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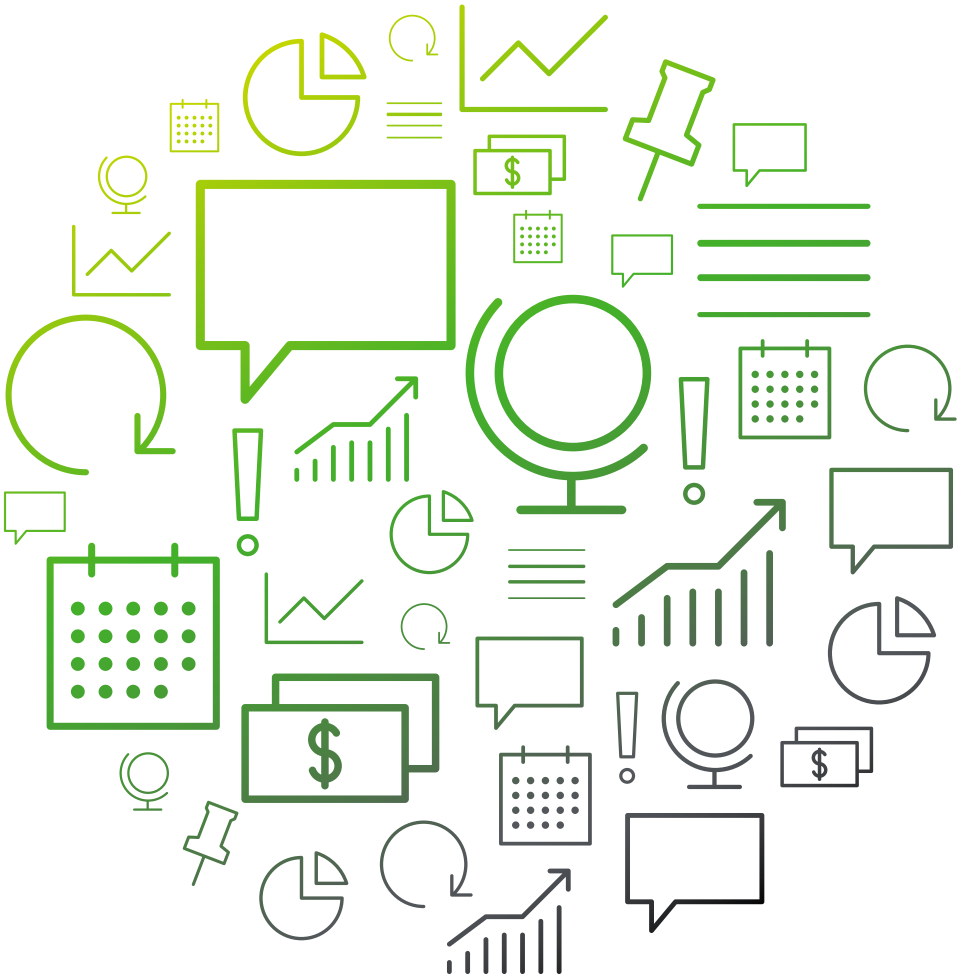

On the board's agenda | US

The 2019 boardroom agenda: Something old, something new?

The end of an old year may cause some to heave a sigh of relief—another year is in the rearview mirror. However, board members and those who work with boards may be looking toward the horizon and wondering what challenges may arise in the coming year. Some challenges never seem to go away, and new ones seem to pop up all the time. Even challenges presumed to be over and done with can return, sometimes in a different guise or with a new twist. And, regardless of whether a challenge is new or old, the board will be expected to deal with it—even if it is something beyond the board's control or outside the scope of its responsibility—because investors, the media and others will ask "where was the board?"

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Board Effectiveness

Board composition

Board composition has been on the boardroom agenda for quite a while, but it has become broader and more complex. Boards are expected not only to have an optimal mix of skills and other qualifications, but also be diverse in a variety of ways, including gender, race, and ethnicity, among other things.

Some progress has been made in board diversity, arguably due to institutional investor pressure. Of the 428 new independent directors joining S&P 500 boards in the year ending May 2018, women comprised 40 percent, and minority women comprised nine percent. Women now represent 24 percent of all S&P 500 directors; 87 percent of S&P 500 boards have two or more women directors (vs. 80 percent the prior year); and 10 S&P 500 boards have 50 percent or more women on their boards. On the other hand, the number of minority men (African-American, Hispanic/Latino or Asian) dropped from 14 percent in 2017 to 10 percent in 2018.[1]

Pressure for increased diversity remains strong. A number of major investors' policies, enhanced in 2018, call for voting against nominating/governance committee members of companies with all-male boards, depending upon the level of engagement with the investor or other factors. And proxy advisors have modified their voting policies accordingly.[2]

Arguably one of the most significant developments in board diversity in 2018 came in the form of a California law requiring public companies headquartered in the Golden State to have at least one female board member, with the number of required female directors increasing over time, depending upon the size of the board. It is unclear whether the law will pass constitutional muster, but for the time being, companies headquartered in California are looking into the impact of the law on their boards. And even if it is held unconstitutional, the fact that a major state has legislated mandatory board diversity may have an impact well beyond California's borders.

