach with stakeholders; the process, timing, and reporting related to inspections; and its use of advisory groups in relation to standard setting.

In terms of standard setting, the PCAOB has noted that its focus areas will include these:

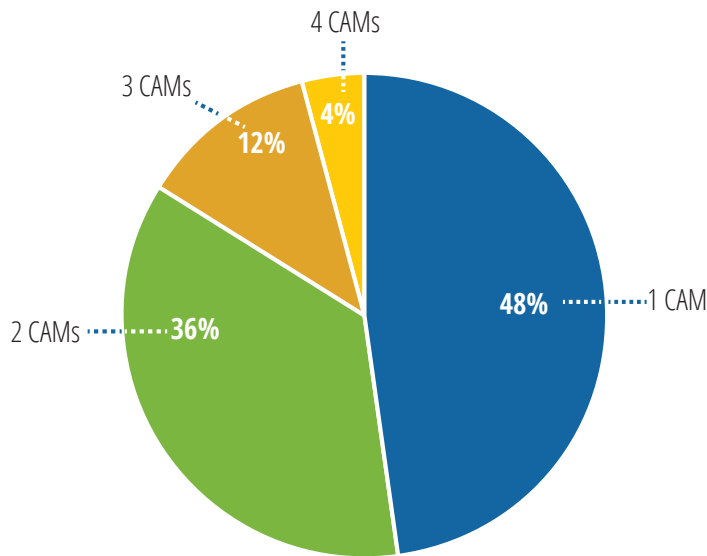
- Monitoring the auditor's implementation of the reporting of critical audit matters (CAMs)
  - CAMs are required to be included in auditor reports of large accelerated filers for periods ending on or after June 30, 2019, and in auditor reports of all other applicable filers for periods ending on or after December 31, 2020.<sup>10</sup> With the phased effective dates, in 2020 the PCAOB is expected to place significant focus on the first CAMs reported through both inspections and a post-implementation review of the standard, and will consider whether changes to the requirements or guidance are needed to achieve the PCAOB's intended results.

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<sup>9</sup> For more on CECL, see [Deloitte's Insights](#).

<sup>10</sup> In July, the PCAOB released a [report](#) on CAMs "to inform audit committees as they engage with their auditors on the new CAM requirements."

### Number of CAMs per auditor's report as of November 29, 2019



Information is based on CAMs included in the auditor's reports of large accelerated filers filed as of 11/29/2019.

Based on CAMs included in auditor's reports as of 11/29/2019, the significant majority relate to goodwill and intangible assets, revenue recognition, acquisitions, and income taxes.

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- Modifying its quality control standards
  - With a concept release on quality-control standards issued on December 17, 2019, in 2020 there is expected to be significant focus on the responses to the concept release and the direction the standards may take. Changes to the quality-control standards may focus on areas that include firm governance and structure (e.g., firm culture, organizational structure, and leadership roles and responsibilities); quality-control risk assessments and monitoring; continuous improvement; and transparency. By understanding such changes, boards and audit committees can enhance their oversight of the external auditor.
- The use of data and technology in conducting audits
  - Big data and the ever-increasing power of technologies continue to change the landscape of businesses and the performance of audits. This area seems to be one of the PCAOB's key areas of focus on its research agenda, with an active task force providing insights to the PCAOB regarding whether additional guidance or changes to the

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standards are needed to facilitate the use of data and technology in conducting an audit. Based on the attention this topic is getting, we may see some action on this project in 2020.

- Standards related to the auditor's supervision of other auditors (other firms and other individuals) outside the accounting firm that issues the audit report
  - The PCAOB's proposal<sup>11</sup> on this topic is intended to increase the lead auditor's involvement in, and evaluation of, the work of other auditors; enhance the ability of the lead auditor to prevent or detect deficiencies in the work of other auditors; and enhance the quality of the work of other auditors. The PCAOB staff is in the process of determining next steps based on the [comments received](#). Given that the staff previously anticipated action in the third quarter of 2019, we may also see some action on this project in 2020.

Other projects on the PCAOB's standard-setting and research agenda include going concern, the auditor's responsibility with other information including non-GAAP measures, and the auditor's responsibilities with respect to noncompliance with laws and regulations.

Separately, in Congress, Rep. Sylvia Garcia (D-TX) has proposed [H.R. 3625](#), PCAOB Whistleblower Protection Act of 2019, which would enhance the PCAOB's current enforcement tips and referral [program](#) by rewarding individuals reporting violations of securities law "relating to the preparation and issuance of audit reports, auditor independence, and the obligations and liabilities of accountants with respect thereto. . . ."

### FASB Priorities

After spending the last decade focusing on major agenda projects, such as revenue recognition and leasing (under the leadership of current chair Russell Golden and his predecessors Leslie Seidman and Robert Herz), the FASB's current agenda includes only a couple of recognition and measurement projects with broader applicability, and several narrower projects focused on improving financial reporting or disclosures in certain targeted areas. Additionally, as always, the FASB spends a significant amount of its time on longer-term conceptual framework and research projects.

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<sup>11</sup> In 2016, the PCAOB [proposed](#) amendments to its auditing standards to strengthen requirements that apply to auditors that are not part of the accounting firm that issues the audit report (other auditors), and proposed a new auditing standard for situations in which the auditor divides responsibility for the audit with another accounting firm. The PCAOB received comments seeking clarifications to some provisions and changes to others. The staff analyzed comments received and, in September 2017, issued a [supplemental request for comment](#) asking for additional feedback.

Chair Golden's second (and last) term expires on June 30, 2020. The new chair of the FASB will be appointed by the Financial Accounting Foundation Board of Trustees who, through their appointments committee, seeks nominations from a wide variety of groups, including financial statement users, preparers, academics, and regulators.

For the remainder of Golden's term, the FASB is expected to focus on these projects:

- Implementation assistance and monitoring of major new accounting standards, including these:
  - Educational and implementation assistance activities for the recently issued, major, new accounting standards, including revenue recognition, lease accounting, accounting for credit losses (mentioned earlier), targeted improvements to hedge accounting, and accounting for long-duration insurance contracts.
  - Implementation and execution of the FASB's post-effective-date review and monitoring program, which seeks immediate feedback on implementation progress and issues for the recently issued, major, new standards, and to inform a longer-term view of each standard's costs and benefits.
- Making continued progress in addressing certain key accounting and reporting issues that stakeholders have asked the FASB to address, including the following:
  - **Accounting for convertible instruments and contracts on an entity's own equity** – This is an area involving significant complexity under current US GAAP, and given this complexity, is a leading source of financial statement restatements. The objective of this project is to improve understandability and reduce complexity, without adversely impacting useful information for users of financial statements.
  - **Reference rate reform** – The FASB is working to identify potential changes to the accounting standards codification to address the potential effects of the market-wide transition from interbank offered rates (such as LIBOR) to replacement reference rates.
  - **Segment reporting** – The FASB is exploring potential improvements to the current segment-reporting guidance, to provide financial statement users with information useful for making decisions.
  - **Disaggregation of performance information** – The objective of this project is to improve the decision usefulness of certain complex line items in an entity's income statement (for example, selling, general, and administrative expense, breaking it out into its components).

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Other projects currently on the FASB's technical agenda include various narrow-scope recognition and measurement projects (e.g., accounting for identifiable intangible assets and subsequent accounting for goodwill, hedge accounting, accounting for share-based payments to customers, consolidation and reorganizations, accounting for asset acquisitions, and accounting for income taxes). In addition, current presentation and disclosure projects are focused on improving disclosures in certain areas for income taxes, inventory, and interim reporting, and simplifying the current guidance related to the presentation and classification of debt on the balance sheet.

### **Board Implications Related to SEC, PCAOB, and FASB Priorities**

The SEC has frequently stressed the importance of board oversight of financial reporting and securities-related matters. Given the above overview of topics, it is likely that 2020 may bring continued regulatory change and possibly more risk to public companies. As such, boards should continue to remain vigilant in their oversight role to make sure that management has adequate policies and mechanisms in place to (1) keep directors informed of these regulatory developments in a sufficient and timely manner, and (2) assess and report on any impact such changes may have on the company.



### **Financial Expertise on the Board**

Given the complexities of the financial arena and the number of regulatory priorities that could impact company strategies, boards are continuing to emphasize the need for having the right financial skills represented. The SEC requires public companies to disclose whether at least one "audit committee financial expert" serves on the audit committee, and if so, the name of the expert and whether he or she is independent of management.<sup>1</sup> There continues to be a high demand for financial experts. According to the 2019 US Spencer Board Index, of the 432 new independent directors,

"27% have financial backgrounds, with boards less interested in accounting and banking backgrounds and more focused on candidates with experience as CFOs/finance executives or investment professionals." This is up from 25.5% of the new independent directors in 2018, and up from 18% in 2008, according to the 2018 US Spencer Stuart Board Index.

<sup>1</sup>SEC 17 CFR PARTS 228, 229 and 249 [RELEASE NOS. 33-8177; 34-47235; File No. S7-40-02] RIN 3235-A166, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002.

The SEC has also emphasized the important role of the audit committee in promoting an environment for management's successful implementation of new accounting standards. It has specifically noted that audit committees should play a role in overseeing companies' implementation, to help make sure that issues are identified and resolved in a timely manner.<sup>12</sup>

The audit committee is often delegated the responsibility for reviewing and continually monitoring any compliance and regulatory matters that could have a significant impact on the company's financial statements. While many of the above potential regulatory changes and developments may fall under the charter of the audit committee, coordination between board committees is critical, as there may be certain regulatory changes that could be delegated to other committees. For example, changes regarding proxy advisors or other broader shareholder proposal process updates may be brought to the nominating/governance committee by the corporate secretary or general counsel's office, or potential new or enhanced risk disclosures may be a full-board discussion.

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<sup>12</sup> See [speech](#) by former SEC chief accountant Wes Bricker in September 2018, in which he stated, "The audit committee plays a vital role in overseeing a company's financial reporting, including the implementation of new accounting standards."



## QUESTIONS FOR DIRECTORS TO ASK

Management may find it helpful to inventory all compliance and regulatory updates or potential changes and, working with the board, to define which committee or if the full board will be primarily responsible for oversight of such topics. To the extent changes impact the financial statements or disclosures, the audit committee should coordinate with the other committees or take primary responsibility.

### General:

- Is management providing an update to the board (or specific committees) about monitoring potential leadership and agenda changes at the SEC, PCAOB, and FASB and how those changes may impact the respective agendas and priorities?
- Does the board have sufficient transparency into the company's assessment of the impact of proposed regulatory and standard changes and implementation efforts and the challenges related to new reporting requirements?
- Does the board advise management about the topics on which the company intends to engage in the public-comment process when proposed regulatory rules are issued?
- Is the company currently taking advantage of existing or new reporting accommodations in the capital-raising process?
- Has management considered the potential risks of using these accommodations, including potential shareholder or other market reaction?

### FASB / PCAOB Specific:

- Does management provide regular updates about relevant standards in the process of being implemented and their related impacts?
- Does the company have sufficient resources and systems to implement new accounting standards and related internal controls?
- Has the external auditor discussed any key changes in auditing standards, including the implementation of CAMs, with management and the audit committee?

