2019 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

A publication of the National Association of Corporate Directors and Partners

Baker Tilly Ceres Deloitte Spencer Stuart

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Baker Tilly
Ceres
Deloitte
Spencer Stuart

ABOUT THIS REPORT

The *2019 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 2019, and follows with four partner contributions that provide distinct insights and projections on the following themes: business risks, climate change, M&A, regulatory priorities, and board composition and succession.

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 *2019 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2019 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

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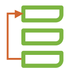
Executive Summary

Key Projections



Board Projections

NACD

- Directors struggle to keep up with a rapidly evolving business landscape. For the second year in a row, NACD's public company governance survey finds that a large majority of directors, almost 70 percent, report that their boards need to strengthen their understanding of the risks and opportunities affecting company performance.
- According to a 2018 NACD poll, 62 percent of board members also view atypical or disruptive risks as much more important to the business environment today as compared to five years ago.

"Boards have a major opportunity to become better sense makers to management in this disruptive environment. Their diverse experiences and distance from day-to-day operations can be a significant aid in helping management to see around corners and recognize new linkages between risks."

Business Risks

BAKER TILLY

- International trade and tariffs, tax reform, cybersecurity, and privacy are key risks that affect boards and organizations from financial, operational, regulatory, technological, and reputational perspectives.
- As boards face mounting pressure from investors and other stakeholders to demonstrate proper oversight of these risks, directors should ensure that their organizations are prepared for regulatory compliance, understand the impact of these risks, and have in place a comprehensive monitoring program.

"Trade pressures can represent a great opportunity to increase the resilience and adaptability of a business. Doing so requires a deliberate choice: become proactive in driving a company's outcome in light of global complexities that, when properly addressed, can further position the business for global growth and operational prowess in both the near and long terms."

Climate Change

CERES

- Although investors are increasingly focused on the impact of climate change on long-term value creation—climate change was the top ESG issue for investors in the 2017 and 2018 proxy seasons—few boards are prioritizing this issue as a critical risk for their companies.
- As climate-related events become more frequent and severe, the business case is likely to become more clear for boards and their management teams.

"Directors should have management assess whether climate change has a material impact on the unique circumstances of their businesses, and, if so, how this impact could be integrated into corporate strategy. This assessment should consider the viewpoints of critical stakeholders, including the investor community, on risks and opportunities."

M&A

DELOITTE

- Data from 2018 find that cross-border mergers and acquisitions activity, as of September, is moving at a pace that matches, and can potentially exceed, 2015's record.
- To effectively prepare their companies for future mergers or acquisitions, it's critical for directors to leverage insights from previous deals and utilize established practices for reviewing M&A proposals. The following actions are recommended: enhance the deal process, explore multiple potential scenarios, strengthen technology expertise, and cultivate an understanding of global dealmaking.

"Rebounding deal-making activity and the highly visible nature of deals combined with the increasing confidence of management teams who view their deals as regularly "hitting the mark" point to the need for boards to assert their objectivity and to apply their experience when evaluating and approving potential transactions."

Regulatory Priorities

DELOITTE

- Since 2017, the SEC has made facilitating capital formation, while maintaining appropriate investor protection, a key priority. This is likely to be an important area of focus for the commission in 2019, so as to encourage more private companies to go public.
- Cybersecurity disclosure is also increasingly on the SEC's radar. This year, the commission released updated guidance urging public companies to inform shareholders of material cybersecurity risks. The SEC is also emphasizing a less burdensome disclosure regime, as well as the implementation of new accounting and auditing standards.

"Boards will need to stay vigilant and ensure that there are adequate policies and mechanisms in place to keep directors informed of these regulatory developments, and they will need to understand how management intends to address them."

Board Composition and Succession

SPENCER STUART

- Board succession has become a key priority for investors. Increasingly, shareholders expect boards to have effective processes in place to evaluate board performance and refreshment. Diversity is a critical part of this, as shareholders pressure boards to ensure that they have the right mix of skills, perspectives, and tenures to execute the company's strategy.
- The following trends in board composition are likely to accelerate in 2019: modest director turnovers, driven by term or age limits; increased recruitment of more diverse and nontraditional candidates; and a greater number of young directors in the boardroom.

"The stakes for having the right people around the boardroom table have never been higher. Directors need to have the skills and experiences that not only align with their company's long-term strategic direction but also enable their boards to effectively advise management amid unprecedented change and business disruption."

Making Sense of Disruption

Public Company Board Projections for 2019

By Friso van der Oord, NACD

No company is immune to disruption, and change, especially in technology, is now exponential. At least so goes the conventional wisdom about today's business landscape that dominates media headlines, business conference themes, and very often board agendas. Many directors now express fear that their companies will be disrupted, rather than becoming the disruptors.

It's therefore no surprise that for the second year in a row, according to results from the *2018–2019 NACD Public Company Governance Survey*, a large majority of directors, **almost 70 percent**, report that their boards need to strengthen their understanding of the risks and opportunities affecting company performance. They believe that their boards struggle to keep pace with fast-moving developments that can create or destroy business value. In a 2018 NACD poll, **62 percent** of board members said that they view atypical, disruptive risks as much more important to the business environment today as compared to five years ago (and none said that they were less important).[1] In the same poll, only **19 percent** of board members reported that they are either extremely or very confident in management's preparedness to address atypical, disruptive risks, while an overwhelming **82 percent** of them indicated that they were either extremely or very confident in management's ability to address known risks.

In this short outlook piece, we will explore key board projections for 2019 about the most disruptive trends affecting businesses. We will offer nuance around these projections, recognizing that change is not uniform across industries, that disruption offers both risks and opportunities, and that directors should not expect to become experts in each new disruptive trend. Rather, we believe that boards can successfully adapt their oversight practices to help management better anticipate and respond to disruption.

TOP 2019 TRENDS BY SELECTED INDUSTRY SECTOR:

- **Energy:** geopolitical volatility, regulatory change, key talent deficits, and economic slowdown
- **Financial Services:** cybersecurity threats, economic slowdown, regulatory change, technology disruption, and industry consolidation
- **Industrials:** geopolitical volatility, economic slowdown, supply-chain disruptions, and key talent deficits
- **Consumer Discretionary:** change in consumer behaviors, economic slowdown, business-model disruptions, cybersecurity threats, and technology disruption.

Key 2019 Projections

1. **Boards have concerns about less controllable, exogenous risks**. Public company directors rate shifting economic and political developments as major trends that will affect their companies next year. In the *2018-2019 NACD Public Company Governance Survey*, almost **50 percent** of them rank changes in the regulatory environment and the threat of an economic slowdown in 2019 as the top issues which have the greatest potential for impacting their organization. **Regulatory change** itself may not invariably be negative, as some industries have benefited from deregulation over the last year. Yet companies are bracing for the effects of proliferating cybersecurity and data-privacy rules as regulators play catch-up in overseeing the digital economy and executives are anxious about the costly compliance impact of a still-pending Brexit deal. See page 6 for projected 2019 regulatory developments.

[1] Data from an NACD member poll on board oversight of atypical risk, conducted via email, March–April 2018.

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

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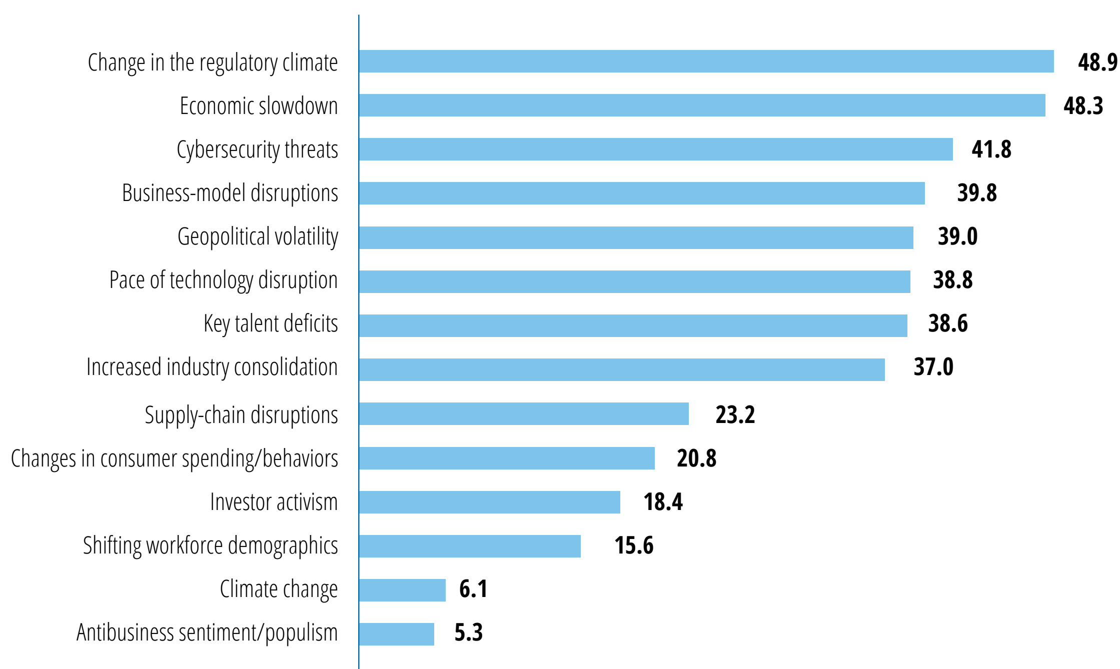

A looming **economic slowdown in the United States** after a long period of expansion is also raising uncertainty. Inflation and interest rates are rising, and stock market volatility is up, triggering questions about whether major market corrections might be near term. Moreover, the recent economic gains have not addressed fundamental concerns about growing income inequality in the United States and other countries. And there is a risk that these economic divisions, both within and between countries, may worsen when the technology revolution accelerates and more jobs are displaced due to automation.

Geopolitical volatility is also projected to be a top-five trend over the next 12 months for almost **40 percent** of corporate directors. A more detailed look at director views of geopolitical issues reveals significant concern about the repercussions of escalating global trade conflicts and domestic political volatility in the United States—issues with which many management teams generally lack deep, operational experience.

These macro trends affect many different markets and industries and are amorphous, creating more business uncertainty than many more-traditional corporate risks. Companies may find the combined impact of these forces harder to control than other risk areas. These forces are also more likely to have unforeseen, far-flung consequences.

PROJECTED 2019 REGULATORY DEVELOPMENTS

1. The United States

CYBERSECURITY AND DATA

- The California Consumer Privacy Act, with directives going into effect January 1, 2020, provides California residents greater control over their own data and the right to bring lawsuits against companies that fail to adhere to these privacy standards. Companies must have data-tracking mechanisms in place by the start of 2019 in order to provide consumers with at least 12 months of data when the law becomes effective.[1]
- The Cybersecurity and Infrastructure Security Agency Act creates the Cybersecurity and Infrastructure Agency (CISA) within the Department of Homeland Security, replacing and consolidating previous departments.[2]
- Entities covered by New York's Department of Financial Services' cybersecurity regulation must have a third-party service provider policy in place that conducts a risk assessment of the systems and data used by third parties and what cybersecurity practices are needed to mitigate those risks.[3]
- South Carolina is requiring insurance companies to put written cybersecurity programs and incident-response plans in place by January 1, 2019.[4]
- Data brokers in Vermont will, as of January 1, 2019, need to make disclosures regarding data privacy practices and create written information-security programs.[5]

DIVERSITY

- Effective January 1, 2019, California will require all companies headquartered in the state to have at least one female director (and in some cases a higher number)[6] by the end of 2019.[7]
- According to the bill that led to the law, five other states have passed similar resolutions (though none of those have become law).[8]
- The new Congress is likely to introduce bills mandating public company board diversity. This will spotlight the issue (even if the bills never become law).[9]

ESG

- Academics (Professor Cynthia A. Williams of York University and Professor Jill E. Fisch of the University of Pennsylvania) have sent the SEC a petition for rulemaking signed by investors and associated organizations representing more than $5 trillion in assets. Among other features, the letter calls on the SEC to develop a comprehensive framework requiring issuers to disclose ESG aspects of each company's operations.[10]

TAXES

- In addition to the well-known implications of the 2017 Tax Cuts and Jobs Act, there is also a regulatory change through a new Supreme Court decision in *South Dakota v. Wayfair Inc.* Overturning an earlier decision, the Supreme Court found that states can collect taxes from companies that are not physically present in their states. For Internet-based businesses, this is a regulation to watch.[11]

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[1] Maria Korolov, *CSO*, "California Consumer Privacy Act (CCPA): What you need to know to be compliant," July 30, 2018.
[2] Department of Homeland Security press release, "Congress Passes Legislation Standing Cybersecurity Agency in DHS," November 13, 2018.
[3] Tiffany Quach, Proskauer *Privacy Law Blog*, "New York DFS Cybersecurity September 2018 Deadline," September 3, 2018.
[4] Norton Rose Fulbright LLP, "Data Protection Report."
[5] Ibid.
[6] "(1) If its number of directors is six or more, the corporation shall have a minimum of three female directors. (2) If its number of directors is five, the corporation shall have a minimum of two female directors. (3) If its number of directors is four or fewer, the corporation shall have a minimum of one female director." California Senate Bill No. 826.
[7] DLA Piper, "California Mandates Female Board Directors for Publicly Held Companies," October 2018.
[8] California Senate Bill No. 826.
[9] NACD, *NACD Washington Review Q3 2018*, Oct. 22, 2018.