For these and other reasons, board composition, including improving diversity, will continue to be a leading item on the 2019 boardroom agenda.

The social purpose agenda[3]

In 2019, boards will almost certainly continue to address "social purpose" issues. These issues cover a broad swath of topics, ranging from climate change to sustainability to corporate culture to pay equity and more.

The current wave of interest in corporate social purpose began in 2016, when shareholder proposals on social issues increased to become the second most prevalent type of proposal. During the 2018 proxy season, this type of proposal constituted 43 percent of all proposals submitted.[4] In addition, throughout this period, several "mainstream" investors have communicated their belief that corporations should have a role in our society beyond a monetary return to investors.

However, investor pressure is not the only driver of the focus on corporate social purpose. First, employee activism is on the rise, with several companies experiencing work stoppages or walkouts to protest company policies and/or actions on various issues. Second, several groups are developing standards to evaluate sustainability performance by corporations.[5] Moreover, companies increasingly recognize that embracing social purpose issues provides a strong value proposition in terms of brand differentiation, talent engagement, risk mitigation, operational efficiency, and access to capital.

As a result of these and other factors, it seems almost certain that corporate social purpose will remain on board agendas in 2019.

Regulatory developments

Audit committees and boards are likely to focus on a number of regulatory developments in 2019. First and foremost is the coming change in auditor reports resulting from rules adopted by the Public Company Accounting Oversight Board (PCAOB).[6] Specifically, beginning in 2019, auditor reports for large, accelerated filers (as determined under rules of the Securities and Exchange Commission, or SEC) will have to include a new section addressing "critical audit matters" or "CAMs." As described by the PCAOB, CAMs are "matters

1. Spencer Stuart 2018 Board Index.
2. See https://www.institutionalinvestor.com/article/b1b4fh28ys3mr9/State-Street-to-Turn-Up-the-Heat-on-All-Male-Boards and https://www.issgovernance.com/iss-announces-2019-benchmark-policy-updates/.
3. For additional information on corporate social purpose, see "On the board's agenda: The board's role in corporate social purpose" (June 2018).
4. See "Shareholder Proposal Developments during the 2018 Proxy Season" at https://corpgov.law.harvard.edu/2018/08/02/shareholder-proposal-developments-during-the-2018-proxy-season/.
5. For example, see "SASB Codifies First-Ever Industry-Specific Sustainability Accounting Standards" at http://www.globenewswire.com/news-release/2018/11/07/1646736/0/en/SASB-Codifies-First-Ever-Industry-Specific-Sustainability-Accounting-Standards.html.
6. https://pcaobus.org/News/Releases/Pages/auditors-report-standard-adoption-6-1-17.aspx.

arising from the audit that required especially challenging, subjective, or complex auditor judgment, and how the auditor responded to those matters." The decision to require CAMs reporting generated considerable discussion, and the impact of such reports is unclear; consequently, audit committees and boards will continue to work with their auditors to assess the nature and extent of CAMs reports.

Audit committees and boards will also be focusing on several new accounting standards that take effect in 2019, and the SEC continues to focus on how companies use so-called "non-GAAP" disclosures.

There are many other areas of potential regulatory activity that boards and their committees may evaluate in the coming year—trade regulations and antitrust enforcement are among them. In addition, the SEC has received suggestions from issuers, investors, and others that the system by which proxies are voted is antiquated and inefficient.

Cyber and other risks

Risk is a perennial topic of board focus, and this focus is likely to increase in 2019. The number and nature of the risks overseen by boards and committees have expanded in recent years to reach virtually all aspects of business, such as brand and reputational risk, strategic risk, and a number of risks associated with technology. The latter category includes innovation and disruption, which can significantly impact companies that choose not to innovate, because they may fall behind disruptive competitors, as well as those that seek to transform their businesses, because they may incur significant losses or worse if unsuccessful.

Perhaps the greatest technology-based risk, however, is cyber risk. Cyber attacks have become increasingly sophisticated and costly; annual global cybercrime costs are expected to grow to six trillion dollars (US) by 2021,[7] and the average cost of a data breach is expected to reach $150 million by 2020.[8] There is no reason to believe that the trend towards more complex and costly cyber attacks will subside. Significantly, cyber risk impacts virtually every aspect of a company's business, including critical relationships with customers, suppliers, regulators, and others, as well as ongoing reputational risks. Cyber risks are also impacting board composition, as nominating/governance committees and boards—as well as congress—consider the advisability of having cyber or technology "experts" on the board. And companies are increasingly aware that cyber resilience—how a company rebounds from a cyber attack and its consequences—is a critical component of addressing the risk. For these reasons and due to their evolving nature, the SEC has continued to emphasize the importance of effectively managing cyber risks and appropriately informing investors about cyber risks and cyber incidents. The SEC has indicated that it will focus on disclosures concerning cyber risk, and the board's role in cyber risk oversight.

