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On the board's agenda | US

The 2018 boardroom agenda—Dealing with challenges old and new

The Center for Board Effectiveness receives many inquiries from clients and others regarding industry and governance trends, what we are seeing and hearing in the marketplace, and how board members can address the complex challenges businesses are facing in the current environment while fulfilling their fiduciary duties.

Regardless of their size, industry and other characteristics, companies frequently face a constant stream of challenges. These can include perennial challenges that require ongoing or periodic attention, as well as new challenges—including new "takes" on long-standing issues—that seem to arise regularly. Even challenges that have been resolved in the past can occasionally awaken and demand attention or action. Investors, regulators and other constituencies—and directors themselves—expect boards to rise to, and address these challenges. Thus, whenever a company is dealing with a challenge, it's not surprising to hear the question "where was the board?"

Developments in 2017 demonstrate the range and depth of the challenges faced by boards. Perennial challenges include strategy, risk, compensation, shareholder engagement and regulatory uncertainty; evolving challenges include board composition, social responsibility, technology risk, culture risk and the combination of innovation and disruption.

This list is not all inclusive; there will be considerations and challenges—possibly many—in 2018 other than those shown above. However, it is likely that some, if not all, of these items could be on the board's agenda in 2018.

Center *for*
Board Effectiveness

Evolving items on the boardroom agenda

Board composition, refreshment and diversity

Boards have been focused on their composition for many years, but the intensity on the topic evolved considerably in 2017, with proxy advisers recommending votes against companies lacking board diversity, mainstream investors casting negative votes at those companies, and other institutional investors launching campaigns to promote diversity, such as the New York City Comptroller's Boardroom Accountability Project Campaign 2.0[1]. Boards are frequently being pressured not only to become more diverse, but also to expand the definition of diversity to include gender, race, ethnicity, age and thought.

"We may see the needle of diversity move significantly in 2018—and in the right direction—in the boardroom," states Deb DeHaas, vice chairman, chief inclusion officer and national managing partner, Center for Board Effectiveness, Deloitte. *"Diversity in the boardroom demonstrably enhances discussions, contributing to stronger oversight and performance."*

The more intense focus on board composition also may increase boardroom discussions on refreshment practices, including term, age, and average tenure limits. It may also result in a richer process for board and committee assessments, including whether to expand the assessment process to include individual directors.

Innovation and disruption

The last few years have seen unprecedented levels of disruption arising from technological innovation across all industry sectors. The board often has a significant role to play in this new "disrupt or be disrupted" environment, regardless of whether or not directors are well versed in technology and innovation. The board can support management's innovative strategies and can execute traditional board responsibilities in a way that supports those strategies, such as considering director candidates with specific skill sets that support innovation; the board can also act as an instigator, challenging management to be more innovative.

"Board members can help the company's management team to plot the right course by assessing whether a company's innovation strategy is ambitious enough," says Henry Phillips, vice chairman and national managing partner, Center for Board Effectiveness, Deloitte & Touche LLP. *"Effective boards can advise companies to take appropriate steps that can help to achieve and sustain long-term success."*

Management can bring innovative ideas to the board, highlighting what has been decided upon and why, as well as what ideas were rejected, engaging the board in in-depth discussions on the risks of action and inaction.

Social impact

There has been a paradigm shift in recent years in which the fundamental purpose of the US corporation, to enhance shareholder value, has expanded to add the impact a company has on other constituencies, such as customers, investors, vendors, employees and the communities in which the company operates—including the global community. One aspect of this change is a new emphasis on sustainability; this encompasses a broad range of issues from environmental concerns to a focus on human capital intended to assure that a company has the workforce necessary to succeed in the future.

Boards often have significant responsibilities in overseeing whether and to what extent their companies "pivot" from the traditional corporate role to a newer, more socially responsible role.

"Companies are increasingly aware that what is socially good for brand is good for business, and conversely, that what is socially bad for brand is bad for business," said Debbie McCormack, managing director, Center for Board Effectiveness, Deloitte LLP. *"Boards need to consider their company's social impact strategy, to help determine if and/or when to launch or enhance socially responsible activities."*

As management is responsible for developing and implementing the strategy, the board's oversight role includes discussing the company's impact on the local and global community. Oversight also includes how management is assessing the risks arising from the nature and extent of any social responsibility/sustainability initiatives to be undertaken by the company.

Technology risk

Board members continue to confirm that technology risk will be on every company's boardroom agenda in 2018. Companies cannot shun the use of technology, as it has become a major driver of performance, growth and disruption across industries. However, the number and nature of technology-related risks sometimes seem limitless—ranging from hacking incidents to reports that algorithms using artificial intelligence have resulted in the posting of false reports on social media platforms.