2. Global

TARIFFS AND TRADE

- The US Trade Representative released a new report critical of China on November 20. This signals no détente in a trade war that has already had impact on import prices and export demand.[12]

CYBERSECURITY AND DATA

- US technology companies may face higher taxes abroad in 2019 due to foreign government policies.[13]
- The United States is proposing tougher rules for investors in transactions involving critical US technology.[14]
- Vietnam's Law on Cybersecurity—similar to China's Cybersecurity Law—goes into effect on January 1, 2019, and poses significant implications for both domestic and foreign companies providing services to customers in Vietnam through the Internet or telecommunications networks.[15]
- The 10 member countries of the Association of Southeast Asian Nations (ASEAN) are creating a framework for cooperating on cybersecurity issues, which may lead to more cross-border collaboration from regulatory bodies in this region.[16]
- India is working to produce its own data privacy legislation in the wake of GDPR through the Personal Data Protection Bill 2018. The bill is said to have borrowed much from the GDPR; however, in addition to its data localization requirements, the bill would give the state unbarred access to personal data in the interest of state security.[17]
- Europe's first wave of enforcement actions is likely after the enactment of GDPR in May 2018. Additionally, the European Union's Directive on Security and Information Systems (NIS Directive)—which went into effect in August 2016 with member states to transpose the law into their national laws by May 2018 (although many countries missed the deadline)—obligates "operators of essential services" (OES) and "digital service providers" (DSPs) in Europe to secure their IT systems and report significant cyber incidents. Organizations identified by individual national laws will need to turn their attention to these cybersecurity requirements after focusing on the privacy stipulations of GDPR.[18]
- Brexit, scheduled for March 29, 2019, will have broad regulatory and compliance implications. While GDPR will serve as the legal standard for data privacy in the United Kingdom until the end of the transition period (currently slotted for the end of 2020), there may be implications for transferring data to the United Kingdom from Europe following the transition period.[19]

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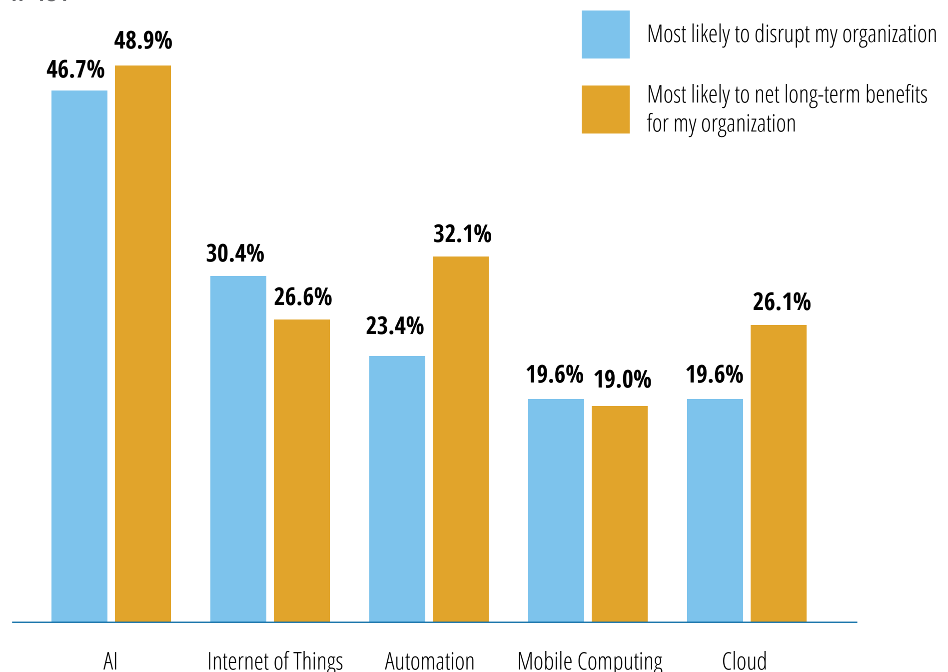
[10] Petition for rulemaking from Williams and Fisch dated Oct. 1, 2018.
[11] *South Dakota v. Wayfair Inc. et al.*, decided June 21, 2018.
[12] Office of the US Trade Representative, *Update Concerning China's Acts, Policies And Practices Related To Technology Transfer, Intellectual Property, And Innovation*, Nov. 20, 2018; Justin Wolfers, "Trump's Tariffs Haven't Really Transformed Trade. Yet.," the *New York Times*, Nov. 21, 2018.
[13] Timothy W. Martin and Sam Schechner, "Facebook, Google May Face Billions in New Taxes Across Asia, Latin America," the *Wall Street Journal*, Oct. 28, 2018.
[14] Kate O'Keeffe, "Treasury Spells Out New Rules on Foreign Deals Involving U.S. Technology," the *Wall Street Journal*, Oct. 10, 2018.
[15] Tilleke & Gibbons, "Vietnam's Controversial New Cybersecurity Law Raises Questions," *Informed Counsel*, Vol. 9 No. 3 August 2018; Mai Nguyen, "Exclusive: Vietnam cyber law set for tough enforcement despite Google, Facebook pleas," Reuters, Oct. 10, 2018.
[16] Charmian Aw and Xiaoyan Zhang, "Southeast Asian nations to form regional framework for cybersecurity cooperation," *Technology Law Dispatch*, Sept. 26, 2018.
[17] Sindhuja Balaji, "India Finally Has A Data Privacy Framework -- What Does It Mean For Its Billion-Dollar Tech Industry?," Forbes, Aug. 3, 2018; Chinmayi Arun, "Three Problems with India's Draft Data Protection Bill," Council on Foreign Relations' *Net Politics Blog*, Oct. 3, 2018.
[18] Yaki Faitelson, "Why The EU NIS Directive Should Be On Your Radar," *Forbes Technology Council* (blog), May 3, 2018; Danielle Kriz and Fred Streefland, "Policy Q&A: The Basics of the NIS Directive," Palo Alto Networks' *Government* (blog), Aug. 13, 2018.
[19] Karl Hemingway, *Password Protected*, "Implications of Brexit on GDPR," Nov. 28, 2018.

2. **Key talent deficit and technology disruptions are seen as major management challenges.** There are a number of disruptors that concern boards greatly, but where their confidence in management's ability to address them is relatively low. Key talent deficits and the pace of technological disruption are both ranked in the *2018–2019 NACD Public Company Governance Survey* in the top half of trends likely to have the greatest impact on organizations, but they rank in the bottom half of board confidence in management's ability to address them. These issues may be particularly challenging for companies to address because they often materialize quickly and unexpectedly, are largely outside of management's control, and may not fit historical patterns. And in the case of technology disruption and key talent deficits, the risks are interconnected, with the growing adoption of emerging technologies amplifying the shortage of skills for critical positions. As a result, boards must evaluate how well management is adapting the company's existing enterprise risk management (ERM) capabilities to anticipate and respond to interdependent risks.

3. **Artificial intelligence is seen as both the biggest technology disruptor and the biggest business enabler**. In the *2018–2019 NACD Public Company Governance Survey*, **47 percent** of directors rate artificial intelligence (AI) as



the biggest technology disruptor, but **49 percent** also regard it as the biggest business enabler most likely to benefit their organizations. And this top ranking of AI is remarkably consistent across respondents from different industries. Boards recognize the transformative power of AI for many dimensions of business, but fear that their organizations, often incumbent companies that struggle to embrace technological innovation, will fail to reap the benefits of AI. Recognizing what's at stake, **50 percent** of boards plan to improve their oversight of digital transformation in 2019.

4. **Climate change is not a critical issue for the next 12 months**. Similar to the results we have seen in our surveys over the last two years, very few boards consider social and environmental issues to be top trends that will impact business performance over the next 12 months. Despite the growing investor and regulatory focus on climate risk, just **6 percent** of respondents in the *2018–2019 NACD Public Company Governance Survey* selected climate change as a top-five trend for the next 12 months. And only **5 percent** indicated that growing antibusiness sentiment will have a major impact in 2019. These results suggest that sustainability concerns are crowded out by short-term priorities. However, directors are certainly not blind to the growing importance of environmental, social, and governance (ESG) related risks and opportunities. In our same *2018–2019 NACD Public Company Governance Survey*, a majority of respondents would like their boards to take action next year: **54 percent** want their boards to improve their understanding of their company's current ESG performance levels and **50 percent** would like their boards to link ESG to corporate strategy.

Adapting Board Oversight in Disruptive Times

No business process can be static in an ever-changing world, and board risk oversight is no exception. In 2018, NACD offered new guidance, a Blue Ribbon Commission report on board oversight of disruptive risk, and a joint white paper with Protiviti on *Strategies for Addressing the New Risk Landscape* to help boards adapt their governance approaches. To prepare directors to deliver effective disruption oversight in 2019, we have selected the most relevant recommended practices from these reports:

- **Ensure management integrates disruption considerations into strategy, performance, and decision making.** Company exposure to disruptive change presents a choice: on which side of the change curve do organizations want to be? For example, organizations need to make a conscious decision about whether they are going to be the disrupter and try to lead as a transformer of the industry or, alternatively, whether they are going to play a waiting game, monitor the competitive landscape, and react appropriately—and in a timely manner—to defend their market share. It is important that the board ground its disruptive-risk oversight with a solid understanding of

Despite the growing investor and regulatory focus on climate risk, just 6 percent of respondents in the *2018–2019 NACD Public Company Governance Survey* selected climate change as a top-five trend for the next 12 months.

Given the pace of change experienced in the industry and the nature and relative riskiness of the organization's operations, does the board understand the quality of the ERM process informing its risk oversight?

the company's key strategic drivers and of the significant assumptions made by management that underpin the strategy. Boards should ask management whether they

- monitor significant risks related to the execution of the strategy and business model and consider the enterprise's risk appetite and risk tolerances in meeting key objectives;
- evaluate the risk-reward balance associated with different strategic alternatives to understand the risks the enterprise is taking on as a result of each alternative for creating enterprise value;
- track the external environment and macroeconomic trends for changes in significant assumptions underlying the strategy and continued relevance of the business model, and evaluate whether disruptive trends exacerbate risk or create market opportunities;
- integrate lead indicators and advanced data analytics into performance monitoring so that it becomes more anticipatory and forward-looking and supports risk-informed decision making and increased accountability; and
- involve the board in key decisions—e.g., acquisitions of new businesses that could offer access to disruptive technologies, entry into new markets, digital transformation initiatives, or alterations of key assumptions underlying the strategy—and invite challenge and open discussion regarding those decisions.[2]

- **Assess the continued effectiveness of the risk-management program.** Given the pace of change experienced in the industry and the nature and relative riskiness of the organization's operations, does the board understand the quality of the ERM process informing its risk oversight? How actionable is management's risk information for decision making? Does ERM effectively capture and assess early warning signals that indicate more unusual or disruptive risks on the horizon? These and other questions focus on the robustness and maturity of the risk-management process. Directors should ensure that the critical attributes of risk-oversight excellence are present:
  - Critical and potentially disruptive enterprise risks are differentiated from the day-to-day risks of managing the business so as to focus the dialogue on the risks that matter to the C-suite and the board.
  - Accountability is established for both traditional and disruptive risks and clearly embedded in the lines of business and core processes.
  - Actionable new risk information is not only reported up but also widely shared to enable more informed decision making.
  - An open, positive dialogue for identifying and evaluating opportunities and risks is encouraged. Consideration should be given to reducing the risk of undue bias and groupthink so that adequate

[2] NACD and Protiviti, *Is Board Oversight Addressing the Right Risks? Strategies for Addressing the New Risk Landscape* (2018), page 16.

attention is paid to differences in viewpoints that may exist among different executives.
  - Advancements in the application of new technologies—including AI, machine learning, mobile technologies, advanced data analytics, and visualization techniques—are used by the organization to strengthen risk prevention, detection, and mitigation.[3]

- **Improve the visibility of disruptive risks in board-management discussions.** In an NACD poll earlier this year, **53 percent** of directors cited the lack of information from management as a key barrier that either somewhat or to a great extent hindered effective oversight of atypical, disruptive risks.[4] The 2018 Blue Ribbon Commission report highlights the fact that lots of valuable information about exposure to disruptive risks already exists within companies, but doesn't always reach senior management and the board on time. The report recommends a number of concrete steps to improve management's reporting to the board:
  - Better leverage the internal audit team to share insights about potentially disruptive risks. They possess a wealth of independent information about possible exposures and red flags.
  - Periodically review the format and content of risk reports to ensure they provide sufficiently forward-looking views of potential risks, including new patterns and linkages between different types of risks.
  - Ensure management reporting considers independent, external data about the company's risk profile and evolving environment.
  - Frequently evaluate the current protocols for escalating information to the board. Do processes established to ensure the proper and timely flow of information to the board keep pace with changes in the business and risk environment? Are reporting thresholds clearly established and well understood?[5]

- **Invest in the skills—within the organization and on the board itself—necessary to successfully navigate disruptive risks.** Directors express doubts about the readiness of their own boards to provide effective oversight of disruptive risks: **74 percent** of respondents to NACD's online poll held in 2018 reported that lack of board knowledge hinders oversight of disruptive risk to at least some extent.[6]

The 2018 Blue Ribbon Commission report highlights the fact that lots of valuable information about exposure to disruptive risks already exists within companies, but doesn't always reach senior management and the board on time.

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[3] NACD and Protiviti, *Is Board Oversight Addressing the Right Risks? Strategies for Addressing the New Risk Landscape* (2018), page 15.
[4] Data from NACD member poll on board oversight of atypical risk, conducted via email, March–April 2018.
[5] *The Report of the NACD Blue Ribbon Commission on Adaptive Governance: Board Oversight of Disruptive Risks* (Arlington, VA: NACD, 2018), pages 19–20.
[6] Data from NACD member poll on board oversight of atypical risk, conducted via email, March–April 2018.

Directors' diverse experiences and distance from day-to-day operations can be a significant aid in helping management to see around corners and recognize new linkages between risks when considering them in the context of the organization's specific circumstances, strategic assumptions, and objectives.

The 2018 Blue Ribbon Commission report outlines a number of action steps:

- Ensure that the selection and evaluation criteria for the CEO and other senior leaders focus on disruption and resiliency, including success in the following areas:
  - Leading the development of ideas and insights about future trends and opportunities
  - Problem-solving and executing successfully in uncertain situations
  - Openness to alternative points of view and early-stage ideas as well as willingness to question assumptions (one's own, and those of others)[7]
- Strengthen board oversight of the talent strategy by discussing how disruptive risks factor into the organization's human capital plans and whether leadership development, compensation, and reward systems reflect the realities of a rapidly changing operating environment.[8]
- Establish requirements for ongoing learning by all directors and incorporate them into the board-evaluation process. Directors need to invest in continuous learning and development in order to grasp the company-specific impact of disruptive new risks and opportunities and to maintain an independent, well-informed point of view about the business and industry. Nominating and governance committees should ask directors to provide updates about how they are taking a proactive approach to ongoing learning.[9]

In sum, boards have a major opportunity to become better sense makers to management in this disruptive environment. Their diverse experiences and distance from day-to-day operations can be a significant aid in helping management to see around corners and recognize new linkages between risks when considering them in the context of the organization's specific circumstances, strategic assumptions, and objectives.