### Disclosures:

- Has management informed the board about potential changes in disclosure requirements applicable to their company and discussed how they intend to implement changes in a way that benefits both the company and its shareholders?
- Do the board use disclosure developments as an opportunity to discuss with management whether they have considered if the company's disclosure could be enhanced, even absent any rule changes?
- Has management provided the board with any benchmarking of disclosures for the board to understand how their governance disclosure in the proxy and the risk factors in the 10-K compare to peers? Is there any opportunity to refresh any disclosures?
- Does the company's cybersecurity planning include consideration of timely disclosure of cybersecurity-related issues?
- How far along is the company in assessing its exposure to risk arising from the transition away from LIBOR, and do its related disclosures reflect that assessment?
- Does the company have an appropriate understanding of what impact Brexit will have on the company, and do its disclosures appropriately reflect that expected impact?





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# Board Oversight in 2020:

## “Mission Critical” Risks Become Mission Critical for Directors

By Adé Heyliger, Ellen Odoner, and Aabha Sharma, Weil, Gotshal & Manges

The *Caremark* case<sup>1</sup> set a very high bar for holding directors personally liable for failing to properly oversee their company’s affairs. Cases alleging that boards have breached their oversight duty in the wake of a wide range of “corporate traumas”—and even tragedies—generally have not survived motions to dismiss. As boards refresh their oversight agendas for 2020, there are useful lessons to be drawn from two decisions of the Delaware courts issued earlier this year that allowed *Caremark* claims to proceed beyond the motion-to-dismiss stage. Against the backdrop of growing investor demand for board oversight of environmental, social, and governance (ESG) related risks and a widening vision of “corporate purpose,” these decisions highlight once again how important it is for boards to

- take a fresh look at identifying their company’s “mission critical” risks;
- ensure the company’s reporting system elevates information about these risks not only to management but also to the board itself in a timely, actionable way;
- document how the board pays attention to these risks; and
- respond appropriately as a board when the reporting system raises red flags.

### Key Projections

#### 1. Boards Will Face Heightened Expectations to Zero in on “Mission Critical” Risks

While directors are not expected to be *omniscient* about each and every risk a company may face, the well-known *Caremark* case made clear that directors are expected to put in place and monitor reporting systems reasonably designed to provide the board with timely, accurate information sufficient to enable it to stay on top of, and make informed judgments about, key risks to legal compliance and business performance. At the same time, claims that boards have not lived up to their *Caremark* duty are described as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”<sup>2</sup> In order to prevail, a plaintiff must show that directors acted in bad faith—that they “utterly failed” to implement a board-level reporting system or, having done so, that they “consciously failed” to monitor it.

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<sup>1</sup> *In re Caremark Int’l, Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).

<sup>2</sup> *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

In *Marchand v. Barnhill*,<sup>3</sup> the Delaware Supreme Court took the unusual step of allowing a *Caremark* claim to proceed. A stockholder of Blue Bell Creameries alleged that the board had breached its oversight duty where, as a result of *listeria* contamination, three people died from eating Blue Bell ice cream, and Blue Bell was forced to recall all of its products, shut down its plants, and accept a dilutive private-equity investment to address a liquidity crisis. The Delaware Court of Chancery dismissed the plaintiff's claim that the board had "utterly failed" to implement a reporting system—the first prong of the *Caremark* duty—citing evidence of Blue Bell's compliance with FDA regulations, third-party testing, and reporting by senior management to the board on "operational issues." In a unanimous reversal, the Delaware Supreme Court stated that, as a monoline company, food safety was "intrinsically critical" to the operation of Blue Bell's business. The Court found that the plaintiff had met his pleading burden based on the following indicia that there was no system at the *board level* for monitoring this critical risk:

- There was *no* board committee with responsibility for food safety.
- There was *no* regular process or protocol requiring management to report to the board on food-safety compliance and risks.
- There was *no* regular schedule for the board to consider the issue of safety compliance.
- The minutes did *not* clearly show that the board had discussed food-safety issues, even at a time when management was aware of yellow and possibly red flags about contamination at the plants.

*Marchand* was not a decision on the merits, and the Court was obligated to draw all inferences in a manner favorable to the plaintiff. Nevertheless, the case illustrates that it is important for all boards—not just those of monoline companies—to take the following steps:

- Identify key compliance and operational risks in a common-sense way based on the business of the company.
- Give these risks a regular spot on the board's agenda.
- Establish clear lines of authority and clear protocols for obtaining information and overseeing the management of these risks.

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<sup>3</sup>*Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019).

One of the allegations the Court emphasized in *Marchand* was the absence of a board committee with the responsibility for overseeing the mission-critical risk of food safety.

## **2. Boards in Highly Regulated Industries Should Expect Particularly Strong Scrutiny**

Less than four months after the *Marchand* decision, the Delaware Court of Chancery allowed a claim to proceed based upon the second prong of *Caremark*—the board’s duty to monitor a reporting system once it has been put in place.<sup>4</sup> A stockholder of Clovis Oncology, a biopharmaceutical company, alleged that the board had consciously ignored red flags that came to its attention about the company’s failure to meet regulatory requirements for a clinical trial of its most promising drug and misleading public disclosure about the testing. After these issues came to light, the FDA delayed approval of the drug and the company lost more than \$1 billion in market value.

Relying on the *Marchand* analysis, the Court noted that Clovis was a monoline company, the drug in question was a “mission critical” product, and the company was operating in a highly regulated industry. The Court distinguished between a board’s oversight of the company’s “*management of business risk* that is inherent in its business plan” and (what was at issue in this case) a board’s oversight of a company’s “*compliance with positive law*—including regulatory mandates.”<sup>5</sup> In a cautionary note for directors of companies in highly regulated industries, the Court expressed the view that Delaware courts are more inclined to find *Caremark* oversight liability when the context is a failure of regulatory compliance.

## **3. Boards Will Refocus on the Effectiveness of Their Oversight Mechanisms**

One of the allegations the Court emphasized in *Marchand* was the absence of a board committee with the responsibility for overseeing the mission-critical risk of food safety. We expect that boards will start to take a closer look at the role of their own board committees and either expand the mandate of an existing committee—so, for example, the compensation committee takes on a broader human-capital management oversight role—or, where appropriate, establish a new board committee to oversee a “mission critical” risk to the company. According to Spencer Stuart’s 2019 US Board Index, among S&P 500 companies, risk committees are becoming somewhat more common than five years ago, with 12 percent of boards having risk committees, compared with 9 percent in 2014.<sup>6</sup>

Accompanying the expanded use of committees, we anticipate the expansion of “risk mapping.” Under this process, responsibility for overseeing key enterprise risks is mapped to the appropriate board committees

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<sup>4</sup> *In re Clovis Oncology, Inc. Deriv. Litig.*, C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019).

<sup>5</sup> *Ibid.*, p. 12.

<sup>6</sup> Spencer Stuart, *Spencer Stuart 2019 US Board Index*, p. 26.

and reflected in their charters. This serves to clarify the oversight responsibilities of each committee and ensure proper oversight of each identified risk. Each committee determines the specific processes and cadence for overseeing the mapped risks and reporting back to the full board.

#### **4. In Focusing on “Mission Critical” Risks, Boards Will Serve the Interests of a Wider Range of Stakeholders**

Under Delaware law—and more than 50 percent of all US publicly traded companies are incorporated in Delaware—directors owe their fiduciary duties to the corporation and its stockholders.<sup>7</sup> Recently, with the endorsement of 181 CEOs, the Business Roundtable issued a *Statement on the Purpose of a Corporation* that pledges a commitment to “all of our stakeholders,” including customers, employees, suppliers, and the communities in which companies operate.<sup>8</sup>

Delaware law is unlikely to evolve anytime soon to include an express duty to stakeholders other than stockholders (outside the realm of public benefit corporations). However, board oversight of “mission critical” risk is one area that seems ripe for broadening to accommodate the wider vision of corporate purpose. As reflected in shareholder voting patterns, developments in investor stewardship codes, and a pronounced increase in “voluntary” corporate sustainability reporting, ESG risks such as climate change/environmental, privacy/cybersecurity, consumer/employee safety, and human-capital management are increasingly deemed to be “mission critical” given the immediate impact and/or the impact over the longer term—for all stakeholders—of failing to address these risks.

Moreover, we anticipate that a wide range of stakeholders will continue to vocalize their views and expectations of boards, a trend that is gaining strength. For example, the push to prioritize human-capital management—the concerns of employee stakeholders—is quickly building momentum. This is evidenced by the increased number of shareholder proposals related to labor and human-capital management filed this year compared to the previous year (from 40 to 55), highlighting issues such as gender pay gap, sexual harassment, and inequitable employment practices.<sup>9</sup> Boards should expect that investors will probe deeper into these and other ESG topics as directors are increasingly called upon to demonstrate engagement with and responsiveness to stakeholder concerns.

The push to prioritize human-capital management—the concerns of employee stakeholders—is quickly building momentum.

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<sup>7</sup> Delaware Division of Corporations, “[2018 Annual Report Statistics](#).”

<sup>8</sup> Business Roundtable, “[Statement on the Purpose of a Corporation](#),” released August 19, 2019, with signatures updated September 6, 2019.

<sup>9</sup> Institutional Shareholder Services, “US Environmental and Social Shareholder Proposals 2019 Proxy Season Review” (October 3, 2019).

The growing focus on corporate culture reinforces the importance of boards setting the tone for the entire corporation and fostering a “speak-up” culture at all levels.

## Major Board Implications

### 1. Focus on Corporate Purpose and Culture

In response to the recent plethora of corporate scandals centered on corporate culture—leading to government investigations, CEO shakeups, loss of market value, and loss of confidence by investors, employees, customers, and the community at large—the institutional investor community is encouraging boards to embrace their leadership roles in establishing corporate “purpose” and “culture.” The annual letters released by the CEOs of BlackRock and State Street Global Advisors are public calls for CEOs and boards to establish a strategic purpose and define corporate culture in order to preserve and enhance long-term value for the company’s numerous stakeholders. Laurence Fink, reminding CEOs that “the world needs your leadership,” writes that “purpose unifies management, employees, and communities. It drives ethical behavior and creates an essential check on actions that go against the best interests of stakeholders.”<sup>10</sup> State Street similarly calls on directors to take proactive steps to review and monitor corporate culture, evaluate its alignment with strategy, and incentivize management to take corrective action, if necessary.<sup>11</sup>

In response to heightened focus on the effectiveness of the board’s role in the oversight of corporate culture, boards are now taking a deeper look at the topic. In PwC’s 2019 Annual Corporate Directors Survey, directors responded that common steps for improvement include enhancing employee development/training programs and whistleblower programs. Directors have also reported that their companies have increased board-level reporting and conducted broad-based employee culture assessments.<sup>12</sup> NACD’s 2019–2020 Public Company Governance survey found that 57 percent of directors set clear expectations for management about board-level compliance reporting and 78 percent of directors reviewed reporting trends based on the company’s hotline.<sup>13</sup>

The growing focus on corporate culture reinforces the importance of boards setting the tone for the entire corporation and fostering a “speak-up” culture at all levels, so that employees feel that the corporation affirmatively values their raising of concerns about business operations or workplace issues. This also includes ensuring effective escalation

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<sup>10</sup>BlackRock’s chair and CEO Laurence Fink, 2019 letter to CEOs, “[Purpose & Profit](#).”