The nexus of technology and board composition is often a current topic among boards, with some suggesting boards should add technology expertise to properly address technology risks, while others recommend adding board members who may better understand technology.

"Fourteen percent of respondents told us they added a director with cyber experience to the board in the past two years[2]," says Ed Powers, national managing principal, Cyber Risk Services, Deloitte & Touche LLP.

To the extent that technological expertise is called for, boards can also acquire such

1. https://comptroller.nyc.gov/newsroom/press-releases/comptroller-stringer-nyc-pension-funds-launch-national-boardroom-accountability-project-campaign-version-2-0/; September 8, 2017
2. 2016 Board Practices Report, page 50

expertise by engaging outside advisers. However, regardless of expertise, board members can continue asking questions, challenging assumptions, and urging management to deal with technology, both as a resource to innovate and disrupt, and as a risk.

"Boards will continue to need to evolve and learn as they address the ever-changing risks related to technology," says Powers.

Corporate culture

In recent months, not a day seems to pass without the media focusing on a new or continuing scandal involving corporate culture, and the spotlight often hones in on the question mentioned earlier: "Where was the board?" For many years, boards have been reminded of their role in setting the "tone at the top," and numerous judicial opinions have noted the board's oversight role for corporate compliance. However, the current focus on culture is new in both kind and degree, and boards need to consider this all-important responsibility.

Corporate culture failures have led to a number of adverse impacts, from the termination of senior leadership to the sale or break-up of the company or, at a minimum, reputational damage. Directors should be mindful of their roles in this matter, including that their behavior will be noted and, possibly, judged by employees, customers, suppliers, shareholders and the community. The risk of inaction, particularly when senior executives are involved, may be viewed as acceptance of poor or unacceptable behavior.

"Culture is an off-balance sheet asset that merits serious oversight by the board," says Carey Oven, national managing partner, Modernizing Compliance and Culture Risk, Deloitte & Touche LLP, *"lest it becomes a significant liability, negatively impacting the bottom line."*

Perennial items on the boardroom agenda

Strategy

Overseeing the development and implementation of strategy is one of the board's primary responsibilities—possibly its most important responsibility, along with CEO succession planning. Particularly in today's environment of exponential change, the role of the board in guiding the company's CEO and management team on the company's strategic path is critical and can be demanding. With the continued debate about short-term results vs. the long-term growth and sustainability, companies need to be prepared with defined short-term strategic objectives that are aligned with the longer-term company vision.

For boards to be "strategic assets" to their companies, boards should consider whether to refresh their strategic oversight role and process, the information they receive from management with regard to strategy, and the risks, key performance indicators and key metrics to be monitored and discussed at each board meeting.

Boards, as a diverse group of highly experienced individuals who can provide an "outside–in" view and broader perspectives, can be essential partners in achieving strategic resiliency with management. The role and value of the board in guiding strategy is gaining recognition.

"Arguably, every topic on the board's agenda ties back to the company's strategy," says Maureen Bujno, managing director, Center for Board Effectiveness, Deloitte LLP. *"The key is having a board that is well-informed, actively engaged, and is able to work with the management team to advise and guide—including recognizing when the company's strategy needs to pivot. To provide such insight, boards need to understand and assess progress against the company strategy on an ongoing basis."*

Risk

The board's oversight responsibility with respect to risk may be its broadest role. First, oversight of risk—including determining risk tolerance, and risk mitigation—permeate literally everything the board does; in fact, it can be argued that no board action should be taken without considering the risks involved. For these reasons, the use of enterprise risk management, or ERM, has been questioned because it suggests that risk is a separate issue rather than one that is integral to everything the board does.

A second factor suggesting that risk oversight may be the board's broadest role is the recognition that there are many types of risk. As a result, while the audit committee may nominally be tasked with risk oversight, it has become increasingly clear that some types of risk "belong" to other committees, and some should more properly reside with the full board. Thus, while the audit committee should properly oversee financial reporting risk, among other things, there are risks associated with ill-advised compensation plans that should be overseen by the compensation committee, brand reputation risks that may best reside with the board, and so on.

"A company's risk appetite and tolerance should be reviewed periodically," says Tonie Leatherberry, board relations leader, Deloitte Risk and Financial Advisory, Deloitte & Touche LLP. *"This will help determine if there are specific risk areas that need more detailed board oversight, which risks to assign to specific committees, and which risks should be addressed by the full board."*

Compensation

Compensation is often a perennial item on the boardroom agenda; as a famous investor once said, "CEO compensation is the acid test for corporate governance reform[3]." However, like other perennial agenda items, the compensation issues that most concern the

3. Heritage Institute, 2007 & 2008

board and/or the compensation committee often vary year to year. In 2018, the issue generating significant boardroom focus will likely be disclosure of the ratio of CEO total pay to that of a median employee.