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[7] *The Report of the NACD Blue Ribbon Commission on Adaptive Governance: Board Oversight of Disruptive Risks* (Arlington, VA: NACD, 2018), pages 15–17.
[8] *The Report of the NACD Blue Ribbon Commission on Adaptive Governance: Board Oversight of Disruptive Risks* (Arlington, VA: NACD, 2018), page 17.
[9] *The Report of the NACD Blue Ribbon Commission on Adaptive Governance: Board Oversight of Disruptive Risks* (Arlington, VA: NACD, 2018), page 18.

2019 Strategic Risks for Boards

By Chris Anderson, Joseph C. O'Neill, Raina Rose Tagle, Jeff Jorge, David Ross, and Tom Wojcinski, Baker Tilly

This outlook focuses on four key risks that affect boards and organizations from financial, operational, regulatory, technological, and reputational perspectives. It takes a board-level view of strategic risks that will have lasting impact well beyond 2019 and incorporates the perspectives of industry-recognized experts from a range of fields who have experience with thousands of clients across major industries:

Source: Baker Tilly.

Navigating a volatile international trade and tariff landscape

Trade pressures can become defining moments in the life span of a company. As trade relations evolve, organizations should take the opportunity to strategically rethink and adjust operations and thereby minimize the impact of import duties and tariffs on profit margins. Boards must confirm their organizations' ability to monitor and act upon the changing landscape of import duties and tariffs to remain competitive and agile for the long term.

The impact of rising trade tensions and increased tariffs can span generations. For example, more than 60 years ago, Germany, France, and the United States engaged in tariff disputes, the effects of which remain today—a 25 percent tariff on imported light passenger trucks is still in force.

The optimal approach during a volatile trade period is to be proactive. When it comes to trade and tariff strategy, organizations must think both short and long term. The best way to manage through this is to leverage trade to boost business. Start with asking your management team the following questions:

- Do we possess the right tools to assess, prepare, and take action on tariffs related to the importing of items that are inputs to the products that we build and sell to the marketplace?
- Have we explored expanding into foreign markets that are posting greater growth than the United States?
- Do those markets also have a favorable trade-relations trend line with the United States?

Organizations should take the opportunity to strategically rethink and adjust operations and thereby minimize the impact of import duties and tariffs on profit margins.

Many organizations do not use a methodical approach nor do they have the technical depth to break down a product in the supply chain, apply the correct classification, and filter it through customs correctly.

Boards must challenge their management teams to consider a range of strategies that can address negative tariff impacts, including these:

1. **Exclusion** – The Office of the US Trade Representative (USTR) oversees a product exclusion process, which offers organizations the ability to obtain product exclusions from additional tariffs in effect on certain products by completing an exclusion request subject to approval by the USTR. However, since April 2013, of the 25,000 exclusion petitions filed with the US government, less than 1 percent have been granted. While you can attempt to petition for exclusion, it is not the most productive course of action.

2. **Strategic Trade Mosaic**[1] – To navigate the products and markets affected by Section 301 of the Trade Act of 1974, consider how the United States is interconnected with other economies. How can this interconnectedness be leveraged to the organization's advantage when "country of origin" matters for imported items? Evaluate and rethink your product supply chain for potential opportunities in intermediary economies to denationalize the product. Consider these questions:

- Where are your products made?
- Where are the products finished?
- How are the products imported into the United States? Are any of them reexported?
- How can such products be denationalized (i.e., be transformed such that they are deemed to be from a different country of origin)?
- What type of trade relationships currently exist in these economies?

These questions factor into how you determine your supply-chain strategy and can help you identify ways to reduce or eliminate tariffs and trade pressures (even with additional logistical considerations) via an intermediary economy.

3. **Harmonized Tariff System (HTS) Reclassification** – Every product (physical good) is classified with a specific code, known as a harmonized tariff code, which can be interpreted anywhere in the world to describe the product regardless of language. Each relevant code classification or reclassification that comes under violation of the current tariff system could mean a fine of $100,000 *per code*. In addition, a two-year jail term could be possible.

Has your company exhausted its analysis on how to import items into the United States? How do you classify or reclassify materials to best navigate the HTS for any negative tariff impacts? Employing the right strategy and process backed by rigorous data analysis for each classification is critical in case of inquiries or violation review. Many organizations do not use a methodical approach nor do they have the technical depth to break down a product in the supply chain, apply the correct classification, and filter it through customs correctly.

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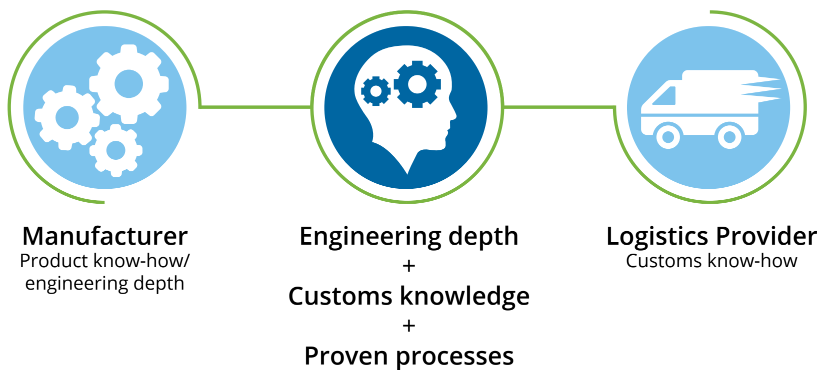
[1] Baker Tilly developed this term and approach.

4. **Integrated Methodology: People, Process, Systems, and Know-How** – From operations, finance, and tax to human resources, legal, and supply chain, a holistic approach offers the company optimal maneuverability and successful outcomes. Boards can provide clear oversight by ensuring that the organization considers all of these elements (people, process, systems, and know-how) in relationship to trade and tariffs and that the organization conducts a regular assessment of issues and opportunities that feed the strategy.



Source: Baker Tilly.

Trade pressures can represent a great opportunity to increase the resilience and adaptability of a business. Doing so requires a deliberate choice: become proactive in driving a company's outcome in light of global complexities that, when properly addressed, can further position the business for global growth and operational prowess in both the near and long terms.

Evolving tax risks domestically and abroad

When considering the Tax Cuts and Jobs Act (TCJA or the Act), subsequent US Treasury Department guidance, and potential legislative technical corrections, boards may find it difficult to determine what the changes may actually mean to their organization and their risk strategy. Tax reform is not the only significant tax risk boards face: the Supreme Court's historic *Wayfair* ruling exposes businesses to a new set of tax compliance issues. While regulatory requirements continue to evolve, the board's role in oversight of risk strategy, including tax risk, can help to ensure navigation of the tax law to achieve the most beneficial impact.

While regulatory requirements continue to evolve, the board's role in oversight of risk strategy, including tax risk, can help to ensure navigation of the tax law to achieve the most beneficial impact.

Executive compensation oversight

The TCJA expanded the scope of the $1 million executive-compensation deduction limitation applied to publicly traded corporations and to non-public companies with publicly traded debt. The Act broadened the covered employee group to include the CEO, CFO, and the next three highest

paid officers, and eliminated the last day of the year requirement. Under the new rules, "once a covered employee, always a covered employee" applies regardless of employee status or death.

The TCJA also eliminated the performance-based compensation exception to the $1 million deduction limitation. However, the changes will not apply to compensation payable under a written binding contract in effect November 2, 2017, provided that the contract is not modified materially after that date. To the extent grandfather relief is available for performance-based compensation, the board should continue to administer the performance-pay awards as it did prior to the TCJA. Recent guidance from the Internal Revenue Service narrowly interprets the applicability of grandfather relief in contracts that include negative discretion.

Boards should adopt the following leading practices related to executive-compensation oversight:

1. Ensure any desired compensation changes are made under a new contract to avoid amending the old grandfather contract.
2. Review and establish a process to monitor compliance of all compensation contracts in existence as of November 2, 2017, to ensure continued qualification with the grandfather rule.

The repercussions of the TCJA reach far beyond the United States.

Key international tax considerations

The repercussions of the TCJA reach far beyond the United States. Because the Act's changes make the US tax system much more attractive for corporations, boards should monitor jurisdictions outside of the US as other jurisdictions likely will take actions to make their tax bases more competitive through a "low-rate, broad-base" business tax strategy.

In preparation for these anticipated changes, boards should consider these possibilities:

Source: Baker Tilly.

State and local tax compliance

The US Supreme Court's momentous decision in the *Wayfair* case opened up a new revenue stream. The ruling sparked a wave of new sales and use tax provisions from states requiring online retailers and other remote sellers to collect and remit sales tax to states in which they do business, without regard for their physical presence. Further, the ruling creates nexus (i.e., sufficient physical presence) in these states for income tax purposes as well. Organizations need to understand their economic nexus footprint and be able to identify states where immediate registration and compliance is required.

Finally, the board should question senior management on the flexibility and nimbleness of the organization's tax structures. In particular, companies should be aware of their debt structure, as new limitations on the deductibility of interest have been enacted as part of the TCJA. From a global perspective, boards should seek to understand the sensitivity of their organization's tax structure—and how the structure may react to potential changes.

The board must stay abreast of tax policy developments and trends domestically and worldwide—and likely will benefit from conferring with subject-matter specialists in this regard—in order to provide strategic, sustainable guidance and oversight for the organization's long-term growth.

Moving board oversight beyond awareness to risk mitigation and cybersecurity assurance

With cybersecurity threats steadily increasing in complexity and a rising demand for transparency and compliance, gaining some level of assurance around cybersecurity appears toward the top of many board agendas. Two industry associations, in particular, serve as champions for board member and director oversight of cybersecurity risks: the National Association of Corporate Directors with the publication of its *Director's Handbook on Cyber-Risk Oversight* and the American Institute of CPAs (AICPA) with the release of the *CGMA Cybersecurity Tool*, "*SOC for Cybersecurity*" and other related guidance on cybersecurity-risk management. As boards continue developing cybersecurity-risk management skills, their oversight focus shifts beyond awareness to assessing their organizations' effectiveness in mitigating cybersecurity risks.

Operational reporting on cybersecurity effectiveness

As boards engage management in cybersecurity risk discussions, directors should expect management to produce reports on the effectiveness of the organization's cybersecurity-risk management program. Management can (and should) collect and analyze relevant performance measures and metrics to determine if cybersecurity safeguards and

The board should question senior management on the flexibility and nimbleness of the organization's tax structures.

controls are operating as intended, and whether any corrective action should be taken to strengthen management's risk-mitigation approaches. While not an exhaustive list, some key processes on which management should report include these:

Asset management. Information technology (IT) departments should have an awareness of authorized devices connected to the organization's network. Management processes should be in place to identify, locate, and remove unauthorized devices on the network.

Incident management. Cybersecurity incidents will happen. Management processes should be in place to readily identify potential incidents and respond/resolve them within established thresholds.

Patch and vulnerability management. Cybersecurity researchers and hardware/software vendors regularly identify vulnerabilities in systems and release patches to better secure the products. Management should regularly apply these patches on a timely basis and report on devices.

Risk management and governance. By now, every organization should have a security policy that defines cybersecurity requirements across the enterprise. Most organizations also approve exceptions to those policies. Organizations with leading cybersecurity management programs institute processes to discuss and authorize new exceptions to the policies and reassess previously approved exceptions.

Independent assurance on the cybersecurity program

Driven by the need for transparency, directors overseeing organizations with complex cybersecurity-management programs or inherently high-risk cybersecurity profiles may seek independent assurance on the effectiveness of the organization's cybersecurity program. Similar to a financial statement audit where the auditor expresses an opinion on the fair presentation of financial reports, independent auditors can express an opinion on an organization's cybersecurity program.

The AICPA established a reporting framework and cybersecurity-risk management program criteria known as SOC for Cybersecurity. Many organizations are considering engaging auditors to prepare a SOC for Cybersecurity report. This report requires management to prepare a

Similar to a financial statement audit where the auditor expresses an opinion on the fair presentation of financial reports, independent auditors can express an opinion on an organization's cybersecurity program.

description of the organization's cybersecurity-risk management program. In such an engagement, the auditor will examine the description and related processes to determine whether it is fairly presented and perform tests on the organization's cybersecurity controls to determine whether they are operating effectively.

A cybersecurity assurance examination addresses several areas including program objectives, risk factors, governance, risk assessment, communication, monitoring, and control implementation, which can provide directors with deeper insight into the organization's current cybersecurity-risk profile and preparedness.

As boards continue to increase their understanding of cybersecurity risks, they must challenge management to provide timely information about the effectiveness of the cybersecurity-risk management program. By regularly reporting performance measures and metrics about key cybersecurity objectives, management can provide a level of assurance to the organization's directors about the performance of the cybersecurity-risk management program. Additionally, regular reports of key data allow directors to observe trends in the cybersecurity program and allow for better governance of the overall cybersecurity function.

As boards continue to increase their understanding of cybersecurity risks, they must challenge management to provide timely information about the effectiveness of the cybersecurity-risk management program.

Elevating privacy risks to the forefront of board agendas

Organizations around the world are still scrambling to comply with the General Data Protection Regulation in the European Union, which went into effect in May 2018. Gartner Inc. predicts that by the end of 2018, more than half of companies affected by the regulation will still not be in compliance.[2] While the data privacy regulatory environment changes rapidly, organizations can take proactive steps to ensure that they stay informed of the existing regulations and of those developing on the near horizon.

Adequate oversight remains a key part of staying on top of data privacy developments. Some regulations specify oversight requirements, and can depend on the type of the organization, the quantity and type of personal data processed, and the locations where operations take place. In many cases, a data protection officer (DPO) must lead the effort. Since the DPO is responsible for overseeing practices related to data protection strategy and implementation, having one in place early on will help ensure that the privacy program is comprehensive and consistent.