<sup>11</sup>Cyrus Taraporevala, president and CEO of State Street Global Advisors, [2019 letter to board members](#).

<sup>12</sup>PwC, *The Collegiality Conundrum: Finding Balance in the Boardroom* (New York, NY: PwC, 2019), p. 23.

<sup>13</sup>The [2019–2020 NACD Public Company Governance Survey](#) presents findings from NACD’s annual questionnaire. The report details responses from more than 500 public-company directors.

processes and requiring senior human resources personnel to report to the board, regularly and directly, on significant human-capital risks. Understanding the types of concerns coming through the company's hotline and other internal reporting mechanisms can be a window for boards into corporate culture.

## 2. Focus on the Board Agenda and Meeting Minutes

Directors should ensure that the board's agenda provides ample time, on a regular basis, to carefully evaluate the company's overall risk-management framework. This *must* include discussions regarding the identification of "mission critical"/"intrinsically critical" risks facing the company, the effectiveness of the current reporting system to elevate information about such risks from management to the board, and risk-mitigation efforts at both levels. Minutes of board meetings should detail the board's risk-oversight efforts. The minutes should capture not only regular board discussions regarding the company's compliance framework, but also

- the specific steps taken by the board to implement and monitor risk-oversight systems,
- management reports apprising the board of key risks, and
- the board's own perception of risks faced by the company and steps that have been taken or will be taken to mitigate such risks.

## 3. Focus on Board-Level Risk-Management Systems

Directors should not rely solely on management to effectively escalate critical issues for board attention. Rather, directors should work closely with management to implement, and subsequently monitor, a board-level risk-management system that is attuned to "mission critical" risks faced by the company. This means directors should institute, at the *board level*, protocols that require management to keep the board apprised of central compliance and operational risks in a timely manner.

Boards should consider putting in place heightened reporting controls—including additional reports from management, board committees, and/or outside advisors—in the event the board hears of or otherwise perceives "red flags," or even "yellow flags," threatening the company. Thought should also be given to structural changes in the reporting hierarchy to ensure that employees are being "heard." For example, depending on company circumstances, this could mean implementing a system that encourages employees to report critical risks either anonymously to appropriate senior management or directly to the board to ease any concerns of a direct impact to their careers. Boards may also wish to establish "safety groups" consisting of nonmanagement employees who report on critical safety concerns directly to management or the board.

Directors should work closely with management to implement, and subsequently monitor, a board-level risk-management system which is attuned to "mission critical" risks faced by the company.



#### 4. Focus on the Role of Board Committees and Director Expertise

While the full board has overall responsibility for risk oversight, boards should consider establishing a separate committee to oversee “mission critical” risks to the company. This may be especially appropriate when companies specialize in a single product or service line, or if they are subject to a high degree of governmental regulation. Consideration should be given in the nominating process to recruiting directors who have industry experience or have otherwise dealt with the types of risks that are central to the company.

#### 5. Consider Retaining Outside Advisors

Directors should consider the need for retaining independent outside advisors to better identify and understand key risks facing the company, as well as the effectiveness of the company’s overall compliance framework and, more specifically, the risk-management framework at the board level. Boards of monoline companies may benefit from industry-specific experts, who have experience working firsthand with other companies addressing similar “mission critical” risks.

#### 6. Tailor Stakeholder Outreach Efforts

A wide range of stakeholders, affected differently by different risks, are increasingly vocal about their views and their expectations for boards. They want to be heard. Tailored engagement efforts can provide directors with a better understanding of what various stakeholders perceive as the corporation’s key business risks, and enable directors to communicate their own commitments to a broadening of corporate purpose and oversight of ESG and other “mission critical” risks.



#### QUESTIONS THE FULL BOARD SHOULD ASK

- Is the design, testing, and monitoring of a board-level risk-management system currently a board priority?
- Has the board taken a fresh look at identifying the company’s “mission critical” risks, including both regulatory/compliance risks and risks from the company’s operations, as they may affect the company’s broader stakeholder base?
- Does the board address “mission critical” risks on a regular basis?
- Does the board need a separate board committee or industry experts on the board to help monitor “mission critical” risks?
- Are written records of the board’s risk-oversight efforts—specifically with respect to “mission critical” risks—maintained in sufficient detail?
- Do any yellow or red flags exist today that call for board scrutiny?



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# The Tech-Savvy Necessity:

## Preparing the Board to Go Beyond the Digital Frontier

By Bill Briggs, Scott Buchholz, Tonie Leatherberry, and Debbie McCormack, Deloitte

Technology governance and oversight in the boardroom, in recent years, has largely reinforced the necessity to defensively protect and preserve an organization and its assets. Increasingly, boards are shifting the tech focus to understand how technology can also be leveraged offensively to create and enable new opportunities, business models, and revenue sources.<sup>1</sup> As a result, many board members are seeking to understand the business impact of emerging technology trends to better exercise oversight without stepping into management's role—in other words, keeping their “fingers in and noses out.”

The tenth annual Deloitte report, *Tech Trends 2019: Beyond the digital frontier*, may increase board members' understanding of several emerging trends that will likely offer their executive teams new avenues for driving strategy, enhancing performance, and mitigating risk. Five of these trends are spotlighted here to provide insight into how technology can function as a catalyst to business strategy and profoundly impact how the board drives governance and oversight efforts.

### 1. Macrotechnology Forces at Work

Digital experience, analytics, and cloud have driven incredible change over the last decade, while three new macrotechnology forces are poised to generate similar transformations over the next decade: digital reality, cognitive technologies, and blockchain.

To harness the power of these forces, leading organizations have been, and still are, taking the following foundational steps, which have proven essential in pursuing digital transformation:

- modernizing core systems to facilitate innovation and growth
- elevating cyber risk and the broader risk domain from a compliance-based activity to an embedded, strategic function
- reengineering the technology function to deliver against the promise of existing and emerging technologies

As macroforces combine and collide, they are moving businesses toward opportunities both known and unknown. As such, they will dominate enterprise IT, business, and sector-specific markets to an even greater extent together than they have individually. As business strategy and technology become increasingly interdependent, boards need to validate that management has technology priorities and plans that are integral to their business strategies; future-forward; spanning short-, mid-, and long-range horizons; and in the best interest of stakeholders.

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<sup>1</sup> Tonie Leatherberry, Debbie McCormack, Khalid Kark, and Robert Lamm, *The Tech-Savvy Board: Engaging with CIOs and management on strategy, risk and performance*, Deloitte Insights, May 15, 2019.

## The three dimensions of technology-board engagement

### PERFORMANCE

**Financial performance.** Impact of technology investments on financial measures such as earnings per share, profitability, margins, and revenue.

**Business operations.** The role of technology in transformation, automation, and enhancement of current business operations.

**Talent.** Attracting, curating, and engaging talent from inside and outside the organization to deliver tech-enabled business capabilities.



### STRATEGY

**Growth and innovation.** Technology capabilities (digital) to deliver business growth.

**Data and insights.** Using data for better business decisions and ability to monetize it.

**Customer experience.** Enabling better customer experience and engagement.

**Ecosystem engagement.** Leveraging ecosystems to deliver higher business value.

### RISK

**Cyber risk.** Clarity on risk appetite; protection and preservation of information assets; capability to respond to threats and incidents; and resilience.

**Regulatory matters.** Use of technology to stay ahead of regulations and compliance and implications of current and future regulations on data and information.

**Industry disruption.** Technologies, platforms, and strategies disrupting existing businesses and industries.

Source: Deloitte US CIO Program.

## 2. AI-Fueled Organizations

Artificial intelligence (AI) is transitioning from an option to a business necessity. In the coming year, many companies will likely continue their march toward embedding AI (e.g., machine learning, natural-language processing, etc.) into nearly every facet of their business operations. Indeed, in two consecutive Deloitte global surveys (2016–17 and 2018), cognitive technologies/AI have topped the list of emerging technologies in which chief information officers (CIOs) plan to invest.<sup>2</sup>

This movement is part of a growing trend in which companies transform themselves into AI-fueled organizations, and using AI becomes an integral component of corporate strategy.

<sup>2</sup> Nitin Mittal et al., “AI-fueled organizations,” *Tech Trends 2019: Beyond the digital frontier*, Deloitte Insights, January 15, 2019, p. 21.

Boards should ask management to address the heightened security and ethical risks associated with collecting biometric and other types of intensely personal data.

Early movers are identifying how to use AI to augment their workforces and refocus employees on value-added activities. Many are discovering that realizing value from AI requires a perceptual shift. Business leaders need to understand “the art of the possible” with AI; otherwise, they risk misapplying the technology or overlooking opportunities altogether.

Board members can benefit from greater exploration of AI concepts to better understand how to anticipate and mitigate the associated risks. Potentially, this exploration could be provided by their management teams as well as external advisors.

### 3. Intelligent Interfaces

Technology is becoming increasingly pervasive, omnipresent, and accessible. In our homes, this frequently translates into talking to a smart device, and having it talk back. Such intelligent interfaces combine the latest in human-centered design techniques with leading-edge technologies such as machine learning, robotics, the Internet of Things (IoT), wearables, advanced augmented reality, and virtual reality.

Working in concert, these technologies can transform how humans, machines, and data interact. In a business context, they are proliferating in product innovation, customer-facing service, go-to-market strategies, and business operations in warehouses, customer service, and, notably, field operations, where workers can speak orders in real time rather than typing them into a computer.

Intelligent interfaces offer businesses opportunities in several areas, including tracking customers’ offline habits, micro-personalization of products and services, and better operational efficiency and personal productivity. Intelligent interfaces are largely thought to be the next great technology transformation. Intelligent interfaces, however, come with significant caveats that parallel their profound potential. Any initiative to deploy intelligent interfaces also requires investment in the supporting infrastructure and data-management capabilities needed to bring them to life. In addition, boards should ask management to address the heightened security and ethical risks associated with collecting biometric and other types of intensely personal data. For instance, organizations, or even nation states, could conceivably target, manipulate, and discriminate against populations based on biometric data collected, such as finger-prints and facial-recognition scans, or health information, like blood glucose levels for diabetes.

### 4. Beyond Marketing: Experience Reimagined

With its emphasis on the human experience, *beyond marketing* is primarily a B2C marketing practice that encompasses new approaches to data gathering, “decisioning” (the automated determination of how and when to provide an experience), and delivery (the distribution of dynamic content consistently across channels). It marks a departure from traditional marketing practices, which sought to bend consumer will in

ways that advanced the company's strategy. Going forward, companies will likely encounter the reverse—a world in which they must adapt their marketing objectives and methods of engagement to meet individualized customer expectations.