Many boards are addressing cyber risk the way they address other challenges—through enhanced oversight, questioning assumptions, and advising management to develop more thorough and robust IT governance.

As they head into the new year, boards will likely need to be even more "risk-intelligent" than has been necessary in the past, including through vigorous enterprise risk management (ERM) programs that can help boards and management alike make more informed decisions on innovation and disruption, as well as other risks.

Culture[9]

Culture has taken on new importance in the wake of recent movements and other developments. In the past, some boards have expressed uncertainty as to how to address culture; after all, directors are only infrequently in company offices, and even then, they tend to be cloistered in boardrooms and nearby offices, making it difficult to know what the corporate culture is like.

That uncertainty is giving way to increased levels of board engagement on the subject. This is happening not only to avoid some of the problems that can result from culture risk, but also in recognition of the fact that a strong, positive culture can have an impact on the bottom line. For example, by enabling a company to become an employer of choice and a company with which others will want to do business.

Many boards are also developing and using improved tools and techniques to help assess and oversee corporate culture. They are using employee engagement surveys to perform baseline assessments of the organization's culture and to periodically reassess how that culture changes over time and in response to various events. They are asking management to provide more information on how it monitors employee conduct and behavior, in order to better foresee anomalies and potential threats and also to drive informed, strategic decisions across business lines.

7. Cybersecurity Ventures, "Cybercrime damages $6 trillion by 2021."
8. Juniper Research, "Cybercrime will cost business over $2 trillion by 2019."
9. For additional information on the board's role in addressing corporate culture, see "On the board's agenda: Corporate culture risk and the board" (April 2018).

Directors are also more capable than ever of performing their own due diligence. Where feasible, such as companies that service the general public, they can and increasingly do visit company locations to assess first-hand how employees behave and interact with customers. They can access websites on which employees post their views and opinions about their employers, to determine the nature and extent of dissatisfaction with corporate culture and behaviors. And they are doing occasional "deep dives" using tools that have been in place for years, such as listening to actual recordings of messages left on corporate hotlines, rather than summaries of messages, to assure that the summaries they receive accurately reflect the substance and tone of the messages.

Boards are also taking responsibility for their own culture in and around the boardroom. Do directors treat each other with respect? Do they encourage healthy debate and discussion? When they are not in the boardroom, do they treat employees with courtesy and seek to engage them?

The focus on culture—both inside and outside the boardroom—is likely to continue and grow with the new year.

Compensation

Compensation may well be the longest-standing item on boardroom agendas, and it shows no signs of being eclipsed as perhaps the pre-eminent item on the boardroom agenda. And in 2019, there are a number of compensation issues that may present challenges for directors, such as:

- **CEO pay ratio disclosure.** 2018 was the first year in which companies were required to disclose the ratio of CEO pay to that of a "median" employee. While these disclosures generated some media attention, they did not appear to generate interest from major institutional investors. That may change in 2019 as comparisons to the prior year ratio may generate questions. For example, executive bonuses for 2018 may be higher due to the strong economy, causing pay ratios to rise, while company stock prices may be lower. In addition, some are calling for more disclosure around pay ratios; in November 2018, a group of institutional investors sent a letter to the boards of the Fortune 500 companies asking for supplemental pay ratio data, such as the geographic location and job function of the "median employee" and a breakdown of the workforce by job function and/or business unit.

- **Pay equity.** Investors and other groups are raising questions about gender and ethnicity pay gaps, and there are indications that this is going to be a major topic of shareholder proposals in 2019.

- **Severance pay for "bad actors."** Recent incidents have raised interest in whether companies are paying severance to executives and others who have left due to violations of company policy, including inappropriate behaviors and, where severance has been paid, why.

- **Director compensation.** Director pay, which in the past has generated little attention or interest, has become something of a hot button due to large payouts resulting from rising stock prices. As a result, many boards have been examining their pay packages and considering caps on pay and other devices to minimize concerns.

- **Tax changes.** As a result of changes to Internal Revenue Code Section 162(m), compensation, the ability to deduct compensation paid to "Named Executive Officers," has been significantly limited, even if it is "performance-based." Compensation committees and boards may want to consider changing their compensation plans or metrics to reflect this change.

Wrapping it up

The topics included in this publication are just some of the items that will likely be on the boardroom agenda for 2019. Other perennial agenda items are sure to be on agendas as well and, given the rapidly changing governance and political environment, it is likely that new matters will come to the fore. In other words, serving on a board of directors will continue to be a challenging role in 2019.

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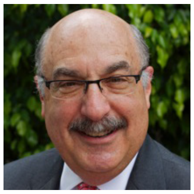

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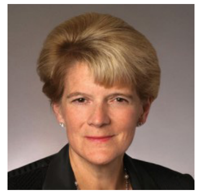

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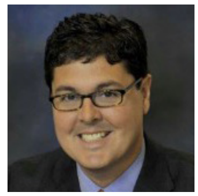

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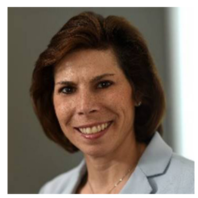

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