[2] News release, Gartner, "Gartner Says Organizations Are Unprepared for the 2018 European Data Protection Regulation," May 3, 2017.

A data privacy program is a process that should be well documented and include records of the organization's efforts and assumptions.

Key tenets of data privacy

A data privacy program is a process that acts as a road map. It should be well documented and include records of the organization's efforts and assumptions. Board members should determine if their organization has begun implementing a data privacy program, and if so, where the organization is in the process. This can be determined by asking the following questions:

TRANSPARENCY

Has the organization taken steps to demonstrate its commitment to protecting personal data?

Are data privacy practices clearly explained in the privacy policy and other public-facing documents?

LAWFUL BASIS OF PROCESSING

Has the organization determined a lawful reason to collect, store, and process personal information?

DATA MINIMIZATION

Are formal data retention schedules developed and consistently followed?

TRAINING AND AWARENESS

Are employees educated on what personal data is and how to handle it?

Are they engaging in data processing activities that could put the organization at risk?

SECURITY CONTROLS

Are appropriate security controls in place to protect personal data?

Are cybersecurity resources adequate, and do they meet or exceed industry standards?

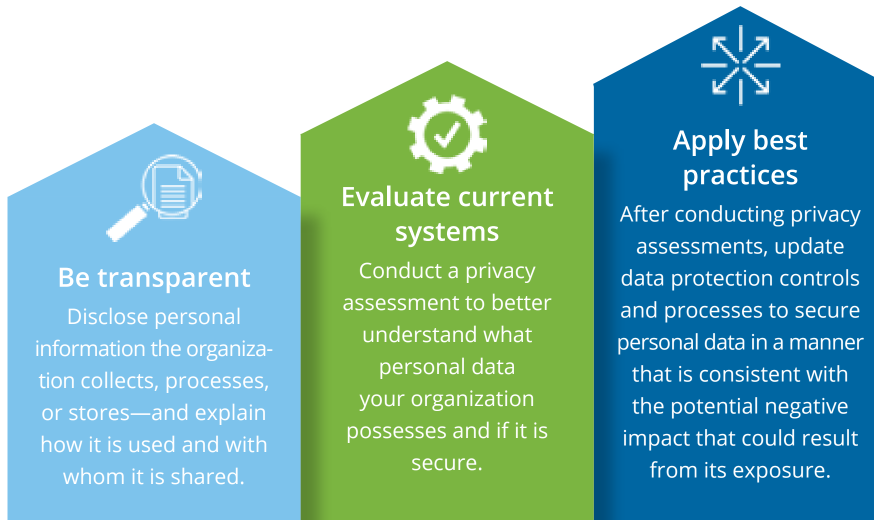
DATA SUBJECT RIGHTS

Is the company prepared for data subjects to exercise their rights?

Could people use privacy as a nonmarket strategy to disrupt the business?

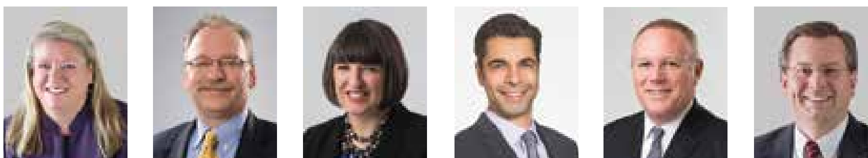
The board's role in data privacy oversight

As awareness of digital privacy around the globe increases, organizations and citizens alike are making more privacy-minded decisions. Now is the best time to start preparing for international data privacy legislation changes with the following steps:



Data protection policies are rapidly changing and developing worldwide. Taking proactive steps with oversight will help your organization to develop a sustainable data privacy program that is ready to adapt to evolving and new regulations.

As awareness of digital privacy around the globe increases, organizations and citizens alike are making more privacy-minded decisions.



Chris Anderson | Joseph C. O'Neill | Raina Rose Tagle | Jeff Jorge | David Ross | Tom Wojcinski

Cris Anderson is managing partner of the firm's growth and specialization, in addition to leading the firm's financial services practice. Joseph C. O'Neill is managing partner of the firm's national tax practice. Raina Rose Tagle is a partner and the risk, internal audit and cybersecurity practice leader. Jeff Jorge is a principal and the international services practice leader. David Ross is a principal and the cybersecurity and privacy growth leader. Tom Wojcinski is a principal with the cybersecurity and information technology (IT) risk practice.

Getting Climate Smart in a Changing Environment

By Veena Ramani, Ceres

Boards should pay attention to the evolution of climate-change risks and opportunities.

1. Introduction

Investors and boards consider environmental, social, and governance (ESG) issues—particularly climate change—in remarkably dissonant ways.

On one hand, investors are more focused than ever on climate change. In 2015, Mark Carney, the governor of the Bank of England and head of the G-20's Financial Stability Board, declared that climate change poses financial risk[1] that threatens the very stability of global financial markets. Nearly 400 investors representing $32 trillion in assets have called on companies[2] to provide disclosure on climate change to help assess this risk. In the last two proxy seasons major asset owners (including BlackRock and Vanguard) helped deliver historic majority votes in shareholder proposals at fossil fuel majors (including Exxon, Occidental Petroleum, and Kinder Morgan), calling on the companies to conduct analyses to understand the impact of climate-change risk on their business.

On the other hand, this message does not seem to be getting through to the majority of corporate boards. In the *2018–2019 NACD Public Company Governance Survey*, NACD found that when directors responding to the survey were asked to choose what top trends they foresee having the greatest effect on their company in the next 12 months, only 6 percent selected climate change as a top-five trend for 2019—unchanged from last year's results.[3]

Given that corporate boards are fiduciaries to their companies *and their shareholders*, it follows that boards should pay attention to the evolution of climate-change risks and opportunities. Being proactive in this way would allow for thoughtful decision making that avoids crises, rather than decision making that reacts to them.

This article explores key trends that corporate boards should keep in mind when overseeing the implications of climate change on their businesses, as well as the effects of these trends on board responsibilities.

2. Projections

The business case for action on climate change will become clearer.

In 2019, the business case for action on climate change will become clearer, as companies deal with the impacts of extreme weather events and take advantage of climate-change-related investment opportunities. The year 2017 featured Hurricanes Harvey, Irma, and Maria among others, leading to a record-breaking $306.2 billion in damages[4] in the United

[1] Mark Carney, "Breaking the Tragedy of the Horizon - Climate Change and Financial Stability" (speech presented before Lloyd's of London, September 29, 2018).
[2] News release, The Investor Agenda, "Nearly 400 Investors with $32 Trillion in Assets Step up Action on Climate Change," Sept. 12, 2018.
[3] NACD, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018). [will insert link at the end of November, when the survey is published]
[4] NOAA Office for Coastal Management, "Hurricane Costs." Last modified Oct. 17, 2018.

States alone. Such "once-in-a-generation" hurricane seasons and other extreme weather events—record heat,[5] wildfires,[6] and floods[7]—seem to be the new normal.

With our global economy, extreme weather events anywhere in the world can impact a company's value chain. Super Typhoon Yolanda, in the Philippines in 2013, was estimated to have a negative effect on the supply chains for 21 percent of US production. A July 2011 flash flood in Thailand forced Honda to reduce its operation days to three per week at its UK plant. In fact, supply-chain disruptions due to climate risk have increased 29 percent since 2012.[8]

Businesses are feeling these impacts. In 2017, 73 companies[9] on the S&P 500 publicly disclosed a material effect on earnings from weather events, and 90 percent felt it was negative.

While the risks are clear, so are the opportunities. A recent Ceres report, *In Sight of the Clean Trillion*,[10] notes that investments needed to stave off the worst effects of climate change will generate tens of trillions of dollars of clean-energy investment opportunities through 2050, and will employ diverse sources of capital. Bloomberg noted that[11] the annual investment in clean energy in 2017 was $333.5 billion, up 3 percent from 2016 and within 7 percent of the all-time record from 2015. Investments in the zero emission and plug-in hybrid vehicle markets alone are projected to be worth $1 trillion by 2030.[12]

Apart from revenue-generating opportunities, an increase in savings can be expected for those companies that make investments in efficiency programs to reduce greenhouse gas emissions. In 2016, 190 Fortune 500 companies collectively reported[13] $3.7 billion in annual savings as a result of energy efficiency programs.

With our global economy, extreme weather events anywhere in the world can impact a company's value chain.

[5] Jason Samenow, "Red-hot Planet: All Time Heat Records Have Been Set All Over the World During the Past Week," the *Washington Post*, July 5, 2018.
[6] Stephanie Ebbs, "'Undeniable Link to Climate Change' in California's Fire Season, Expert Says," ABC News, Aug. 8, 2018.
[7] "Clear and Present Warning: Kerala Floods Match Climate Change Forecasts," the *Hindustan Times*, Aug. 25, 2018.
[8] Ben DiPietro, "The Morning Risk Report: Ignore Extreme Weather Threats at Your Supply Chain's Peril," Dow Jones, Aug. 4, 2017.
[9] Jessica Williams, Michael T. Ferguson, Miroslav Petkov, and Michael Wilkins, *The Effects Of Weather Events On Corporate Earnings Are Gathering Force*, a report from S&P Global, June 11, 2018.
[10] News release, Ceres, "'Clean Trillion' Investment Goal in Sight and Achievable, New Ceres Report Says," May 10, 2018.
[11] Angus McCrone, "The Force Is With Clean Energy: 10 Predictions for 2018," Bloomberg NEF, Jan. 16, 2018.
[12] CDP, "Low Carbon and High Tech Put Auto Sector in Flux," Jan. 18, 2018.
[13] Web page, ceres.org, "Getting Climate Smart: A Primer for Corporate Directors in a Changing Environment," May 14, 2018. Accessed Oct. 29, 2018.

The volume of climate change regulation and litigation will increase. Despite President Trump's 2017 announcement he'd decided to withdraw the United States from the Paris Climate Agreement, we anticipate that in 2019 companies will continue to face regulatory risks from climate change from other nations and subnational jurisdictions.

The rest of the world has reaffirmed its commitment to meet the goals of the Paris Agreement, resulting in rapid growth of climate-change regulations globally. The number of climate-change-related regulations has grown to 1,500,[14] up from 72 in 1997, and this trend is expected to continue. Additionally, a number of US cities and states, notably California, New York State, Seattle, and Atlanta have adopted strong regulations on climate change.[15] In September, California passed a law[16] putting the state on a path to 100 percent carbon-free energy by 2045.

We also anticipate continued growth in litigation on climate change. As of March 2017, there were more than 800 cases[17] filed in the United States concerning the impacts of climate change. While the vast majority of the cases name the government as defendant, a growing number look to hold companies liable for damages associated with carbon emissions. The most prominent of these focus on oil and gas companies. State attorneys general of New York, Massachusetts, and the Virgin Islands launched investigations of Exxon[18] (in New York's case, a suit has been filed)[19] to see if the company has lied to the public about the risks of climate change. In addition, a coalition of cities, states and municipalities have filed civil lawsuits against a number of oil and gas companies over the costs of climate change impacts,[20] including rising sea levels. And a recent legal memorandum[21] warns that the legal basis for many of these lawsuits can extend to companies outside the oil and gas industry.

As of March 2017, there were more than 800 cases filed in the United States concerning the impacts of climate change.

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[14] Policy brief, London School of Economics and Political Science, Columbia Law School, Leeds University, *Global Trends in Climate Change Legislation and Litigation: 2018 Snapshot*, May 2018.

[15] Bloomberg Philanthropies Support, *Fulfilling America's Pledge: How States, Cities, and Businesses Are Leading the United States to a Low-Carbon Future*, Executive Summary, 2018.

[16] Alexei Koseff, "California Approves Goal for 100% Carbon-free Electricity by 2045," the *Sacramento Bee*, Sept. 10, 2018.

[17] Policy brief, London School of Economics and Political Science, Columbia Law School, Leeds University, *Global Trends in Climate Change Legislation and Litigation: 2018 Snapshot*, May 2018.

[18] David Hasemyer, "Fossil Fuels on Trial: Where the Major Climate Change Lawsuits Stand Today," InsideClimate News, Oct. 24, 2018.

[19] John Schwartz, "New York Sues Exxon Mobil, Saying It Deceived Shareholders on Climate Change," the *New York Times*, Oct. 24, 2018.

[20] David Hasemyer, "Fossil Fuels on Trial: Where the Major Climate Change Lawsuits Stand Today," InsideClimate News, Oct. 24, 2018.

[21] Wachtell, Lipton, Rosen & Katz memorandum, John Savarese and Jeffrey Wintner, "Climate Change Litigation Threatens to Spread Beyond Oil and Gas," July 10, 2018.

Voluntary business leadership on climate change will continue, creating peer pressure.

We anticipate that businesses will continue to make voluntary leadership commitments on climate change, in part inspired by the reputational benefits of making such commitments. More than 2,000 businesses—including major US companies like Walmart, Google, Target, and Nike—have reaffirmed their commitment[22] to help meet the requirements of the Paris Agreement. More than 480 companies globally, including nearly a fifth of the 500 largest global companies, have set science-based targets, with 130 new companies making commitments between January and September of 2018.[23] US companies that have made such commitments include PVH, AECOM, Salesforce, and The Kraft Heinz Co., among others. More than 150 global companies, including Royal Bank of Scotland, Sony, and others have committed to sourcing 100 percent of their energy needs from renewable sources.[24]

As the number of large companies acting on climate change has grown, pressure has mounted on their supply chains and their peers to follow suit. Walmart launched an effort in 2018 called Project Gigaton to remove one billion tons of carbon dioxide from its supply chain between 2015 and 2030, citing "brand loyalty"[25] as one of the reasons. The number of companies identified as leaders on engaging suppliers on climate change doubled between 2017 and 2018.[26]

As the number of large companies acting on climate change has grown, pressure has mounted on their supply chains and their peers to follow suit.

Investors will continue to prioritize climate change.

As the business case for action on climate change has become clearer, and the risks of inaction have intensified, we anticipate that climate change will remain an investor priority in 2019.