Consumers tend to judge all their brand experiences against their best experience, raising the bar over time. Hyper-personalized customer experiences may become the new standard. By the same token, delivering highly curated experiences creates risks concerning fraud, cyber threats, and data security, along with additional regulatory and compliance demands for protecting customer data. Accordingly, boards should ask the executive team how it is managing and mitigating risks associated with technology infrastructure required to deliver customer experience and growth.

## 5. Connectivity of Tomorrow

Despite its mission-critical nature, networking has traditionally lacked the “wow factor” ascribed to other high-profile, disruptive technologies. With the emergence of 5G (the fifth generation of cellular wireless technology), edge computing, and new technologies for making internal networks faster and more secure, networking has been thrust into the spotlight as potentially being the catalyst for the biggest transition since the advent of smart phones. Proliferating mobile devices, sensors, serverless computing, increasingly expanding volumes of shared data, and automation all require advanced connectivity and differentiated networking. In particular, 5G represents a sweeping change which features

- greater speed;
- lower latency, the lag time between pinging the network and getting a response; and
- vast capacity, the ability to connect massive numbers of sensors and smart devices within a network.<sup>3</sup>

The improvements offered by 5G could make some of the hottest emerging technologies practical at scale, such as autonomous vehicles, virtual reality, cargo and passenger drones, and advanced robotics. Just as we largely didn't foresee having ride-sharing apps on our smart phones or the ability to exchange money without a wallet, the next stage of networking will likely usher in new business opportunities that can't presently be imagined. To get a head start on overseeing the various connected networks that will be possible moving forward, board members will want their management teams to build security controls that are ubiquitous—being embedded, inspected, and enforced at the data, device, and user-identity levels.

The improvements offered by 5G could make some of the hottest emerging technologies practical at scale, such as autonomous vehicles, virtual reality, cargo and passenger drones, and advanced robotics.

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<sup>3</sup>Patrick Nelson, “[Private 5G networks are coming](#),” *Network World*, November 7, 2018.

Boards should understand both the broad set of risks that technology creates and its potential business benefits—particularly, how it can advance or disrupt strategy and improve or impede performance.

### Board implications

The common thread running across all of these trends is the fusion of business and technology strategies: business strategy is now technology strategy. Boards should understand both the broad set of risks that technology creates and its potential business benefits—particularly, how it can advance or disrupt strategy and improve or impede performance. Simply put, being tech-savvy has become an essential capability for today's board member.

Below are some tips for becoming a tech-savvy board member:

- **Put offensive applications of technology on the board agenda.**

Today, many boards tend to focus more on the defensive implications of technology, such as cyber risk, resiliency, and disaster recovery. Boards have an obligation to guide the company toward growth and innovation, as well as a duty to protect it from threats. Conversations on how to use technology offensively need to be on the board agenda. As digitization continues to expand, technology is increasingly becoming the path to growth for enterprises. Board agenda items that cover growth and performance should consider how and what technology will be leveraged to exploit these objectives. It is critical that board members be cognizant of how technology can be integrated into board oversight discussions on strategy, performance, talent, and the future of work.<sup>4</sup>

- **Bring on members with appropriate technology competencies.** A Deloitte study found that high-performing S&P 500 companies were more likely (31%) to have a tech-savvy board director than other companies (17%).<sup>5</sup> Though adding a tech-savvy member may seem like a simple solution, it's not always possible to do this quickly. Nor is it wise to become overly reliant on a single member or advisor, or to add a director whose competencies don't extend to areas other than technology. Instead, boards should consider the need for technology skills as part of their board composition and refreshment activities, making technology acumen a part of the selection criteria, in addition to other skills and experiences needed to support the business's strategy. Meanwhile, board members should consider board education in key technology areas that are relevant to the company's strategy.

- **Engage with technology leaders early and often.** Particularly when tied to business strategy and outcomes, ongoing technology conversations between board members and technology leaders can help break through barriers, while helping board members raise their awareness and knowledge of the technology being used or being

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<sup>4</sup> *Framing the future of corporate governance: Deloitte Governance Framework.*

<sup>5</sup> Khalid Kark, Jason Lewis, and Caroline Brown, *Bridging the boardroom's technology gap*, Deloitte Insights, June 29, 2017.



planned within the company. These interactions may take the form of board presentations by technology leaders; deep-dive sessions with the CIO, Chief Digital Officer (CDO), Chief Information Security Officer (CISO), or other technology leaders in between board meetings; or external education sessions outside of the board meetings.

Boards might also consider leveraging committees and subcommittees to monitor technology issues. This may involve forming a specific, board-level technology committee or assigning specific technology topics to an existing committee, such as the audit or risk committee.

No matter where the committee-level technology conversation takes place, it is important to balance opportunity- and growth-related technology discussions (which are offensive) with those about risk and resiliency (which are defensive). It is also important to remember that the overall responsibility for technology oversight remains with the full board.

- **Leverage IT investment to grow operational efficiencies.** Only a few years ago, it wasn't unusual for ongoing operations to consume more than 70 percent of the IT budget.<sup>6</sup> Cheaper storage and processing costs, cloud platforms, technology modernization, and automation in IT have helped drive down ongoing operating costs to about 50 percent today in leading organizations, with those organizations' CIOs expecting them to continue to drop to about 40 percent over the next three years.<sup>7</sup> In an era of largely flat budgets, the fact that some organizations have been able to shift 20 percent of their IT spend from keeping the lights on to enhancing and growing the business represents significant change. These findings from the 2018 Deloitte global CIO Survey underscore the vanishing line between business strategy and technology strategy, and give the board an opportunity to have a robust discussion with management about how to leverage IT investments to grow the business.
- **Support appropriate experimentation.** Technology experimentation is essential for unearthing new opportunities to drive strategy, enhance performance, and mitigate risk. However, when exploring the boundaries of what's possible through technology, it may not be feasible to approach capital planning with the precision that is traditionally demanded, since the likelihood of success cannot be predicted precisely and the outcomes of new digital efforts are largely unknowable. Boards should work with management to create

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<sup>6</sup> Bill Briggs et al., *Follow the money: 2018 global CIO survey*, Chapter 3, Deloitte Insights, August 8, 2018.

<sup>7</sup> Ibid.

decision-making frameworks that accommodate the abstract nature of the digital frontier so that the organization can support technology experimentation in a structured, financially responsible manner.

### Conclusion

Board members are expected to understand technology well enough to credibly monitor and oversee the execution of management's strategic objectives. As macrotechnology forces collide and companies push beyond the digital frontier, curiosity about tech advances alone will no longer be sufficient, and directors may need to go the extra mile in becoming tech-savvy. In addition to educating themselves about existing technologies, they will likely need to develop intellectual agility, i.e., the ability to interpret and apply emerging technologies not only defensively to solve complex business problems and mitigate risks, but also offensively to monitor and oversee strategy and enhance business performance. Building intellectual agility around the application of technology will require greater engagement with CIOs, CISOs, and other technology leaders—along with a shift in mind-set to see technology strategy and business strategy as one and the same.



### QUESTIONS FOR DIRECTORS TO ASK

- Does the board have sufficient depth and breadth of technology understanding for the current environment? What can we do to increase the tech-savviness of the current board?
- Is the board considering technology as a core part of company strategy at a regular cadence?
- Do conversations about the current and future use of technology cover an appropriate mix of offensive/defensive or agility/resilience angles?
- What disruptions in the marketplace could impact the business?
- How does the work of the committees with respect to technology considerations relate to and differ from the work of the full board?
- How does the board explore technology's impact on growth and performance?
- What strategies does the board have to boost effective interaction between management and board members with respect to technology issues and decisions?
- What kind of relationship does the board wish to have with IT leadership? How does it want to oversee technology leadership, talent, and succession?



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#### Glossary<sup>8</sup>

- **Internet of Things (IoT)** — The ability of consumer and industrial products to send and receive data via the Internet.
- **Wearables** — Technology devices that can be worn as accessories, embedded in clothing, or implanted in the body—often capable of sending and receiving data via the Internet.
- **Networking** — Linking multiple computing devices so they can exchange data; also refers to the process of building and maintaining computer networks, including hardware, software, protocols, and wired and wireless technology.
- **Edge computing** — Enabling low-latency connectivity by using a “mini cloud” to process data as close as possible to a device.

<sup>8</sup> Definitions derived from *Tech Trends 2019: Beyond the Digital Frontier*.

# Fresh Perspectives:

## Increasing the Diversity of Experience, Expertise, and Ideas in the Boardroom

By Julie Hembrock Daum, Spencer Stuart

In this era of rapid technological change and market disruption, boards have their work cut out for them just to keep pace with what is happening in their own companies, let alone in the broader, converging business environment. To remain an asset to the company—and to be prepared to make a meaningful contribution to enterprise strategy and able to challenge management effectively—boards need to continually consider refreshment and seek out directors who can bring in much-needed knowledge and experience from the front line.

Responding to the evolving demands on boards and a growing investor focus on board composition, many boards are diversifying perspectives in the boardroom. As a result, the profile and skill set of the director continues to shift.

The data presented here is based on our analysis of the most recent proxy statements from 491 S&P 500 companies filed between May 30, 2018, and May 15, 2019, and responses to our governance survey from 113 nominating/governance committee members conducted in the second quarter of 2019.

The following represent the key board trends that Spencer Stuart believes will continue or accelerate in 2020, and how these trends are likely to shape board priorities in 2020 and beyond.

### **Boards Will Continue to Prioritize Diversity When Recruiting New Directors**

Amid pressure from investors, proxy advisers, and, in some states, new regulations, boards will continue to accelerate the addition of women and minority directors to their membership. Proxy advisers ISS and Glass Lewis each have established policies recommending voting against the nominating committee chairs (and potentially other directors) of companies with no female directors, unless certain mitigating factors apply. Several major institutional investors, including State Street Global Advisors (SSGA) and BlackRock, have also taken a stand on gender diversity, voting against nominating chairs when there are no female directors on the board. Going one step further, BlackRock voted against directors, usually the chair or members of the nominating committee, at companies that did not have at least two women on the board and didn't have a clear policy on board diversity or hadn't improved board diversity.<sup>1</sup> Regulators, too, are pressing for progress on diversity. California established gender quotas for companies headquartered there, mandating boards to have at least one female director by the end of 2019 and two to three female directors, depending on board size, by the end of 2021. New Jersey is considering

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<sup>1</sup> See Shirley Westcott, “[2019 Proxy Season Preview](#),” the *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), April 15, 2019; the ISS press release, “[ISS Announces 2019 Benchmark Policy Updates](#),” November 19, 2018; and “[ISS and Glass Lewis Policy Updates for the 2019 Proxy Season](#),” *Sidley Update*, November 27, 2018.

similar legislation,<sup>2</sup> while a new Illinois law requires public companies headquartered there to disclose the racial, ethnic, and gender diversity of their boards of directors.<sup>3</sup>

Boards have increased the pace of recruiting women and minority directors. Of the 432 independent directors added to S&P 500 boards in the 2019 proxy year, a record-breaking 59 percent are from these historically underrepresented groups, up from half in 2018. Gender diversity is a clear boardroom priority, with women constituting 46 percent of the 2019 incoming class, compared to 40 percent in 2018. More than 90 percent of S&P 500 boards now have two or more women directors, up from 86 percent in 2018 and 53 percent in 2009.