The CEO pay ratio rules adopted by the SEC under the Dodd-Frank Act become effective for the 2018 proxy season. While the SEC's rules and interpretive guidance implementing the Act significantly eased the compliance burdens, many corporations still view the requirement as burdensome without providing useful information to investors. And for many companies, the biggest source of concern has become the disclosure of the median employee's pay, as workers who are paid below the median may believe they are underpaid, creating a potential for significant employee relations and communication challenges. In addition, companies reporting low median compensation levels could be open to criticism for not providing employees with a "living wage" or offshoring manufacturing jobs to low-cost jurisdictions.

On the investor front, a survey[4] conducted by ISS indicates that institutional investors are expected to consider the CEO pay ratio as an additional data point when evaluating whether to support a company's Say on Pay vote, but are unlikely to consider it a major factor in their voting decision. Investors may view the 2018 pay ratio as a "base line" to be used in evaluating future pay ratio disclosures (especially if the ratio increases without a strong rationale).

Perhaps reflecting this, ISS's and Glass Lewis' 2018 proxy voting guidelines do not include any specific provisions related to the CEO pay ratio disclosure, and ISS and Glass Lewis have both stated that they will not consider the CEO pay ratio in developing its voting recommendations. Most likely, the proxy advisory firms will include the CEO pay ratio and median employee's compensation in their respective proxy voting reports with little or no commentary.

The media may pour over the disclosures and publish lists by industry and geography, highlighting companies and industries with the lowest median, highest CEO pay ratio, etc. But, these comparisons may have limited value due to the unique composition of each company's workforce and the wide range of assumptions and methodologies used to determine the median employee, which can create a lack of comparability across companies and industries.

"Given the high level of interest in this disclosure, boards should receive updates on the status of the CEO pay ratio calculations and disclosures, gain a high level understanding of the methodology and assumptions used to estimate CEO pay ratios, review the draft proxy disclosure to satisfy themselves that the company has a well thought out internal and external communication strategy to address employee, investor, and media inquiries," says Mike Kesner, principal, Deloitte Consulting LLP. ***"Outliers, in particular, are likely to get the most scrutiny, and boards of those companies should be prepared for potential adverse publicity."***

Shareholder engagement

In the recent past, only a handful of companies engaged with their shareholders; with some exceptions, the only companies that engaged were those that could afford to—generally because of size and resources or because they had great stories to tell—and those that did not engage, could not because they often had "issues" that needed to be explained. That world has changed. Largely as a result of the requirement to conduct "say on pay" votes, many companies of all sizes and across all industries now routinely seek to talk to their investors to support their proxy solicitation efforts and to be comfortable that they have investor support. Some investors are concerned that they are running short on the time available for engagement.

Another sea change in engagement is greater participation by board members. Until the advent of say on pay, the notion of having directors speak to investors was often viewed as an aberration. That is no longer the case; many directors routinely speak to investors, particularly in areas where having management do so could prove awkward, such as addressing concerns with board composition or structure and executive compensation. What was once an aberration is now the new normal.

"Boards and management should consider the nature and extent of the board's role in shareholder engagement," states Bob Lamm, independent senior advisor, Center for Board Effectiveness, Deloitte LLP. ***"Board members have the opportunity to educate shareholders and communicate strengths in governance and other areas along with management."***

Regulatory uncertainty

Regulatory uncertainty often exists and in many, if not all, industries. And, to be technical, it's not just regulation; the uncertainty begins with existing laws and pending legislation that can effect significant changes in those laws, as well as in the regulations adopted or to be adopted under those laws. Moreover, it can take years to resolve statutory and regulatory uncertainties, and the alternatives posed in different versions of pending legislation or regulations call for widely divergent approaches. However, that may not offer much consolation to boards that are conscientiously trying to help their companies to grow and prosper in an era of extreme uncertainty.

"Management can prepare the board through scenario planning, lining up advisers ahead of time and by providing ongoing updates on changes in the regulations," says Krista Parsons, managing director, Center for Board Effectiveness, Deloitte & Touche LLP. ***"Board members can expect management to provide periodic updates on pending regulatory changes and be prepared to ask candid questions about potential implications and readiness."***

4. 2017–2018 ISS Global Policy Survey, September 25, 2017

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