Climate change continued to be the top ESG issue that investors focused on in the 2017[27] and 2018[28] proxy seasons. While the number of ESG resolutions voted on in 2018 decreased compared to 2017, a big reason for this decline was a record number of withdrawals, as investors reached agreements with companies on actions to be taken. Both proxy seasons also marked the historic majority votes on shareholder proposals on climate change.

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[22] Web page, wearestillin.com, "Who's In." Accessed Oct. 30, 2018.

[23] News release, Science Based Targets, "Surge in Global Business Embracing Climate Science to Navigate Low-carbon Transition," Sept. 13, 2018.

[24] Web page, there100.org, "Companies," Accessed Oct. 30, 2018.

[25] Zeke Turner and Sarah Kent, "How Companies Are Pushing Ahead on Climate-Change Targets," the *Wall Street Journal*, Nov. 16, 2017. Accessed Oct. 30, 2018.

[26] Web page, cdp.net, "Surge in Climate Leadership, as Apple, Honda, Microsoft, & Others Awarded for Tackling Emissions in the Supply Chain," Jan. 29, 2018.

[27] Mark Manoff and Stephen W. Klemash, "2017 Proxy Season Review," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), July 9, 2017.

[28] Meaghan Kilroy, "Environmental, Social Issues Big in Proxy Season," *Pensions & Investments*, July 09, 2018.

We are starting to see a growing number of legislative efforts promoting sustainability disclosures.

Major investors like BlackRock,[29] Vanguard,[30] Fidelity,[31] and State Street have started to signal their focus on climate change as an engagement priority. Close to 300 investors representing $31 trillion in assets under management recently launched a five-year effort to engage the most carbon-intensive companies in the world[32] on their climate-change strategies, governance, and disclosure.

Finally, the investment case is also becoming clear. A recent academic study showed that an investment portfolio with long positions in carbon-efficient companies and short positions in carbon-inefficient companies generated a positive abnormal return of 3.5 to 5.4 percent per year.[33]

The demand for disclosure and board oversight of climate change will grow.

As investors continue to focus on climate change, we anticipate a growing demand for robust climate-change disclosure, particularly financially-relevant climate disclosures that investors can integrate into their analytics. As a part of this call, investors are recommending that companies use standards developed by the industry-led-and-developed Task Force on Climate-related Financial Disclosures[34] (TCFD). Most ESG disclosure frameworks, including the Global Reporting Initiative, Sustainability Accounting Standards Board, and others have updated their approach to be aligned with that of the TCFD.

Additionally, we are starting to see a growing number of legislative efforts promoting sustainability disclosures. Delaware recently adopted a voluntary Sustainability Certification Law[35] requiring participating companies to have their "governing body" approve their approach to sustainability, and to be transparent about these efforts, including through a sustainability report. Senator Elizabeth Warren (D-MA) has proposed a new Climate Risk Disclosure Act[36] that calls upon the US Securities and Exchange Commission to issue new rules on climate risk disclosure, building on their 2010 interpretive guidance.[37]

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[29] BlackRock, *BlackRock Investment Stewardship Engagement Priorities for 2018*, March 2018.
[30] Vanguard, *2018 Investment Stewardship Annual Report*, 2018.
[31] Ross Kerber, "Exclusive: Fidelity May Back Climate Resolutions, a Milestone for Activists," Reuters, May 27, 2017. Accessed Oct. 30, 2018.
[32] Web page, climateaction100.org, "Global Investors Driving Business Transition." Accessed Oct. 30, 2018.
[33] Publication, Stanford University and Yonsei University, *Is 'Being Green' Rewarded in the Market?: An Empirical Investigation of Decarbonization Risk and Stock Returns*
[34] Web page, fsb-tcfd.org, "Task Force on Climate-related Financial Disclosures | TCFD - Homepage." Accessed Oct. 30, 2018.
[35] John Zeberkiewicz, "Delaware's Voluntary Sustainability Certification Law," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), July 15, 2018.
[36] News release, warren.senate.gov, "Warren, Colleagues Unveil Bill to Require Every Public Company to Disclose Climate-Related Risks," Sept. 17, 2018.

Investors are also honing in on the role of corporate boards. The largest public pension funds in the country—CalPERS[38] and CalSTRS[39]—have updated their Global Governance Guidelines calling on portfolio company boards to demonstrate competence in climate change. The Boardroom Accountability Project 2.0,[40] launched by New York City Comptroller Scott Stringer, is focused on the makeup of the boards of the 151 focus-list companies, examining issues such as diversity and climate-change expertise.

3. Major board implications/Questions that boards should ask

Drive the analysis of what climate change means to your business. Directors should have management assess whether climate change has a material impact on the unique circumstances of their businesses, and, if so, how this impact could be integrated into corporate strategy. This assessment should consider the viewpoints of critical stakeholders, including the investor community, on risks and opportunities.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has recently launched guidance[41] on how an organization's enterprise risk management system can be applied to environmental and social risks, such as climate change. Investors are also looking for companies to conduct 2 Degree Scenario analyses, or assessments of how their businesses will be impacted by policies and restrictions consistent with achieving the Paris Agreement. Ceres recently released guidance on how to conduct such analyses in the oil and gas[42] and electric power[43] industries.

Look at your board governance structure for climate-change oversight. Where climate change is identified as having a material impact on the business, boards should examine their oversight structure for climate change with a view to understand whether it allows for the issue to be

QUESTIONS FOR DIRECTORS TO ASK

- Is climate change factored into the materiality analyses that my business runs?
- Is climate change on our risk/opportunity map?
- Does my business assess the financial outcomes of climate change?
- How often is climate change discussed by my board? Does it need to be discussed more regularly?
- Is it valuable to formalize oversight of climate change by the board?
- Are there other ways in which we can ensure and demonstrate that climate change is discussed regularly by the board?

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[37] United States Securities and Exchange Commission, *Commission Guidance Regarding Disclosure Related to Climate Change [Release Nos. 33-9106; 34-61469; FR-82]*, by Elizabeth M. Murphy, Feb. 2, 2010.

[38] The California Public Employees' Retirement System, *CalPERS Governance and Sustainability Principles*, June 18, 2018.

[39] Krista Noonan, CalSTRS news release, "CalSTRS Enhances Corporate Governance Principles with Expanded Board of Directors Accountability Standards," July 21, 2016.

[40] Web page, comptroller.nyc.gov, Office of the New York City Comptroller Scott M. Stringer, "Boardroom Accountability Project." Accessed Oct. 30, 2018.

[41] News release, Committee of Sponsoring Organizations of the Treadway Commission, "Launching Today: New Draft Guidance for Applying Enterprise Risk Management to Environmental, Social and Governance-related Risks," Feb. 7, 2017.

[42] Ceres, *A Framework for 2 Degrees Scenario Analysis: A Guide for Oil and Gas Companies and Investors for Navigating the Energy Transition*, December 6, 2016.

[43] News release, Ceres, "New Ceres Framework Enables U.S. Electric Power Industry to Assess Climate Change Risks and Opportunities," April 10, 2018.

QUESTIONS FOR DIRECTORS TO ASK

- Who is the top-most executive with responsibility for my firm's climate-change performance? To whom does he or she report?
- How does climate change stack up against other priorities for this individual?
- How does sustainability factor into this individual's compensation? What specific metrics are linked to compensation? What is the percentage of pay at risk?
- How is the board's compensation committee engaged in board deliberations on climate change?

discussed regularly and in depth. One option to consider is whether to formalize climate as an explicit board priority. Sixty-two percent of the largest companies in the world[44] and 31 percent of large US companies[45] have formal board sustainability oversight systems.

Consider if your board is "competent" to oversee climate change. Boards should assess whether directors have sufficient expertise to provide informed oversight on an issue like climate change, when it is material. Large institutional investors are starting to call on portfolio companies to make their boards "climate competent," and investors have started to file resolutions calling for companies to nominate climate-competent directors to their board. Only 17 percent of the largest public global companies[46] have even one director with demonstrated expertise in ESG.

What does a board that is competent for climate change look like? Ceres' report, *Lead From the Top*,[47] notes that such a board should have enough knowledge about the issue in question to "be able to ask the right questions, support or challenge management as needed and ultimately make informed and thoughtful decisions." This competence can be achieved by (i) integrating climate change into the board nominations process, (ii) educating the entire board on climate change, and (iii) having the board engage regularly with stakeholders and shareholders on climate change.

Consider how to hold management accountable for climate-change performance. Compensation is a potent lever to incentivize management toward performance on key issues, and where climate change is identified as a material issue for a company, boards should look to how their company's goals and performance on climate change are linked to executive compensation. In spite of the fact that investors are increasingly focused on linking executive compensation and sustainability, only 32 percent of large global companies[48] and 23 percent of large US companies[49] link executive compensation with sustainability issues like climate change.

[44] Ceres, "SYSTEMS RULE: How Board Governance Can Drive Sustainability Performance," May 14, 2018.
[45] Web page, ceres.org, *Turning Point: Corporate Progress on the Ceres Roadmap for Sustainability*, "Governance Key Findings." Accessed October 30, 2018.
[46] Ceres, "SYSTEMS RULE: How Board Governance Can Drive Sustainability Performance," May 14, 2018.
[47] Ceres, *Lead From the Top: Building Sustainability Competence On Corporate Boards*, Sept. 14, 2017.
[48] Ceres, "SYSTEMS RULE: How Board Governance Can Drive Sustainability Performance," May 14, 2018.
[49] Web page, ceres.org, *Turning Point: Corporate Progress on the Ceres Roadmap for Sustainability*, "Governance Key Findings." Accessed October 30, 2018.

Encourage greater transparency on climate change.
With investors increasingly prioritizing climate change as an investment priority, they are also looking for companies to provide financially relevant disclosures on their exposure to climate change. Given the role of the board in overseeing financial disclosures, where climate change is material, boards could encourage thoughtful disclosure of material risks and opportunities, as well as quantified metrics, in the company's financial filings.

Much of the discussion around the issue of climate risk disclosure is being focused on the recommendations of the TCFD.[50] The recommendations detail a governance system and a set of processes that would allow companies to generate meaningful analytics on the impact of climate change on their business, which the TCFD then recommends companies disclose in their financial filings. As of September 2018, 513 organizations have pledged their support[51] of the TCFD.

Conclusion

Companies and their boards now face a growing array of threats to their core business and to their shareholders' investments brought about by multiple manifestations of climate change. At the same time, investors are increasingly concerned about climate change and its risks, and they are stepping up calls for corporate oversight and action.

Corporate boards have a critical role to play in working with management and guiding company action on climate change. Boards should be proactive in order to address this critical challenge and secure their investors' best interests over the long term.

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As part of her role, Veena leads Ceres' 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 work on sustainability disclosure.

QUESTIONS FOR DIRECTORS TO ASK

- Do corporate directors on my board have expertise or experience in climate change?
- How is climate change expertise integrated into the board nominations process? Should it be explicitly identified as a board qualification?
- Are there opportunities to educate the entire board on climate change? What are some of the ways to make expertise on climate change available to the board?
- Do our major investors care about climate change? How often do we talk to them about it?
- How does my company currently disclose risks and opportunities from climate change?
- Should climate change be discussed in our financial filings?
- Has management looked at the TCFD Recommendations and considered whether they are appropriate for our company?

[50] Web page, fsb-tcfd.org, "Task Force on Climate-related Financial Disclosures | TCFD - Homepage." Accessed Oct. 30, 2018.
[51] Web page, fsb-tcfd.org, "TCFD Supporters as of the One Planet Summit September 18." Accessed Oct. 30, 2018.

Mergers and Acquisitions: What Should Boards Expect in 2019

By Larry Hitchcock, Tonie Leatherberry, Joel Schlachtenhaufen, and Russell Thomson, Deloitte

Every year, Deloitte surveys more than 1,000 corporate and private equity (PE) executives about the current state of mergers and acquisitions (M&A) and their expectations for the next 12 months. Presented in the ***Deloitte 2019 M&A Trends report,***[1] *the survey findings—combined with client interviews and insights from Deloitte senior leaders who frequently work with boards on M&A strategy—shed light on potential M&A opportunities and need to get M&A right. In our article, we find that boards may consider four strategies to prepare for future M&A transactions: increase deal review rigor, develop multiple deal scenarios, improve technology proficiency, and apply cross-border deal experience.*

To place 2019 in context, the 2018 global M&A activity as of September is accelerating at a pace that might match or even exceed that of 2015, the high-water mark for global dealmaking over the past 25 years (Figure 1). A Deloitte analysis of Thomson Reuters's strategic M&A deals data indicates that through the end of August, 2018 has already seen $2.5 trillion in deal value across more than 25,000 proposed transactions, lagging behind last year in terms of volume, but indicating an uptick in value. With this context in mind, M&A deal activity and cycles over the past 25 years can provide a strong base of experience for executives and board members to draw upon when evaluating potential deals in the current market.

Drivers of deal activity vary by industry and geographic market; how-

Figure 1.

Global M&A 1990–August 2018 YTD (Strategic deals only

Source: Deloitte analysis of Thomson Reuters's M&A data, as of September 2018

[1] The state of the deal: M&A trends 2019, Deloitte.

ever, given that the United States commonly accounts for 40 to 45 percent of global M&A, based on Thomson Reuters's M&A data, important factors likely include pro-business legislation (such as a repeal of many restrictive regulations which free businesses to pursue growth and expansion for coal, oil and gas, or financial services), US tax reform, and undistributed corporate profits, which have continued to climb since early 2017.[2]

Will 2018's robust deal activity continue into 2019? Based on Deloitte's *2019 M&A Trends Report* of more than 1,000 executives involved in M&A transactions, client conversations, market observations, and analyses, we identified the following trends per Figure 2 below:

Figure 2.

Source: Deloitte's *2019 M&A Trends Report*

What are the implications of these 2019 projections for the corporate boards of directors and management teams that need to get M&A deals right? Activity over the past 25 years provides a significant experience base from which they may draw when considering how to address opportunities and risks associated with proposed transactions.

Activity over the past 25 years provides a significant experience base from which boards may draw when considering how to address opportunities and risks associated with proposed transactions.