Racial and ethnic diversity also appears to be a recruiting priority for S&P 500 boards. About one in four new S&P 500 directors added in 2019 (23%) are minorities (defined as African-American/Black, Asian, and Hispanic/Latino), an increase from 19 percent in 2018. Among the top 200 S&P 500 companies, 19 percent of all directors in 2019 are male or female minorities, up from 17 percent in 2018.

Our survey of S&P 500 nominating/governance committee members reveals that increasing diversity, especially gender diversity, will continue to be a top recruiting priority. Thirty-six percent of respondents said their board's highest recruiting priority is adding women directors, the highest of any recruiting profile, and 40 percent said female directors will be the director candidates most in demand over the next three years. Nearly one-quarter (24%) said minority candidates will be in demand over the next three years.

Nominating/Governance Committee Member Survey	
Current highest-priority board recruiting profiles	Skills, qualifications, and backgrounds most in demand over the next 3 years
1. Female directors (36%)	1. Female directors (40%)
1. Technology experience (34%)	2. Technology experience (38%)
2. Active CEO/COO (32%)	3. Active CEO/COO (35%)
3. Financial experience (28%)	4. Digital/social media experience (26%)
4. Operational experience (27%)	5. Minority (24%)

<sup>2</sup> Jeff Green and Andrea Vittorio, “New Jersey Follows California in Measure to Add Women to Boards,” Bloomberg, December 21, 2018.

<sup>3</sup> Peter Hancock, “Illinois companies now must report on board diversity,” the Chicago Sun Times, August 27, 2019.

Women and minority directors are one of the driving forces behind the changing profile of new S&P 500 directors, enhancing the diversity of thought, experience, and expertise in many boardrooms.

The focus on increasing gender and ethnic diversity will inject a broader set of functional, industry, and generational perspectives into the boardroom.

For years, investors have been urging boards to look beyond CEOs and experienced directors to find boardroom talent. Boards are now listening. In addition to the increasing gender, racial, and ethnic diversity of new directors, the professional backgrounds, areas of expertise, and ages of directors joining S&P 500 boards will continue to shift. We are already seeing these shifts:

- CEO experience isn't required: 65 percent of the 2019 incoming class came from outside the top executive ranks of CEO, chair/vice chair, president, and chief operating officer.
- Functional and other corporate leadership experience is valued: 23 percent of new independent directors in 2019 have experience as division/subsidiary heads or as executive vice presidents, senior vice presidents, or functional unit leaders.
- Board experience isn't a requirement: 27 percent are serving on their first public-company board.
- Age diversity is a lower priority: 16 percent are 50 or younger, a small decline from 17 percent in 2018 and 2017.

Women and minority directors are one of the driving forces behind the changing profile of new S&P 500 directors, enhancing the diversity of thought, experience, and expertise in many boardrooms. The data show differences between the profiles and skill sets of these historically under-represented groups and a traditional director profile. For example, women and minority new directors are far less likely to be CEOs or experienced directors: only 19 percent are current or former CEOs compared to 44 percent of nonminority men, and 34 percent are serving on their first public-company board, nearly double the rate (18%) of nonminority directors.

As a result of their diverse backgrounds, these directors bring different types of leadership and professional experience to the boardroom. They are more likely to be current or former line or functional leaders (31% versus 11% for nonminority men) or to be academics, consultants, or to work in the nonprofit or government/military sectors (18% versus 7%). These directors are less likely to have backgrounds in investment management (7% versus 14%). They also tend to be younger: 18 percent of women and minority directors are 50 or younger, compared to 12 percent of nonminority men.

Low turnover and long tenures will continue to impede meaningful change in overall composition, absent changes in refreshment practices.

While women and minority men represent more than half of the new S&P 500 directors, continued low boardroom turnover remains a persistent impediment to meaningful year-over-year change in the overall composition of S&P 500 boards. As a result, in spite of the record number of female directors in the 2019 incoming class, the representation of women on S&P



500 boards increased incrementally to 26 percent of all directors, up from 24 percent in 2018. In fact, about two-thirds of boards that increased the number of women on a net basis increased the overall size of their board.

Many boards—44 percent—have maintained or reduced their size on a net basis over the past year. Twenty-nine percent of S&P 500 boards made no changes to their roster of independent directors—neither adding nor losing independent directors—and 15 percent reduced the overall size of their boards. On average, S&P 500 boards added less than one new director in 2019 (0.88 new directors per board). Meanwhile, while average director tenure has trended modestly lower since 2015 (from 8.5 years to 8 years), 17 percent of independent S&P 500 directors have served on their boards for 11–15 years and 13 percent for 16 years or more.

Turnover on boards today is largely driven by mandatory retirement, and this is likely to continue to be the case in 2020. Seventy-one percent of S&P 500 boards disclose a mandatory retirement age for directors, but boards continue to raise retirement ages, further entrenching directors. Among S&P 500 companies with retirement-age policies, 46 percent set the age at 75 or older, compared with just 15 percent in 2009. Four boards have a retirement age of 80.

Board demographics suggest turnover will remain low, as only a small percentage of sitting independent directors are approaching retirement age. Just 15 percent of the independent directors on boards with mandatory retirement policies are within three years of the age cap. With these directors averaging 63 years of age, most S&P 500 directors have years of potential service before reaching mandatory retirement.

### The Implications for your Board

Business demands and investor pressure are influencing boards' composition and refreshment strategies. Boards can use the following recommendations to enhance short- and long-term approaches to their composition:

#### Assess Skills and Incorporate Results From Performance Assessments Into Board Succession Planning

Investors increasingly are looking at individual director commitment and performance. To do so they are analyzing the number of boards a director serves on, director meeting attendance, tenure, and the overall relevance of directors' skills to the needs of the business. Many have their own definitions of overboarding or excessive tenure. They consider meaningful full-board, self-, and peer assessment as a best practice for evaluating and enhancing board performance and promoting boardroom refreshment.<sup>4</sup>

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<sup>4</sup> See *Proxy voting guidelines for U.S. securities*, BlackRock, January 2019; *2019 Proxy Voting and Engagement Guidelines: North America*, State Street Global Advisors; and "ISS and Glass Lewis Policy Updates for the 2019 Proxy Season," *Sidley Update*, November 27, 2018.



In fact, board performance assessments are a widespread practice. Nearly all S&P 500 boards report conducting some sort of annual performance evaluation, and, more recently, individual-director evaluations have started to gain traction. Forty-four percent—up from 38 percent in 2018 and 22 percent 10 years ago—report some form of individual-director evaluations in their proxies.

The most effective boards use the results of board and individual-director assessments as a fundamental element of strategic board-succession planning. They also consider whether the skill sets and profiles of current directors are still relevant in light of changing business needs and the future of the business. Considerations include a mix of age, experience, and background among the board to help foster better debate and decision making while avoiding groupthink.

### **Set Expectations Around Tenure**

Recognizing the importance of regular board refreshment, savvy boards openly discuss and forge agreement on both appropriate director turnover and refreshment and how they will be achieved. Board leadership sets the tone about the length of director service at the outset, ideally ensuring that directors understand that renominations are not simply assumed—they are based on the current needs of the board to effectively oversee the company's evolving strategy, and require the sustained high performance of individual directors.

In addition to setting clear expectations around director tenure, boards should periodically assess whether tenure-limiting policies are appropriate. Most boards rely on mandatory retirement policies to promote turnover. In some cases, boards make exceptions to mandatory retirement ages to keep a particular director on the board. This can become problematic, as it can set a precedent for all future directors nearing retirement age. Another tenure area that boards can focus on is the optimal mix of board-tenure levels or aggregate board tenure. Some boards seek to balance their composition with a mix of tenures that includes new directors, directors with medium tenures, and directors with long tenures.

### **Embrace a Continuous Improvement Mind-Set**

High-performing boards assess the culture and dynamics in the boardroom to understand how they can operate more effectively. They use annual assessments to understand the performance and contributions of the board as a whole and those of the individual directors. These boards view composition as a strategic asset and take a formal approach to board refreshment, taking a multiyear view of departures and using assessments to strategically plan for board openings.

To make the most of the increasingly diverse perspectives in the boardroom, boards should define and manage a board culture to facilitate constructive interactions between board members. For boards striving to be more dynamic, performance oriented, and shareholder focused, getting culture right is key.



## BOARD OVERSIGHT QUESTIONS

- What mechanisms are we using to ensure board refreshment?
- How frequently are we conducting a side-by-side comparison of directors' skill sets and experiences against the company's strategic agenda?
- Have we fostered an environment that encourages individual directors to think critically about their contributions and the relevance of their skills to the company strategy?
- Are we effectively using our annual board assessment and regular executive sessions to consider the culture and dynamics in the boardroom and ways to operate more effectively?
- Have we clearly communicated with investors that we have a process in place to ensure that our current board is the best fit for the future of the business?



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# Projections on Emerging Trends: ESG and Shareholder Engagement

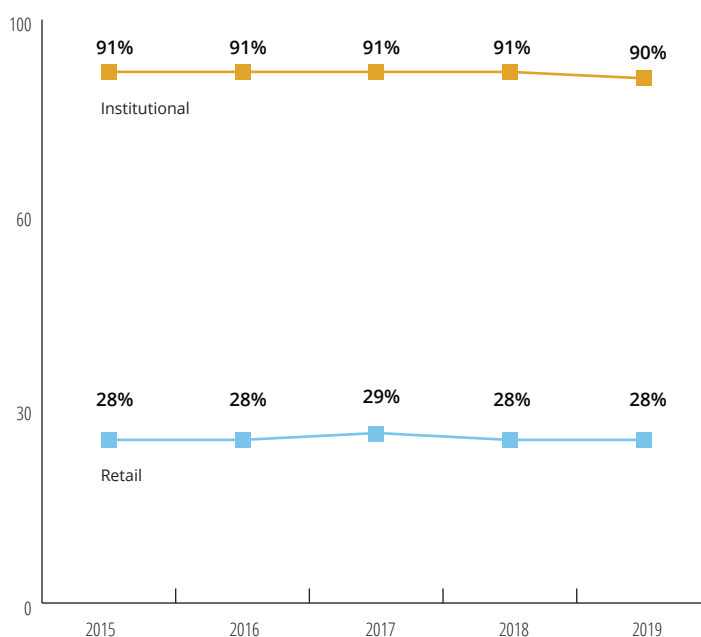
By Chuck Callan and Dorothy Flynn, Broadridge Financial Solutions

## Brace Yourself for an Eventful Year

Shareholder engagement is the watchword for 2020, thanks to the nexus of constituents focused on environmental, social, and governance (ESG) issues. Interest in ESG among institutional investors is heating up at a time when employees and smaller shareholders—particularly millennials—are pushing companies to think beyond the bottom line

Boards that effectively utilize technology to improve external communications are better positioned to both “sense” and address stakeholders’ growing focus on board diversity, climate change, and other ESG issues. This effective utilization ranges from monitoring social media to analyzing proxy-voting outcomes on ESG matters among peer companies. Recent regulatory developments that would place limits on shareholder proposals and proxy advice are not expected to diminish increasing expectations for corporations to demonstrate progress on making a positive impact on society. Management and boards should expect continued engagement with shareholders, not only in annual shareholder meetings but throughout the year.