Look to the future, learn from the past

Corporate boards and executives pursuing a merger or acquisition—to grow inorganically, to expand in geographic markets, to gain new capabilities, or to block competitors—have a continuing duty to shareholders to optimize value from each deal they undertake. However, Deloitte analyses of Standard & Poor's Capital IQ data for recent transactions by strategic buyers continue to show significant variance in deal outcomes. While

[2] *Undistributed Corporate Profits (UCP) With Inventory Valuation and Capital Consumption Adjustments*, Bureau of Economic Analysis (BEA).

some transactions are remarkably successful, others still lag significantly and continue to diminish shareholder value.

The good news is that some companies consistently exceed estimates used to justify the deals to investors. In our review of Capital IQ data for Fortune 500 companies with the highest total shareholder returns over the past five years, we found that at least eight in the 75th percentile pursued M&A as a core strategy.

Further, stakeholders (particularly investors) evaluate boards and management teams, in large part, based on their ability to build healthy companies that consistently grow profitably. Our analyses of Capital IQ data show that, across a range of industries, companies that acquire effectively typically improve earnings growth in the years following M&A activity.

While trends are moving in the right direction, it is evident that deals do not consistently achieve their expected returns, a fact borne out by our survey participants. Twelve percent of corporate respondents say that a majority of their M&A deals are not generating the expected return on investment. This is down from just under 40 percent in spring 2016. Six percent of PE survey respondents say that a majority of their deals are missing the mark—this is consistent with what respondents reported a year ago and continues the downward trend from a high of 54 percent in spring 2016.[3] Considering the steep rise in deal volume alongside a decline in deal value since 2016 (Figure 1), survey respondents' shifts in answers might stem from increased confidence of more easily being able to extract a return on investment on smaller deals than focusing on fewer larger deals—something that will be interesting to monitor going forward.

While trends are moving in the right direction, it is evident that deals do not consistently achieve their expected returns.

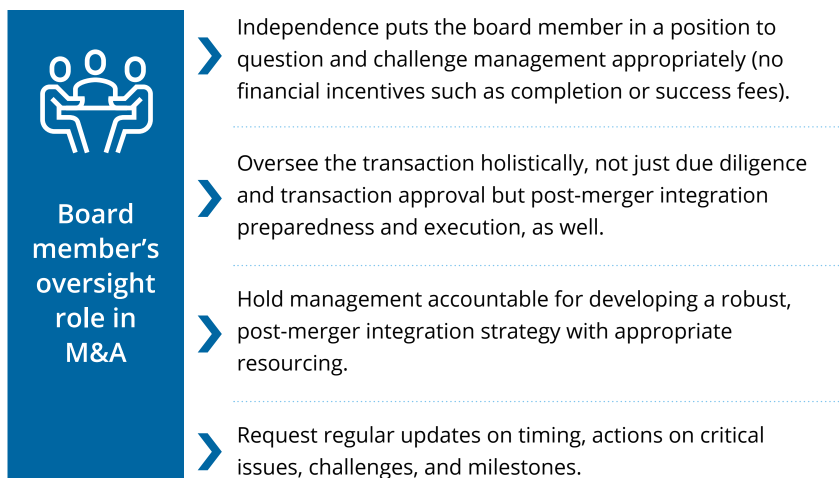
What can boards do to prepare for future M&A transactions? How can they leverage previous deal experience and lessons learned to improve their chances of delivering on expected returns? Many public company boards have established practices for reviewing the growth strategies that management uses when contemplating M&A. Moreover, many companies have policies that specify board review points when pursuing deals that are consistent with the organization's overall direction in strategic plans, capital allocation plans, and annual operating budgets. Our research and interviews with subject-matter experts point to four other recommended actions:

1. Increase deal review rigor
2. Develop multiple deal scenarios
3. Improve technology proficiency
4. Apply cross-border deal experience

[3] The state of the deal: M&A trends 2018, Deloitte.

Increase deal review rigor
Boards have an important oversight responsibility for all phases of an M&A transaction (Figure 3) and, therefore, should be very deliberate in their proceedings.

Figure 3.



Source: Deloitte

However, some board members—who are often recruited for their contacts and deep functional knowledge—lack substantive transactional and/or operational M&A experience, which may cause them to miss potential red flags during the diligence process.

One way boards can increase the rigor of pre- and post-transaction deal reviews is to seek and share back-and-forth input from all involved committees. In addition, a deal playbook can help board members confirm that the committees answer relevant questions. Board members also should have specific deal-related training to support their committee responsibilities. Here are some examples:

- A specific committee could be identified to regularly review a proposed acquisition to determine its fit with approved corporate strategies and long-range growth plans.
- The compensation committee would recommend methods and incentives to retain key talent.
- A specific committee could be identified to review potential cyber risk issues and insist that they be covered in diligence.
- The audit committee would review accounting and financial policy and other factors that may pose reputational risk.
- Some companies have added an independent director with M&A experience to help add oversight expertise to their boards.

Some board members—who are often recruited for their contacts and deep functional knowledge—lack substantive transactional and/or operational M&A experience.

Each deal thesis identifies critical value-creation elements that are anticipated for that transaction. Board members should be educated about these value levers so they can pressure test against them—probe management's thought process and its plan to deliver on each element's anticipated value.

Develop multiple deal scenarios

Boards should consider whether deal reviews should include multiple scenarios. Our experience suggests that management typically presents to the board an acquisition case with clearly stated assumptions pertaining to overall trends, competitive landscape, deal rationale, supporting economic justification, and potential risks. However, it is less common to engage the board in a dialogue that involves multiple scenarios—an approach that can create a richer discussion and a better understanding of the opportunities and risks.

Take for example, a US-based Fortune 500 company that acquired a much smaller business in an emerging market to gain access to customers and new technology for packaging consumer and industrial products. In this case, the rationale was clear and the business case met established thresholds for the internal rate of return so the board approved the deal. However, management and the board members did not engage in a dialogue centered on future scenarios that could affect the viability of the business; for example, a scenario in which the customer base and the business's production locations shifted in response to tariffs—even though these developments were plausible and central to justifying the deal.

When boards review integration plans, a single-scenario approach usually prevails.

Similarly, when boards review integration plans, a single-scenario approach usually prevails: an integration leader presents a time-sequenced plan of activities that cover areas such as combining back-office functions, merging information technology systems, and revising sales incentives to promote cross selling. Here, too, board members can initiate dialogue around multiple scenarios that consider numerous internal and external factors that could impact integration efforts.

Improve technology proficiency

Responses to Deloitte's *2018 M&A Trends Report* revealed a significant change in executives' motivation for conducting M&A: technology had become the top reason for pursuing deals. This finding tracks with corporations' growing adoption of technologies including blockchain, cognitive technologies, and cloud computing. The responses also reflect a decided shift in the ways companies interact with their customers and channel partners, who increasingly rely on smartphones and other digital devices.

A broad range of technology-related considerations may arise during an M&A transaction, which may pose challenges for boards. Examples include these:

- Assessing specific technologies and deciding whether M&A (versus partnering or internal development) is the preferred strategy to address important industry changes
- Determining whether the company can quickly and effectively apply acquired technologies to capitalize on opportunities and whether the technologies offer sustained or only transitory advantages
- Evaluating how the acquiring company can manage talent associated with a technology-based deal so unplanned turnover does not negate the value of the acquisition
- Gauging the risks of pursuing deals with companies whose cybersecurity standards and programs may not be fully revealed until the asset is acquired

One way boards have sought to strengthen their technology proficiency is by recruiting tech-savvy members. Deloitte analysis suggests that only 3 percent of public companies appointed a technologist to newly opened board seats in 2016.[4] Other steps include insisting on technology-specific diligence with a strong commercial dimension (competitive factors, alternate and potential disrupting technology, commercial fit within current organization, etc.), conducting ongoing board member training in technology-related considerations, insisting on a technology chapter in the deal playbook, and engaging advisors with appropriate expertise.

One way boards have sought to strengthen their technology proficiency is by recruiting tech-savvy members.

Apply cross-border deal experience

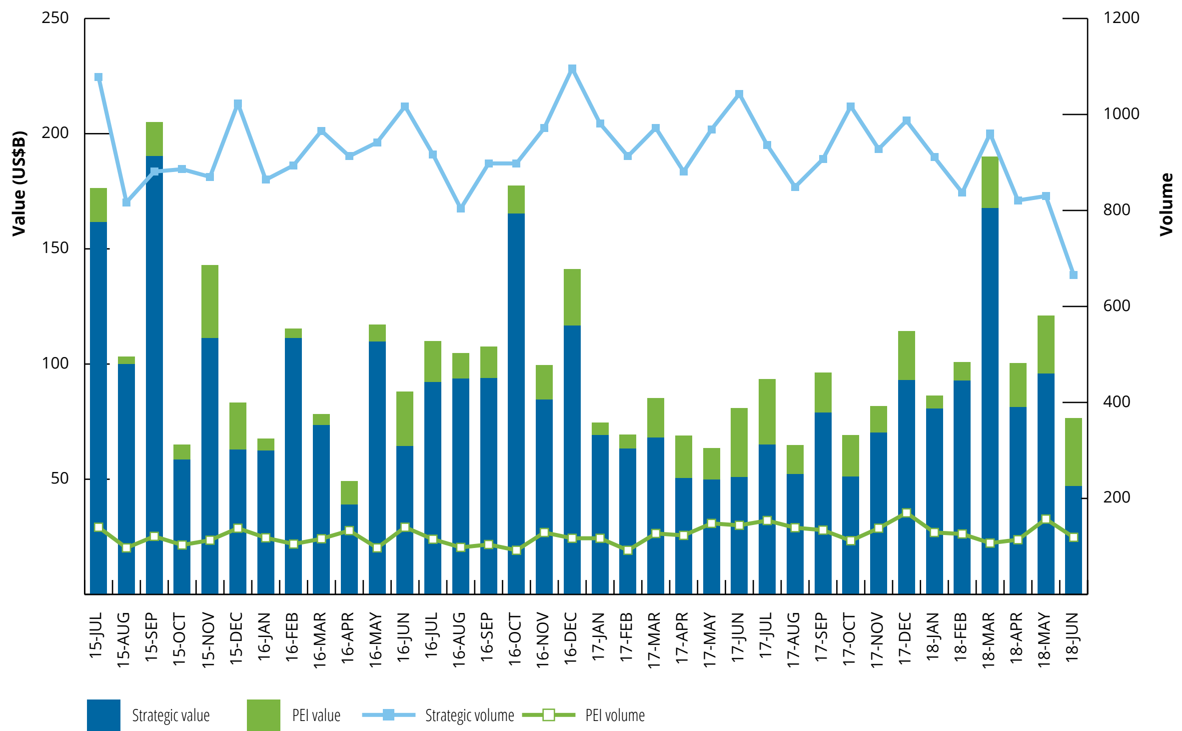
Based on our analysis of Thomson Reuters's M&A data, cross-border dealmaking continues at a strong pace. Upwards of one-third of deals (whether measured by value or volume) are now cross-border deals (Figure 4). With increased risk of rising trade protectionism in different regions, it is likely that companies will consider cross-border M&A as a hedge against fluctuating input cost as well as a way to maintain access to attractive consumer markets.

In order to provide effective oversight of cross-border transactions, board members need insight into how macroeconomic forces, industry-specific trends, regional business practices, and regulatory requirements may shape deals that management proposes and pursues. In particular, longer-term M&A trends and 2018 cross-border activity suggest that boards of US-headquartered companies may need to cultivate a careful understanding of transactions that involve investments in countries that are receiving significant attention in terms of M&A transactions,

[4] *Bridging the boardroom's technology gap*, Deloitte.

Figure 4.

Value and Volume of Cross-Border M&A: July 2015 to May 2018



Source: Deloitte analysis of Thomson Reuters's M&A data, as of September 2018.

such as the United Kingdom, Ireland, Germany, and China. For example, in evaluating a proposed deal, especially one with multicountry integration plans, board members should consider tax policies and practices that may underlie the deal's economic justification: labor and contract laws that may influence talent retention, currency rate fluctuations that may impact the combined company, potential for Foreign Corrupt Practices Act (FCPA) violations that could raise post-close issues, and cybersecurity and intellectual property protection.

An educated board is an effective board

M&A can be one of a company's most strategically important and significant undertakings—no matter the size, a merger or acquisition presents numerous opportunities and challenges that a board should weigh when approving and overseeing its pursuit and execution. Still, considering the risk associated with other ways of executing a growth strategy—greenfield construction of a facility in a new market, funding technology

development internally, or expanding into a new product area—M&A is an important strategic option.

An educated board is an effective board. To that end, we suggest that all deal participants—board members, executive management, committee members—collaborate to increase deal review rigor, develop multiple deal scenarios, improve technology proficiency, and apply cross-border deal experience. A good starting point is to work together to answer questions in each of the four focus areas, such as the following:

1. **Increase deal review rigor**

- When pursing an acquisition that considerably increases the debt-to-earnings ratio, has the board tested the plausibility of generating the cash necessary to return the company to debt levels that are more manageable and sustainable?
- Has the audit committee considered that off-contract deductions and slow payments by key customers may constrain cash flow and slow the ability to pay down debt?
- Has the compensation committee reviewed and approved the incentive and retention plans for leaders who join the company?
- Does the board across committees understand that departures of key leaders could be followed by turnover among top sales staff, which then may hamper the ability to generate sales and pay down debt?
- Has a committee been charged with identifying the risk posed by the acquired company's IT infrastructure (for example, if its systems are not structured in a way to enforce compliance to customer contracts)?

2. **Develop multiple deal scenarios**

- What disruptive technologies exist in the market or are emerging that could significantly impact the fundamentals of the deal thesis?
- How sound or risky are the tax strategies being employed for the cross-border elements and what are the implications of various outcomes?
- What financial impact assumptions have the greatest impact on value sensitivity and what can be done in advance to mitigate the potential downsides?
- What if competition intensifies after the acquisition closes? How would management respond to aggressive actions by competitors? What is the plan to retain key accounts?
- To what degree could emerging technologies like cloud computing accelerate the integration, offsetting the risk of a large-scale integration of technology infrastructure and systems?

Has the board considered adding a board-level technology committee, an individual board member with technology experience, or a management-level technology committee that would report to the board?

3. Improve technology proficiency

- Has the board considered adding a board-level technology committee, an individual board member with technology experience, or a management-level technology committee that would report to the board?
- What efforts can the board undertake to infuse technology expertise into its decision making?
- What can be done to spot technology challenges earlier?
- What metrics should be used to evaluate success?

4. Apply cross-border deal experience

- What type of experience has management had in cross-border deals?
- What challenges exist with different regulatory bodies (e.g., European Union, US Federal Trade Commission)?
- Have sufficient up-to-date risk scenarios related to escalating trade conflicts been incorporated into our cross-border acquisition strategy? Especially consider these:
  - The possibility that the performance of the acquired business could be adversely impacted by public policy, trade, and tariffs
  - The potential need to evaluate scenarios like asset divestitures or country exits (embargoed nations) that may be necessary to secure regulatory approval for the deal and the investment thesis
  - Delays in regulatory approval that influence the duration and investment in pre-close planning
- Is there clear understanding of labor complexities in key markets (e.g., German and French work councils)?
- Has the deal team addressed rules around license to operate and complexities around legal entity changes around transactions?

Rebounding deal-making activity and the highly visible nature of deals combined with the increasing confidence of management teams who view their deals as regularly "hitting the mark" point to the need for boards to assert their objectivity and to apply their experience when evaluating and approving potential transactions. As noted in this article, that suggests looking at proposed deals from different vantage points and recognizing areas that fall outside the direct experience of board members. Drawing upon the experience of management teams and board members sets up the productive engagement needed when considering and pursuing acquisitions given the stakes involved. Certainly, positive outcomes work to the benefit of a broad set of stakeholders that benefit from M&A activity including shareholders, customers, and employees.

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2019 SEC and Other Regulatory Priorities

By Mark Miskinis, Consuelo Hitchcock, Ashley Elizabeth Corey, and Andrea Perdomo, Deloitte

The US Securities and Exchange Commission (SEC) chair, Walter Joseph "Jay" Clayton, has consistently emphasized in discussions about SEC priorities 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 meeting its oversight responsibilities, the SEC took action in a number of areas in 2018 that underscored its focus on facilitating capital formation while maintaining appropriate investor protections.

Consistent with its governance role, the board, as a whole or through its committees, should keep these priorities in mind as directors engage with management to understand how their companies are monitoring and adjusting to regulatory changes. This is especially important in the areas that are likely to be a continued focus for the SEC in 2019.

Facilitating capital formation

Clayton made clear at the outset of his term in mid-2017 that making US capital markets more attractive, especially to growing companies, was among his top priorities. Since then, the SEC has taken a number of actions designed to encourage more private companies to go public, or that allow more flexibility for current public companies without compromising investor protections.

The SEC has taken a number of actions designed to encourage more private companies to go public, or allow more flexibility for current public companies, without compromising investor protections.

Some of those actions have expanded the availability of existing reporting accommodations to a broader group of companies. These include expanding the definition of Smaller Reporting Companies (SRCs) to allow more companies to take advantage of scaled disclosure requirements, as well as extending the availability of certain Emerging Growth Company (EGC) accommodations, such as providing a nonpublic review of IPO registration statements, to non-EGCs as well.

The SEC has also encouraged companies to utilize its process to request modifications to certain financial reporting requirements if those disclosures are burdensome to prepare and do not provide material, incremental information to investors.

In 2019 the SEC is likely to continue focusing on actions intended to support capital formation. For example, when the SEC adopted the expanded SRC definition, Clayton directed agency staff to consider whether reducing the number of companies that qualify as "accelerated filers" also might facilitate capital formation by reducing compliance costs (e.g., reducing the number of companies required to obtain auditor attestation on their internal control over financial reporting), while maintaining appropriate investor protections. That project is also included on the SEC's regulatory agenda[1] for 2019, along with other projects, including one on earnings releases and interim reports for "ways to ease companies' compliance burdens while maintaining appropriate levels of disclosure and investor protection."

[1] US Securities and Exchange Commission, Agency Rule List - Fall 2018.

Boards should ask management to keep them apprised of regulatory accommodations that the company is considering utilizing in its capital raising efforts and should understand the considerations that went into that decision. Specifically, boards should consider the following questions when discussing this area with management:

- 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?

Disclosure effectiveness

For several years, the SEC staff has been reviewing the disclosure requirements for public companies with the aim of improving the disclosure regime for the benefit of both companies and investors. Notably, this initiative, which the SEC refers to as the "disclosure effectiveness initiative," has crossed administrations. Former SEC chair Mary Jo White launched the initiative in 2013, and Clayton has maintained it as a priority under his leadership. The SEC took several actions related to this initiative in 2018, and the agency is expected to do so in 2019.

For example, in August 2018 the SEC approved a group of rule amendments to eliminate disclosure requirements that it determined had become redundant, duplicative, overlapping, outdated, or superseded. Clayton characterized the changes as being for the benefit of both public companies and investors, and part of the SEC's efforts to ensure its requirements remain effective and efficient, even as the capital markets evolve.

The SEC has a number of other projects related to disclosure effectiveness in process, including a proposal to simplify the requirements related to when issuers of debt securities must include separate financial information of certain other entities (e.g., guarantors). The agency also has topics on its regulatory agenda[2] for 2019 related to making changes to certain industry-specific disclosures and modernizing reporting requirements related to significant acquisitions, as well as continuing a broad review of certain business and financial disclosure requirements in Regulation S-K, which is the central repository for nonfinancial statement disclosure requirements for public companies.

Boards should be aware of changes in disclosure requirements applicable to their companies and discuss with management how they intend to implement changes in a way that benefits both the company and its shareholders. As the SEC solicits input on new issues, boards should also consider discussing with management whether the company intends to

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[2] US Securities and Exchange Commission, Agency Rule List - Fall 2018.

At the outset of the disclosure effectiveness initiative, the SEC emphasized its belief that many companies could improve their disclosure under the current rules through more focus on material and relevant matters, eliminating redundant disclosures and tailoring generic disclosures to the company's facts and circumstances.

engage in the public comment process. In this regard, boards may consider discussing the following questions with management:

- Does the board have sufficient transparency into the company's assessment of the impact of proposed changes and implementation efforts and the challenges related to new reporting requirements?

Boards could also use these developments as an opportunity to discuss with management whether it has considered if the company's disclosure could be improved, even absent rule changes. At the outset of the disclosure effectiveness initiative, the SEC emphasized its belief that many companies could improve their disclosure under the current rules through more focus on material and relevant matters, eliminating redundant disclosures and tailoring generic disclosures to the company's facts and circumstances.

Cybersecurity disclosure

In 2019, the SEC is expected to continue to focus on how cyber risks affect all parts of the capital markets. For public companies, this focus likely will be consistent with updated guidance the SEC issued in February 2018 regarding public companies' disclosure obligations related to matters involving cybersecurity risk and incidents, as well as the importance of cybersecurity policies and procedures.

That guidance emphasized that the frequency, magnitude, and cost of cybersecurity incidents make it important for companies to take steps to ensure they are informing investors about material cybersecurity risks, even if they have not yet been the target of a cyberattack. The guidance also addressed the importance of controls related to the identification and escalation of a cybersecurity incident to the appropriate levels within an organization, as well as the need to address cybersecurity incidents in insider trading policies.

More recently, in October, the SEC released an investigative report[3] that cautioned companies to consider cyber threats when they are implementing their internal accounting controls. The report focuses on the internal accounting controls of nine issuers that were victims of variants of schemes involving spoofed or compromised electronic communications from persons purporting to be company executives or vendors, commonly referred to as business email compromise scams.

The February guidance specifically addressed the importance of board involvement, stating "disclosures regarding a company's cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues allow investors to assess how a

[3] SEC Investigative Report Release No. 84429, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements*, Oct. 16, 2018.

[4] US Securities and Exchange Commission, *Commission Statement and Guidance on Public Company Cybersecurity Disclosures*, Feb. 26, 2018.

board of directors is discharging its risk oversight responsibility in this increasingly important area."[4]

Consistent with this focus by the SEC, boards are encouraged to not only understand the cyber risks their companies face, the controls in place related to those risks, and the reporting implications of those risks, but also should consider the importance of communicating to investors the board's role in overseeing these risks. Accordingly, board members may consider asking the following questions:

- Does the company's cybersecurity planning include consideration of timely disclosure of cyber-related issues?
- How timely and in what manner are cybersecurity incidents communicated to the board?
- Is there appropriate disclosure of the board's role in the oversight of cybersecurity risk?

Implementation of new accounting and auditing standards

After the significant effort to adopt changes to revenue recognition, many companies immediately turned their attention to the implementation of other new standards, including accounting for leases and current expected credit losses, which for public companies are to be adopted in 2019 and 2020, respectively. Based on observations of companies' adoption of the revenue standard, the SEC staff has been publicly discussing its views on key adoption activities, including the need to focus on internal control considerations and disclosure obligations, including transition disclosure.

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

In addition to the recently issued accounting standards, boards and their audit committees should also be aware of the Public Company Accounting Oversight Board's new standard for the auditor's report. The new standard is intended to make the auditor's report more informative and relevant to investors.

A number of changes to the form of the auditor's report have already gone into effect, but the most significant change—the identification and communication of critical audit matters (CAMs)—will begin to phase in for large accelerated filers in 2019, with the first such reports due for fiscal years ending on or after June 30, 2019.

CAMs are defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that

- relates to accounts or disclosures that are material to the financial statements; and
- involves especially challenging, subjective, or complex auditor judgment.

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Views on SEC proxy processes and rules

The SEC hosted a roundtable on November 15, 2018, to hear views from different perspectives on a number of the commission's proxy process and rules, including these:

- **Proxy voting mechanics and technology:** panellists discussed current proxy voting issues, such as voting accuracy, transparency, and efficiency, as well as universal proxy cards. Participants shared ideas on how to improve in these areas, including by leveraging technology.
- **The shareholder proposal process:** the discussion centered on the appropriate ownership thresholds for shareholder proposals, as well as the potential benefits of additional guidance from the SEC regarding the determination to grant or refuse no-action relief to companies seeking to exclude a shareholder proposal.
- **The role of proxy advisory firms:** participants also discussed the extent to which proxy advisory firms influence voting decisions, how the firms address potential conflicts of interest in their business model, and the value of their proxy research.

In announcing the roundtable, Chairman Clayton noted that "Shareholder engagement is a hallmark of our public capital markets, and the proxy process is a fundamental component of that engagement." After considering the input from the roundtable, the SEC may consider whether to refine its rules and processes in this area.

Audit committees are encouraged to engage with their auditor to understand when it will begin reporting CAMS related to the company's audit and what the reporting may look like for their company, and should keep the full board apprised as appropriate.

Audit committees are encouraged to engage with their auditor to understand when it will begin reporting CAMs related to the company's audit and what the reporting may look like for their company, and should keep the full board apprised as appropriate.

More generally, boards should ensure that management has sufficient resources focused on the implementation of new standards and the related controls, and should discuss with management how the new standards may affect the company's disclosure. Boards may consider asking the following questions:

- Does the company have sufficient resources 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?

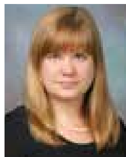
Proxy issues

Heading into the 2019 proxy season, boards should also be aware of the SEC's recent focus on proxy-related issues. In addition to understanding the potential effect on their companies of any changes to the proxy process, boards should consider how the governance disclosure in a company's proxy compares to its peers. For example, in recent years, Deloitte has tracked S&P 100 companies' proxy disclosures and observed a trend toward more robust voluntary disclosure around the audit committee's oversight of the independent auditor and related issues. In engaging with management on the company's proxy process, the board may consider asking this question:

- Has the board recently taken a fresh look at the governance disclosure in the proxy and compared it to the proxy disclosure trends of its peers?

The SEC has frequently stressed the importance of board involvement and oversight in financial and securities-related matters. It is likely that 2019 will continue to bring regulatory change to public companies. As such, boards will need to stay vigilant and ensure that there are adequate policies and mechanisms in place to keep directors informed of these regulatory developments, and they will need to understand how management intends to address them.

Mark Miskinis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New Voices in the Boardroom: The Gradual Evolution of Board Composition

By Julie Hembrock Daum, Spencer Stuart

The stakes for having the right people around the boardroom table have never been higher. Directors need to have the skills and experiences that not only align with their company's long-term strategic direction but also enable their boards to effectively advise management amid unprecedented change and business disruption. Board succession has emerged as a key priority for shareholders, who increasingly expect boards to have a rigorous process in place for assessing board composition and refreshment. Of particular concern are whether there is enough diversity in the boardroom, whether the board has the right combination of skills, and how the board views director tenure.

Notably, directors with diverse profiles are increasingly joining US boardrooms. However, a chronically low rate of director turnover is bringing about only gradual shifts in the overall makeup of US boards. The modest pace of change is likely to persist, meaning that corporate boards are likely to evolve only incrementally.

Looking to the year ahead, the following represent the board trends Spencer Stuart believes will continue or accelerate in 2019, and how they are likely to shape board composition in 2019 and beyond.

Directors with diverse profiles are increasingly joining US boardrooms.