## Participation | Percentage of Shares Voted



Source: *ProxyPulse*, a Broadridge and PwC Initiative. Second Edition 2019. Used with permission.

Yet, in many cases, directors do not have a complete view of all shareholders' sentiment. Across all US companies, around 30 percent of shares on average are held by retail investors, but they vote only 28 percent of the shares they own, according to *ProxyPulse*. Conversely, institutional investors hold about 70 percent of the shares (and vote 90% of them), so their voices are more likely to be heard.<sup>1</sup>

Management and directors that communicate business strategies, ESG policies, and significant business developments—through notifications and news feeds to retail investors' mobile phones—are bringing more small shareholders out of the shadows. Broadridge reports a record 2.7 million retail positions were voted via MobileProxyVote.com during the 2019 proxy season, and more than two million positions were cast from brokerage websites via Investor Mailbox.<sup>2</sup> Voting is also now possible from some apps.

When they engage, retail shareholders can make a significant impact, because their ownership, as a segment, is on average greater than the very largest institutional investors. Retail investors are typically performance oriented—when they vote, they reward companies that perform well, and when they are unhappy, they often “vote with their feet” by selling their shares. The challenge for boards and managers is to provide easily-digestible communications, on ESG and other topics. “Layered” proxy disclosures that offer summaries of key information in microsites can also reduce the effort to vote.

## Key Projections

### ESG Will Continue to Be at the Fore

Due to rising expectations for corporations to make a positive impact on society, ESG will continue to be an important aspect of board engagement for shareholders, employees, and proxy advisors focused on long-term business impact.

ESG engagement efforts come at a time of increased pressure generally on directors. The number of directors failing to receive majority support (at least 50% in favor) continues to climb, from 345 in 2015 to 478 in 2019, based on votes processed by Broadridge—despite fewer directors up for election.<sup>3</sup>

Moreover, the number of directors failing to receive at least 70 percent support has also continued to increase, from 1,185 in 2015 to 1,726 in 2019.<sup>4</sup> Failure to surpass this threshold can result in recommendations against directors in following years.

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<sup>1</sup> Broadridge and PwC, *ProxyPulse*, 2nd ed. (2019), p. 5.

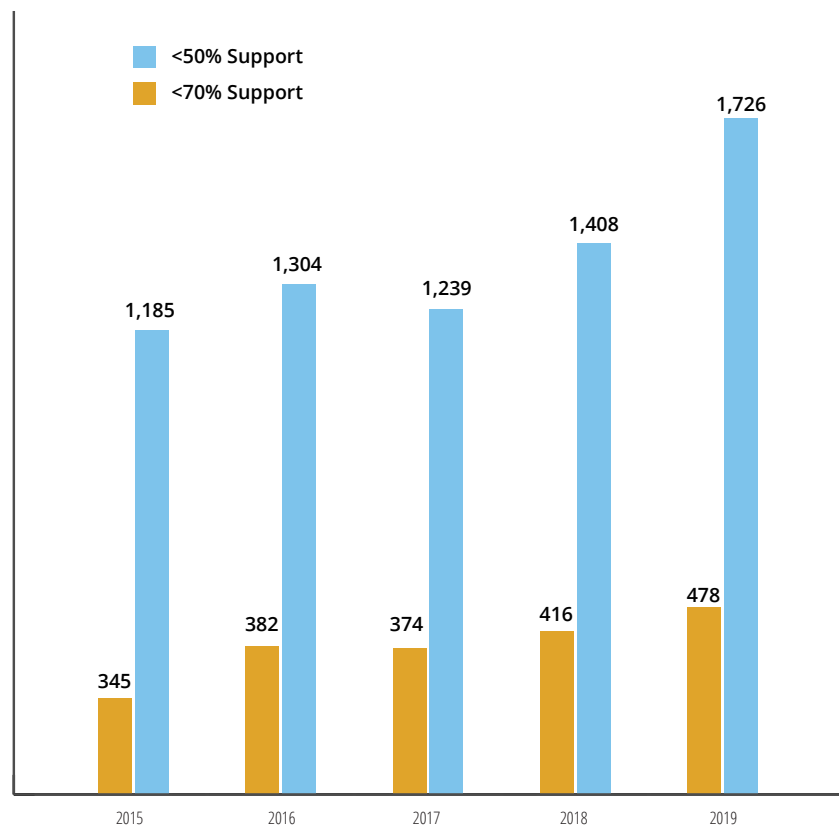
<sup>2</sup> Broadridge, *2019 Proxy Season Key Statistics and Performance Rating*, p. 1.

<sup>3</sup> Broadridge and PwC, *ProxyPulse*, 2nd ed. (2019), p. 5.

<sup>4</sup> Ibid.

Heading into 2020, boards need to develop new and robust means of engaging all stakeholders on companies' ESG policies and progress.

Number of Directors Failing to Receive Support



Source: *ProxyPulse*, a Broadridge and PwC Initiative. Second Edition 2019. Used with permission.

These trends are happening despite generally rising stock valuations. Good performance *alone* does not guarantee that all constituents will support directors. Heading into 2020, boards need to develop new and robust means of engaging all stakeholders on companies' ESG policies and progress. "We are in the throes of a historical shift in perception" about the impact of climate change and investors' desire to express their views on the subject, says Dr. Alexis Crow, PwC's lead, Geopolitical Investing.<sup>5</sup>

Globally, sustainable investing assets stood at \$30.7 trillion at the start of 2018, a 34 percent increase in two years, according to the Global Sustainable Investment (GSI) Alliance.<sup>6</sup> Total US-domiciled assets under

<sup>5</sup>Alexis Crow, "Climate investing: Is it sustainable?", the Atlantic Council Blog, October 10, 2019.

<sup>6</sup>GSI Alliance, *2018 Global Sustainable Investment Review*, p. 5.

<sup>7</sup>Ibid., p. 6.

management using sustainable strategies and related ESG criteria grew 38 percent to \$12 trillion in recent years.<sup>7</sup>

The Paris Climate Accord immediately comes to mind with the term ESG. However, ESG has come to mean much more—covering board diversity, shareholder voting rights, board independence, and other matters. Good governance is a part and parcel of making a positive impact on society.

There are many signs of progress. For example, the number of ESG-related shareholder proposals declined to 381 in 2019 from its peak of 426 in 2015, in part because companies are taking proactive steps and engaging with investors outside of the annual shareholder meeting process. But that's no reason for complacency, because when ESG proposals come up for a vote, as a result of concerted campaigns or other shareholder action, institutional support has been rising. Over the past four years, it rose from 25 percent in 2015 to 32 percent in 2019. By contrast, retail shareholders were less supportive of such proposals over the same time frame: when they voted, retail support was in the low-to-mid teens.<sup>8</sup>

We expect that could change as millennials surpass 50 percent of the US workforce in 2020, and as growing numbers of them own more stock. Multiple surveys show climate change to be the most important issue to people born between 1981 and 1996.<sup>9</sup> As employees, shareholders, and consumers, millennials are an increasingly important constituency to corporations. Board members, in turn, need to anticipate the concerns and sentiments of this shareholder cohort.

Recent events at Amazon provide a strong indicator of the changes to come, as directors think about the broader stakeholder engagement.

At its 2019 annual meeting, Amazon's board recommended a vote against a climate-change proposal calling for the company to report how it is "planning for disruptions posed by climate change, and how Amazon is reducing its company-wide dependence on fossil fuels."<sup>10</sup>

The proposal, put forth by roughly 8,000 employees, received just 30 percent support from shareholders,<sup>11</sup> but the issue remained of paramount importance to Amazon's workers. In September, as Amazon employees prepared to join a larger protest over the tech industry's perceived inaction on climate, the company announced that it was the first signatory of

As employees, shareholders, and consumers, millennials are an increasingly important constituency to corporations.

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<sup>8</sup> Based on Broadridge's 2019 ProxyPulse™ data. It covers the results of 4,059 public company annual meetings held between January 1 and June 30, 2019. ProxyPulse data is based on Broadridge's processing of shares held in street name. The five-year trend data covers the proxy season, which is when the majority of public company meetings occur.

<sup>9</sup> Deloitte, *The Deloitte Global Millennial Survey 2019*, p. 6.

<sup>10</sup> "Amazon: Adopt the Workers' Climate Plan Resolution," posted on ActionNetwork.org.

<sup>11</sup> Amazon.com 8-K Filing, May 22, 2019.

<sup>12</sup> Amazon, "Amazon Co-Founds the Climate Pledge, Setting Goal to Meet the Paris Agreement 10 Years Early," Amazon.com press release, September 19, 2019.

Boards should ensure that their companies have identified the most relevant stakeholder groups and that they have a robust strategy to engage with them.

“The Climate Pledge,” and committed to net zero carbon emissions by 2040, a decade ahead of the Paris accord’s goal.<sup>12</sup>

As the Amazon example suggests, broad groups of stakeholders will likely continue to make ESG demands of management and director “mindshare” in 2020 and immediately beyond. Boards should ensure that their companies have identified the most relevant stakeholder groups and that they have a robust strategy to engage with them. Companies may want to give a higher profile to communications on their progress in ESG areas.

### **Proxy Advisory Policies Will Continue to Impact Voting**

Board members will continue to focus on policy recommendations coming from proxy advisory firms. For example, Glass Lewis announced it will “recommend supporting well-crafted, binding shareholder proposals that increase shareholder value or protect and enhance important shareholder rights.”<sup>13</sup>

On other ESG matters, Glass Lewis also declared:

- It will “generally support shareholder proposals requesting that companies provide disclosure concerning the diversity of their workforce. . . .”<sup>14</sup>
- “May consider recommending that shareholders vote against members of the board who are responsible for oversight of environmental and social risks.”<sup>15</sup>

In November 2019, Institutional Shareholder Services (ISS) released its *Proxy Voting Guideline Updates for 2020*.<sup>16</sup> The report highlighted three issues for US corporations:

- **Independent Board Chair – Shareholder Proposals:** ISS will generally recommend a vote in favor of *shareholder* proposals requiring chair persons to be independent directors.
- **Share Repurchase Program Proposals:** ISS will recommend a vote in favor of *management* proposals to institute open-market share repurchase plans permitting shareholders to participate on equal terms.
- **Problematic Governance Structures – Newly Public Companies:** ISS will recommend a vote against individual directors or the entire

<sup>13</sup>. Courteney Keatinge, “Glass Lewis’ Shareholder Initiative Guidelines,” *Harvard Law School Forum on Corporate Governance and Financial Regulations* (blog), November 9, 2018.