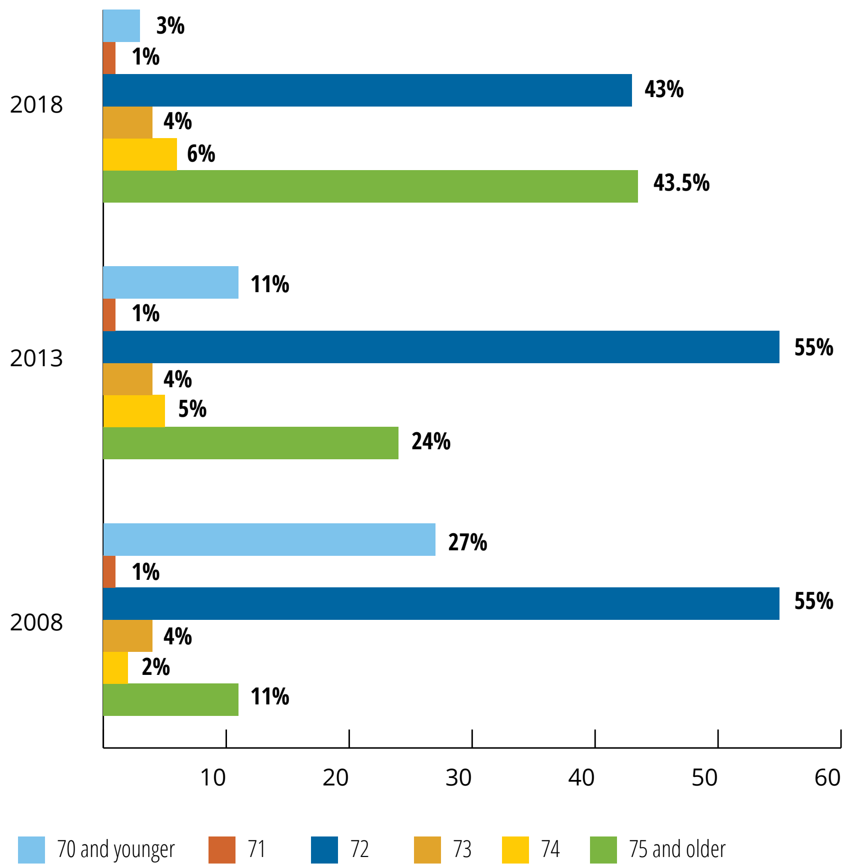
Turnover will continue to be driven by director departures and mandatory retirement in the near term.

In 2018, S&P 500 companies added the highest number of new directors since 2004—roughly 0.88 new independent directors per board. That said, overall turnover in US boardrooms is modest, and is likely to remain so for the foreseeable future, impeding meaningful year-over-year change in the overall composition of S&P 500 boards. During the 2018 proxy season, a little more than half of S&P 500 boards (57%) added one or more new directors.

Barring changes in boardroom refreshment practices, this trend is likely to continue. Limits on director tenure are rare today. Only 25 S&P 500 boards (5%) set explicit term limits for nonexecutive directors, with terms ranging from 9 to 20 years. Additionally, it does not appear that individual and/or peer assessments are regularly used by boards to promote refreshment. Only 38 percent of S&P 500 companies report some form of individual director evaluations, a percentage largely unchanged over the past five years.

Instead, S&P 500 boards are likely to continue relying on mandatory retirement policies to stimulate board turnover. Today, 71 percent of S&P 500 boards disclose a mandatory retirement age for directors, consistent with the past five years. Retirement ages also continue to climb. In 2008, a meager 11 percent of S&P 500 companies with mandatory retirement policies set the age limit at 75 or older, compared to 43.5 percent today. More than half of these companies mandate a retirement age of at least 73 or older. Three boards have a retirement age of 80.

Mandatory retirement age



Experience as a CEO, board chair, or similar position is no longer viewed as the only qualifying credential for director candidates.

Three-quarters of the independent directors who left S&P 500 boards in the 2018 proxy season served on boards with mandatory retirement ages. The age limits appeared to have influenced many of these departures—37 percent of retirees had reached or exceeded the age limit at retirement, and another 16 percent left within three years of the retirement age. Currently, only 16 percent of the independent directors on S&P 500 boards with age caps are within three years of mandatory retirement.

The boardroom will gradually be reshaped by new perspectives and expertise.

While modest turnover will continue, evidence suggests that boards will use openings from director departures to inject fresh perspectives and expertise into emerging areas of need.

For one thing, experience as a CEO, board chair, or similar position is no longer viewed as the only qualifying credential for director candidates.

Of the 428 new independent directors added to S&P 500 boards in the 2018 proxy year, only 35.5 percent were active or retired CEOs, board chairs, or similar, down from 47 percent a decade ago. Nor is a background in a public company boardroom a requirement. First-time public company directors constituted 33 percent of the 2018 class of new S&P 500 directors. These first-timers are younger than their peers and more likely to be actively employed (64% versus 53%). They are less likely to be CEOs or chief operating officers, and more likely to have other managerial experiences such as line or functional backgrounds or to hold roles in division/subsidiary leadership. They are also more likely to be minorities: 24 percent of first-time directors in 2018 are minorities, versus 19 percent of all new S&P 500 directors.

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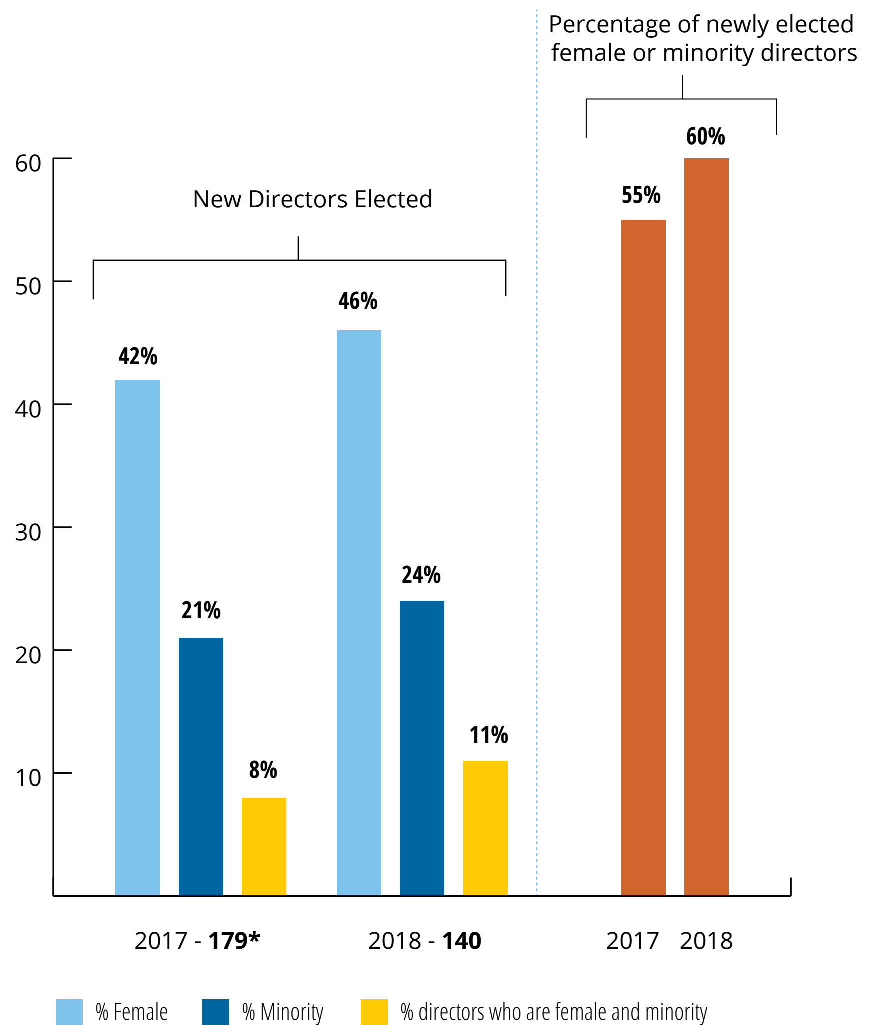
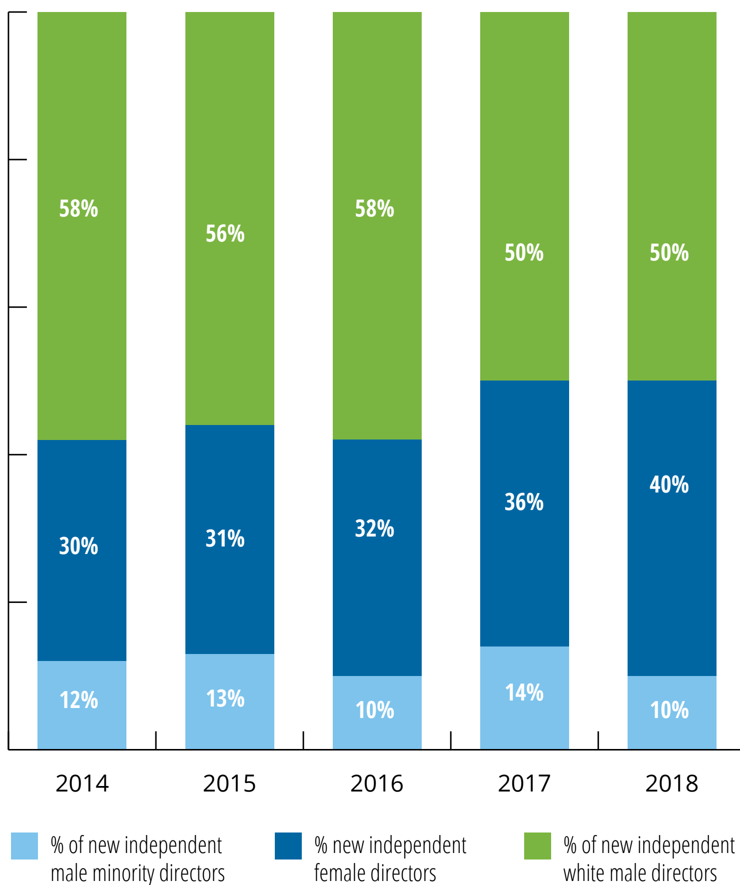
First-time directors



*Includes directors who had served or were serving as an executive director on a public company board.

Recognizing the strategic imperative for new perspectives and experience in the boardroom, boards are increasingly adding directors with backgrounds in technology, digital transformation and technologies, consumer marketing, and other areas of emerging importance. Financial talent remains prized, especially the experiences of chief financial officers, finance executives, and/or investment professionals. That said, as investors have continued to press for more gender diversity, S&P 500 boards have increased the number of women directors, reaching a new high: 40 percent of new directors in the 2018 proxy year are women, an increase from 36 percent in 2017.

Percent of new female and minority independent directors in the S&P 500



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Boards are also likely to enhance disclosures about composition. As interest in boardroom composition among investors has increased, a growing number of companies are voluntarily enhancing their disclosures to highlight the diversity of their boards and to showcase how director skills and qualifications align with company strategy. In fact, nearly a third

(30%) of S&P 500 companies have published a board matrix spotlighting the skills and qualifications of each director on their governance web page.

Younger directors may become a potent new voice in the boardroom.

As boards prioritize new areas of expertise—such as industry and functional experience in technology and digital transformation, and certain areas of marketing and finance—many are tapping "next-generation" directors whose qualifications align with the needs of their organizations. One out of six directors (17%) in the 2018 class of new directors is age 50 or younger.

Given that their backgrounds and profiles differ from more traditional board members, these directors are likely to bring varied perspectives to boardroom discussions. Nearly two-thirds of these "next-gen" corporate directors have expertise in three sectors: technology/telecommunications (34%), consumer goods (16%), and private equity/investments (14%). A majority (almost two-thirds) are serving on their first public company board. More than half (53%) are women.

Interestingly, these directors may also be less likely to have lengthy tenures, due to factors such as the demands of their careers, a desire to move on, or dissatisfaction with their board experience. Twenty-eight (7%) of the 417 directors who left an S&P 500 board seat in the 2018 proxy season were 55 years old or younger, with an average tenure of five years. Other directors who departed their boards over the same period had a much longer tenure on average (12.7 years) and were 68.4 years old on average.

Business demands and investor pressure are likely to change how boards think about composition and refreshment strategies.

The implications for your board

Business demands and investor pressure are likely to change how boards think about composition and refreshment strategies. Increasingly, directors are recognizing that board composition should support and reflect the strategic needs of the organization. Boards can use the following recommendations to enhance short- and long-term approaches to their composition:

Have an ongoing refreshment strategy.

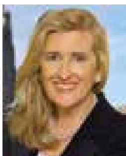
The composition of the board should be viewed as a strategic asset. Boards will be better prepared to plan for and take advantage of openings if there is a formal approach to refreshment. This includes regularly reviewing and aligning the board's makeup to the company's strategic direction, identifying desired competencies for future directors, and regularly infusing the board with perspectives relevant to the organization's future needs.

Increasingly, investors consider meaningful full-board and individual assessments as "best practice" not only for evaluating and enhancing board and director performance but also for promoting boardroom refreshment. While annual evaluations have become the norm for boards, far fewer—38 percent of S&P 500 boards—report some form of individual director evalua-

tions. Proactive boards assess skills and attributes, incorporating results from board self-assessments. They also take a multiyear view of departures, including upcoming board leadership changes, and set clear expectations around director tenure.

Position new directors for success.
The nominating and governance committee chair and other board leaders should ensure that the board has a robust new-director orientation program in place. Incoming directors, particularly younger and first-time board members, benefit from an orientation and continuing education that familiarize them with the company's needs and the board's approach to governance. At a minimum, a director onboarding program should provide insights about public disclosures and nonpublic materials (such as board meeting minutes, forecasts, budgets, strategic plans, etc.) and socialize the new director(s) with key executives and members of senior management. Additionally, the board should recognize that new directors may find it helpful to partner with a mentor—formally or informally—who they can turn to for questions and feedback.

With greater focus on diversity, board culture becomes critical.
Boards are adding new perspectives to enhance board deliberations and improve outcomes. But greater diversity also increases the likelihood of misunderstanding and tension among directors with different points of view and backgrounds. In the past, boards tended to be more homogeneous and, as a result, there was typically more implicit agreement about director interaction and behavior. Today, with higher levels of diversity in the boardroom—whether in terms of experiences, skills, gender, race, ethnicity, nationality, and/or age—it's critical to create a boardroom culture that facilitates constructive interactions between board members. All boards can benefit from cultures that value inquisitiveness and flexibility, and where directors are comfortable challenging one another's—and management's—assumptions and ideas.



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KEY QUESTIONS FOR DIRECTORS TO CONSIDER:

- Does the board as currently constituted give the company its best shot at success in supporting the strategy?
- What additional, and potentially underrepresented, skills or expertise would significantly enhance the board's ability to do its job?
- What are our refreshment mechanisms and strategy, and how are they communicated to stakeholders, including investors?
- Are we using board evaluations to help identify gaps in expertise and skills the board may require in the coming years?
- Is our onboarding program robust and tailored to individual director needs and backgrounds?

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