<sup>14</sup>. Ibid.

<sup>15</sup>. Ibid.

<sup>16</sup>. Institutional Shareholder Services, *ISS Americas: Proxy Voting Guidelines Updates for 2020*.





## Engagement And Technology

Boards need to ensure that they have a good understanding of their shareholders and make sure that strategies are in place for engaging retail shareholders, especially if they're expecting a close vote. The SEC has underscored the importance of more retail participation in proxy voting and wants retail investors to be more informed about proxy matters.<sup>23</sup> Technology can reduce the effort required to vote, helping retail investors participate more easily.

A variety of technological solutions can be utilized for engaging retail shareholders. Examples include these solutions:

- **Push Notifications:** Push notifications via text messages can alert retail investors who often put proxy materials aside with the intention of returning to them later but then fail to do so before the deadline. Firms can also “push” proxy information via media releases into retail shareholders’ news feeds through a variety of digital news outlets.
- **Enhanced Emails:** Firms can make email communications more appealing by including visuals, branding, more prominent calls to action and voting features, short videos featuring the CEO and board members, and educational information for retail investors. Secure emails are being sent to investors to access voting sites without the need for pins or special “control numbers.”
- **Virtual Shareholder Meetings:** These make annual meetings more accessible to a greater number of shareholders, while eliminating the need for the board to travel to attend the meeting. Most companies permit all interested stakeholders to attend virtually, although many do not permit nonowners to ask questions. During the 2019 proxy season, the number of virtual shareholder meetings rose by 15 percent over the prior year, according to Broadridge Financial Solutions, the largest communications provider.<sup>24</sup>
- **Interactive Proxy Microsites:** Proxy microsites can be transformative because they make proxy documents more consumable, summarizing the essence of proposals in plain language. AI-based systems can learn investor’s content preferences and highlight the information they most want to see.

<sup>23</sup> Main Street Investors Coalition, “Retail Investors Front and Center for SEC Chairman Clayton,” posted on [mainstreetinvestors.org](https://mainstreetinvestors.org), October 16, 2018.

<sup>24</sup> Based on Broadridge’s 2019 ProxyPulse™ data. It covers the results of 4,059 public company annual meetings held between January 1 and June 30, 2019. ProxyPulse data is based on Broadridge’s processing of shares held in street name. The five-year trend data covers the proxy season, which is when the majority of public company meetings occur.

board if boards (a) adopt bylaws or charters that are materially adverse to shareholder rights, or (b) implement multiclass capital structures having unequal voting rights without a sunset.

Board members also need to be aware of the *Proxy Advisor Interpretation and Guidance* issued by the US Securities and Exchange Commission (SEC) in August, 2019. The SEC now requires greater disclosure from proxy advisors on any potential conflicts of interest, as well as higher standards of accuracy around the recommendations they provide. Voting advice is considered a solicitation and as such there could be liability for materially false and misleading statements.<sup>17</sup>

ISS has sued the SEC over its new regulations.<sup>18</sup> Some advocates fear that the outcome could have a significant impact on proxy advisory firms' ability to do their job. "We believe that the Commission's new Proxy Advisor Interpretation and Guidance is likely to create substantially increased costs and unnecessary burdens on the process by which proxy advisors render their advice," Ken Bertsch, executive director at the Council of Institutional Investors (CII), wrote in a comment letter to the SEC in October. "Among others, these include increased litigation, staffing and insurance costs that are almost certainly going to be passed on to institutional investors and their underlying retail clients."<sup>19</sup>

Boards will need to monitor these regulatory developments.

<sup>17</sup> Securities and Exchange Commission, *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*.

<sup>18</sup> Cezary Podkul, "Proxy Advisory Firm Sues SEC Over New Rules," the *Wall Street Journal*, updated November 1, 2019.

<sup>19</sup> Ken Bertsch, "CII Letter to the SEC—Proxy Advisor Regulation," the *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), October 15, 2019.



## QUESTIONS FOR THE BOARD

Board members should ask themselves or management these questions before proxy season:

- Do we understand our investor's current and evolving governance priorities?
- Are we doing enough to refresh the board and to address institutional investors' recommendations on board diversity and tenure?
- Do we have a strategy for engaging our retail shareholders?
- Do we have appropriate time on our agenda to discuss the ESG matters most relevant to us—along with our stakeholder's views on these issues?
- Have we identified the most relevant stakeholders to engage?
- How does our ESG disclosure compare to that of our peer group? Should we disclose metrics that track progress?

## Institutional Investors Stay Focused on Board Diversity

Some leading institutional investors will publish their voting policies for the 2020 season in Q1. Board members need to fully understand how the governance priorities of their largest institutional shareholders are evolving.

State Street Global Advisors, for example, announced last spring that in 2020 it will start voting against all nominating and governance committee directors (not just the chair) at companies where they have concerns about gender diversity, and are unable to engage in “productive dialogue” with management.<sup>20</sup>

Since the introduction of State Street’s “Fearless Girl” initiative in 2017, the company says 423 firms added a female director, and 22 committed to doing so in the near term. “However, 57% of the companies that we identified have failed to take action.”<sup>21</sup>

BlackRock’s chair and CEO, Laurence Fink, has also made ESG a clear priority: “To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.”<sup>22</sup>

Some directors and managers are looking to go beyond simple statements of purpose by disclosing the “progress metrics” they’re tracking.

In sum, shareholder engagement is the watchword for 2020, due to the nexus of constituents focused on environmental, social, and governance (ESG) issues. Interest in ESG is heating up among all stakeholders—particularly millennials, as well as major institutional investors and proxy advisers. Developing new and robust ways of engaging all stakeholders is key to addressing growing expectations for corporate societal impact. Boards that leverage technology to understand sentiment and improve communications will be better positioned to meet rising expectations.

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<sup>20</sup> State Street Global Advisors, *Stewardship Report 2018–19*, p. 36.

<sup>21</sup> Ibid.

<sup>22</sup> Larry Fink, “A Sense of Purpose,” *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), January 17, 2018.



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Dorothy Flynn

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# Bridge Over Troubled Waters:

## How Boards Can Manage the Risks of the Global Water Crisis

By Veena Ramani, Ceres

### Introduction

“Day Zero”—the crisis moment when a local water supply goes completely dry—is fast becoming part of business vernacular. The phrase, which got its start when Cape Town, South Africa, nearly went dry in 2018, is now spreading as other global markets face similar water crises.

For example, India—one of the biggest, fastest-growing economies in the world—is experiencing the worst water crisis in its history. The Indian city of Chennai is in the midst of an historic drought, leaving its population of 9 million without water security.<sup>1</sup> According to the Indian government, 21 major cities will run out of groundwater by 2020, putting around 100 million people at dire public-health risk.<sup>2</sup>

The human tolls also exact business costs. India is not only one of the largest consumer markets in the world, it is also a major technology and manufacturing center. Water embedded in the production of Indian exports uses almost four times the amount of water used by Indian households and industry,<sup>3</sup> suggesting that water scarcity will be a serious risk to economic activity in the future.

On the other end of the spectrum, floods are also causing huge impacts. The 2010 floods in Pakistan destroyed the country’s cotton crop and led to a rise in commodity prices on cotton worldwide.<sup>4</sup> Closer to home, between 1980 and 2013, the United States suffered **more than \$260 billion** in flood-related damages.<sup>5</sup> The 2019 flooding of the Mississippi river, which lasted 107 consecutive days, caused more than \$2 billion in damages.<sup>6</sup>

Despite these dramatic examples, escalating financial losses, and worrisome projections for the future of water, companies—and their boards—are not yet doing enough to consider water impacts on their businesses. Even in the face of the particular vulnerability of the food sector, more than two-thirds of the world’s largest food companies have boards that still do not explicitly oversee water risks.

As fiduciaries to their companies and shareholders, corporate board members should pay attention to escalating global water issues—as both business risks and opportunities. Elevating scrutiny on the increasingly material issue of water will allow for thoughtful planning and decision making and provide competitive advantages against industry peers.

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<sup>1</sup> Niha Masih and Joanna Slater, “As a major Indian city runs out of water, 9 million people pray for rain,” the *Washington Post*, June 28, 2019.

<sup>2</sup> NITI Aayog, *Composite Water Management Index: A Tool for Water Management* (New Delhi, India: NITI Aayog, 2018), p. 22.

<sup>3</sup> David Fickling, “How India’s Water Ends Up Everywhere But India,” Bloomberg, July 5, 2019.

<sup>4</sup> Augustine Anthony and Michael Georgy, “Pakistan floods destroy crops and could cost billions,” Reuters, August 12, 2010.

<sup>5</sup> Kimberly Amadeo, “Floods’ Effect on the Economy and You,” an article posted on [thebalance.com](http://thebalance.com) and updated on June 25, 2019.

<sup>6</sup> Associated Press, “Flood damage will cost more than \$2 billion for Mississippi river towns” the *Chicago Tribune*, June 25, 2019.

## Key Projections

### Companies Will Face Water Risks Across Their Value Chains

Water risks are already impacting the corporate bottom line and affecting corporate operations and supply-chain performance. In 2018 alone, companies reported water-related financial losses to the tune of \$36 billion.<sup>7</sup> Corporate boards should keep the following risks in mind, especially in the face of business continuity concerns:

- **Operational risks:** The [2018 water crisis in Cape Town](#), South Africa, forced 87 percent of surveyed businesses to cut their water consumption by more than half. Protracted droughts in Brazil and large parts of Europe in 2017 and 2018 caused significant reductions in hydropower generation,<sup>8</sup> including a 47 percent drop for the EDP Group.<sup>9</sup>
- **Supply chain risks:** Flooding across the Mississippi River Basin caused millions of acres of corn and soybeans to go unplanted,<sup>10</sup> driving up futures prices for the primary ingredients for livestock feed.<sup>11</sup> As a result, from mid-May to mid-June 2019, shares of Tyson Foods fell 4.8 percent, while shares of Sanderson Farms Inc. and Pilgrim's Pride Corp. fell more than 11 percent.<sup>12</sup>
- **Reputational and social license to operate risks:** Over 1 million local retailers in Tamil Nadu, India, stopped selling Coca-Cola and Pepsi products over concerns that the companies' bottling operations were diminishing the state's scarce water resources.<sup>13</sup> Constellation Brands is facing strong local opposition to a \$1.5 billion brewery it seeks to build in Mexicali, a desert region that relies on the already stressed Colorado River.<sup>14</sup>

### Water Risks Will Intensify

Recent studies from a range of groups underline that stresses from water availability and demand will only grow. As these stresses increase, they could pose disruptive risks for boards and management to consider. Their impacts include the following:

Recent studies from a range of groups underline that stresses from water availability and demand will only grow. As these stresses increase, they could pose disruptive risks for boards and management to consider.

<sup>7</sup> See the "[Treading Water: Global Water Report 2018](#)" web page posted on [cdp.net](#).

<sup>8</sup> Irene Banos Ruiz, "[Hydropower supply dries up with climate change](#)," an article posted on [dw.com](#) on March 1, 2018.

<sup>9</sup> "[EDP - Energias de Portugal S.A. - Water 2018](#)" posted on the site of EDP Group.

<sup>10</sup> Humeyra Pamuk, P. J. Huffstutter, and Tom Polansek, "[UPDATE 1-U.S. farmers face devastation following Midwest floods](#)," Reuters, March 20, 2019.

<sup>11</sup> Kevin Kliesen, "[Crop Prices and Flooding: Will 2019 Be a Repeat of 1993?](#)" The Federal Reserve Bank of St. Louis, June 6, 2019.

<sup>12</sup> Corrie Driebusch, "[Meat Producers Hit on Flooding Concerns](#)," the *Wall Street Journal*, June 17, 2019.

<sup>13</sup> See "[Tamil Nadu: Traders ban Pepsi, Coca-Cola to support local products](#)," published on [bbc.com](#) on March 1, 2017.

<sup>14</sup> Alex Zaragoza, "[As Big Beer Moves In, Activists in Mexicali Fight To Keep Their Water](#)," posted on NPR's *The Salt* (blog), March 26, 2018.

Water use is predicted to grow by 50 percent between 2007 and 2025 in developing countries and 18 percent in developed ones, causing a widening gap between supply and demand.

- **More Frequent Droughts and Floods:** The frequency of droughts, floods, and major storms [more than doubled](#) from 1980 to 2014.<sup>15</sup> The [frequency](#) of these events will continue to rise, especially in rapidly growing and storm-prone cities across Asia, as climate change intensifies.
- **Growing demand for water:** Water use is predicted to grow by 50 percent between 2007 and 2025 in developing countries and 18 percent in developed ones,<sup>16</sup> causing a widening gap between supply and demand—a situation that will only become worse as the global population swells by another 2 billion people and industries use ever more of the world’s water resources. By 2030, water supplies are only expected to satisfy 60 percent of global demand, on average.<sup>17</sup>
- **More High-Risk Areas:** According to the World Resources Institute’s (WRI’s) [Aqueduct Water Risk Atlas](#), 17 countries—home to one-quarter of the world’s population—face “extremely high” levels of baseline water stress, where irrigated agriculture, industries, and municipalities withdraw more than 80 percent of the available water supply, on average, every year, leaving minimal reserves for droughts. Even though the United States ranked 71st on WRI’s list, pockets of the country, such as New Mexico, still face “extremely high” water stress, and Arizona, California, Colorado, and Nebraska show “high water stress” levels.<sup>18</sup>

#### Key Sectors Will See Greater Water Risks—and Opportunities

While all companies will face some degree of water risk across their value chain, key industries will be particularly affected. The global food sector, which uses 70 percent of the world’s fresh water to grow crops and feed animals,<sup>19</sup> faces \$459 billion of revenue at risk from lack of water availability for irrigation or animal consumption. A further \$198 billion may be at risk from changing precipitation patterns affecting crop production areas.<sup>20</sup>

The apparel sector also faces escalating risks. Fibers like cotton are particularly water intensive—it takes 2,700 liters of water, or what one person drinks in 2½ years—to make one cotton shirt. A growing number

<sup>15</sup> European Academies’ Science Advisory Council, Leopoldina – Nationale Akademie der Wissenschaften (March 21, 2018). New data confirm increased frequency of extreme weather events: European national science academies urge further action on climate change adaptation. Posted on *ScienceDaily*. Retrieved November 15, 2019 from [www.sciencedaily.com/releases/2018/03/180321130859.htm](http://www.sciencedaily.com/releases/2018/03/180321130859.htm).

<sup>16</sup> Deborah Zabarenko, “[Water use rising faster than world population](#),” Reuters, October 25, 2011.

<sup>17</sup> “[UN Report: World Faces 40% Water Shortfall by 2030](#),” VOA, March 22, 2015.

<sup>18</sup> Jordan Davidson, “[A Fourth of the World is Living Under Extreme Water Stress, Says New Research](#),” EcoWatch, August 6, 2019.

<sup>19</sup> Jacob London, “[Commentary: Water risks and the food sector’s bottom line](#),” *Pensions & Investments’ Industry Voices* (blog), July 2, 2019.

<sup>20</sup> See the “[Water Use and Pollution](#)” webpage on Ceres’s [engagechain.org](http://engagechain.org).



of apparel brands, such as EILEEN FISHER, Patagonia, and Levis, have recognized this reality and are pioneering a movement toward better water stewardship across their supply chains.<sup>21</sup>

### **Increasing Energy Needs Will Intensify the Water Crisis**

Global water consumption for power generation and fuel production will more than double by 2040,<sup>22</sup> with water-intensive coal use accounting for half of this growth. Forty-seven percent of the world's thermal power plant capacity—mostly coal, natural gas, and nuclear—and 11 percent of its hydroelectricity are located in highly water-stressed areas.<sup>23</sup>

Water-intensive energy extraction is creating competitive pressures in water-stressed areas of the United States. Hydraulic fracturing (“fracking”) for natural gas deposits uses extremely large volumes of water and, in drought-prone Texas, threatens the availability of water for the state's growing population, agriculture producers, and other industries. During the state's most recent drought (2011–2015), Texas cotton farmers and other agricultural producers lost billions of dollars because they didn't have enough water to plant crops.<sup>24</sup>

### **Investor Attention to Water Risks Will Increase**

Given the risks to business performance, water will be a growing priority for investors in 2020—and beyond. Investors are increasing their focus by refining their understanding of water-risk issues. A group of more than 100 institutional investors with more than \$25 trillion in assets under management are collaborating to advance methods for analyzing water risks as part of Ceres' [Investor Water Hub](#). In early 2019, a group of 83 investors managing \$6.5 trillion in assets called on major fast-food companies to disclose how they are managing water and climate impacts in their global supply chains.<sup>25</sup> Dutch Investor ACTIAM has set a goal for its investment portfolio to be “water neutral” by 2030—or in other words to “consume no more water than nature can replenish or cause no more pollution than is acceptable for the health of humans and natural ecosystems.”<sup>26</sup>

Given the risks to business performance, water will be a growing priority for investors in 2020—and beyond. Investors are increasing their focus by refining their understanding of water-risk issues.

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<sup>21</sup> Kirsten James, “Saving Water Is on Trend in the Apparel Industry,” Water Deeply, January 31, 2017.

<sup>22</sup> See the “[Water-energy nexus](#)” web page on [iea.org](#).

<sup>23</sup> Aaron Kressig, Logan Byers, Johannes Friedrich, Tianyi Luo, and Colin McCormick, “[Water Stress Threatens Nearly Half the World's Thermal Power Plant Capacity](#),” posted on the *World Resources Institute Blog*, April 11, 2018.

<sup>24</sup> Ceres, [Hydraulic Fracturing & Water Stress: Water Demand by the Numbers](#), February 3, 2016.

<sup>25</sup> See the Ceres press release, “[Global investors turn up heat on fast food companies to tackle climate and water risks](#),” posted to [ceres.org](#) January 29, 2019.

<sup>26</sup> Monika Freyman, “[Water Neutrality: The Next Frontier in ESG?](#),” posted on the CFA Institute's *Enterprising Investor Blog*, April 29, 2019.



## What Should Boards Do?

As boards expand their work on ESG issues, boards of companies in key sectors should work with management to assess and address their exposure to water risks.

### Work With Management to Assess Exposure to Water Risks

Directors should encourage management to assess whether water risks have a material impact on the unique circumstances of their businesses, and, if so, consider how these potential impacts should be integrated into corporate strategy.

This analysis should focus on both direct operations and supply chains. It should also consider various kinds of water risks, including scarcity and quality risks, regulatory risks, and risks to the social license to operate. Risk assessments should incorporate the viewpoints of critical stakeholders, including the investor community and external water experts.

*Emerging practice:* Ingredion uses multiple third-party tools to identify crops and growing regions facing a variety of water- and climate-related risks. This analysis informs how the company prioritizes which growers to include in its sustainable-sourcing programs. Once these growers are identified, the company uses the Sustainable Agriculture Initiative's Farm Sustainability Assessment to understand its most critical water challenges.

### Consider the Governance Structure for Water-Related Oversight

Where water risks are identified as being relevant to a company, boards should examine their oversight structures to determine how water risks could be discussed by the board, both regularly and in depth. Options to consider include (1) strengthening board committee charters to explicitly mandate oversight of water, and (2) holding regular board-management briefings on water-related risks.

*Emerging practice:* The Public Responsibility Committee of the General Mills board of directors meets three times per year and is briefed on the results of water-risk assessments by the firm's chief supply chain officer. The committee is also responsible for reviewing and approving water-risk management strategies and investments.

### Incentivize Executives for Improved Management of Water Risks

Compensation is a potent lever to incentivize management performance on key issues. When management has identified water risks as material for a company, boards should look at how their company's goals and performance on water risks are linked to executive compensation.

*Emerging practice:* Molson Coors provides incentives to its corporate executive team, its COO, CPO, management unit, and business-unit managers based on progress on key sustainability performance indicators (KPIs). These KPIs include water consumption per hectoliter of production and water use efficiency in the agricultural supply chain and malting operations.

### Encourage Greater Water-Risk Disclosure

Robust disclosure of a company's approach in proactively addressing water risks will give stakeholders, particularly the investor community, the information they need for their decision making.

**Emerging practice:** Danone, among other food and agriculture companies, is now routinely reporting on water scarcity risks and the steps it's taking to assess these risks in developing new manufacturing sites. ADM's executives discussed drought and extreme weather impacts in the company's 2019 earnings calls.

## 4. Conclusion

Water risks, whether from scarcity, extreme weather events or increased competition from water use, are intensifying globally. Companies face these risks across their value chains—from their operations to their supply chains to the values and health of their employees and customers to their very license to operate. Boards should pay proactive attention to this important issue as a part of their oversight of corporate risk, strategy, and value creation.



### QUESTIONS FOR THE BOARD

#### Company Exposure to Water Risks:

- Does our company face risks from water availability or quality in our operations or supply chain?
- Is water risk material to our business performance?
- Is water risk integrated into our Enterprise Risk Management system?
- How will our business strategy need to be changed in a water-constrained future?

#### Governance Structure for Water-Related Oversight:

- Are water risks being raised systematically in full-board discussions?
- Is our board familiar enough with water risks to allow for an informed discussion and smart decision making?

#### Incentivizing Executives for Improved Management of Water Risks:

- How does water risk factor into our business strategy and goals?
- How can we motivate executives to prioritize performance on our water strategy and goals?

#### Encouraging Greater Water Risk Disclosure:

- Which stakeholders most affected by our planning and performance on water-related issues, and what information do they want?
- What are the best forums in which to share information about our water-related planning and performance with our stakeholders and shareholders?



Veena Ramani is the senior program director of the Capital Market Systems program at Ceres. As part of her role, Veena leads Ceres's work on critical market levers that will help scale the transition to sustainable capital markets, including governance systems that companies should put in place at the corporate board level to allow for effective board sustainability oversight. She also oversees Ceres's work on sustainability disclosure.

## Contributing Partners



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