

A close-up photograph of a person's torso and hands. They are wearing a dark blue pinstripe suit jacket over a white shirt and a red textured tie. Their hands are holding a brown and orange striped American football. The background is a solid dark color.

# C-SUITE

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## Playbook for Diversity

Bringing the NFL's Rooney  
Rule to the boardroom

Is diversity disclosure making a difference?

Important risk issues for 2018

Vetting boards for better performance

Risk oversight questions boards should ask

Interview with Luis A. Aguilar, former SEC  
Commissioner and current board member





What will be the biggest risk for corporate boards looking forward to 2018?

# A Delicate Balance





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Damian is a Managing Director for Marsh Inc. He has worked with some of the firm's largest clients to manuscript policies with state-of-the-art coverage. In his capacity as Claims Advocate, Damian has built an extensive network among clients, senior underwriting and claims executives, and securities and coverage attorneys. Damian joined Marsh in 1995 after serving as Senior Claims Counsel at a large insurer specializing in commercial and financial institution directors and officers' liability claims.

### Unprecedented Political Dynamics Yield Risk of Uncertainty

Directors and officers today face unprecedented potential for personal exposure, given today's evolving risk landscape. Shifting regulatory priorities, increased scrutiny by regulators, a volatile business environment, cyber risk and increased legal exposures are only some of the significant issues directors and officers face, and the stakes continue to rise.

Looking ahead to 2018, we predict that boards will continue to face evolving risks relating to cybersecurity, climate change and the fallout from the ongoing, unprecedented political dynamics in the U.S. With respect to those politics and the rapidly changing political landscape, regulation risk continues to be the wild card with the most potential to plague boards going forward.

To date, the Trump Administration has focused its deregulatory efforts at easing rules on existing legislation. For example, regulators dropped plans to restrict bonuses on Wall Street—plans that had been opposed by banks and brokerage firms. The Administration also seeks to ease rules governing speculative investing by financial institutions, disclosure of executive pay in public filings and the powers of the Consumer Financial Protection Bureau. The changes effected or proposed to date are based almost entirely on the executive branch's rulemaking authority.

In the early days of 2017, policy changes emanating from Washington were identified as key drivers of the economic and business outlook. As the year draws to a close, there are lingering doubts as to whether the Administration will succeed in enacting any of its key agenda items, including tax and health care reform and infrastructure spending. There is an emerging consensus that, if Congress does not act before the end of 2017, little will happen in 2018 due to election year politics. A larger question is whether the lack of action will adversely impact the stock market, which has been on an increased trajectory in 2017.

For large corporations that deeply invest in long-term planning, the challenges presented by this uncertain climate cannot be understated. Boards must remain vigilant regarding regulatory changes and proposals in order to ensure adequate protection for directors and officers in this volatile environment.



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Douglas K. Chia is Executive Director of The Conference Board Governance Center. He joined The Conference Board in February 2016. Mr. Chia previously served as assistant general counsel and corporate secretary of Johnson & Johnson. Before joining Johnson & Johnson in 2005, he served as assistant general counsel, corporate of Tyco International and practiced law at the global firms Simpson Thacher & Bartlett and Clifford Chance, both in New York and Hong Kong.

## The Specter of Activist Investors

The biggest risk will continue to be the specter of activist investors unexpectedly seizing opportunities to transfer value from the company to shareholders and threatening to replace some or all of the board members—and ultimately the CEO—as a means to those ends.

As we've seen recently with Procter & Gamble (P&G) and Automatic Data Processing (ADP), a board can never be too prepared for a shareholder activist campaign. It seems like we're now reading about a new activist campaign on a weekly basis! Two billion-aire hedge fund managers familiar to all of us are seeking seats on those companies' boards in separate proxy contests. Trian Fund Management founder Nelson Peltz has targeted P&G, and Pershing Square Capital Management founder Bill Ackman put ADP in his crosshairs.

**STEVE KLEMASH***Partner, Americas Leader***EY CENTER FOR BOARD MATTERS**[ey.com/boardmatters](http://ey.com/boardmatters)

Steve leads the Americas Center for Board Matters (CBM) at Ernst & Young and regularly engages with board and committee members to understand their views, exchange ideas and discuss boardroom issues. Effective corporate governance is an important element in building a better working world. Under Steve's leadership, the EY Center for Board Matters supports boards, committees and directors in their oversight role by providing content, insights and education to help them address complex boardroom issues. Using our professional competencies, relationships and proprietary corporate governance database, we are able to identify trends and emerging governance issues. This allows us to deliver timely and balanced insights, data-rich content, and practical tools and analysis for directors, institutional investors and other governance stakeholders.

## Shaping Long-Term Strategy Through Innovation and Transformation

Boards are not lost for significant risks to monitor: business model disruption, geopolitical, cybersecurity and regulatory compliance are just a few. Boards must manage these risks at the same time they may deliberately accept risk to seize new strategic opportunities.

To sustain growth and performance, companies need to maintain a balanced and integrated approach to enterprise risk management. Boards should confirm that management is giving appropriate consideration to managing risk-return trade-offs to drive value creation. Some level of risk or uncertainty may be necessary to gain economic opportunity. An investment in an emerging technology could be viewed as risky, but could improve efficiencies and expand a company's capabilities in new ways. The capacity to manage risk and the willingness to take risks and make forward-looking choices are key elements that drive growth and position companies to create long-term value.

One of the greatest risks—and a focus for boards today—relates to its role in shaping an organization's strategy in an environment of unpredictable change. Given the challenges of quarterly meetings and annual earnings forecasts, combined with the other aspects of risk management, boards and management can lose focus on the need to make investments in innovation that have potential to create significant long-term competitive advantages.

Boards work closely with management on strategy, but specifically, boards need to ensure that companies are appropriately future-proofing the business through the right innovations and transformations. The challenge is that investment in innovation can initially drag financial performance and show positive performance well after the initial investment time—typically beyond three years.

Many companies continue to have strategic planning cycles within one- to three-year time horizons. But as Jeff Bezos told *Wired* magazine in 2011, "If



More boards are finally realizing the need for regular communication with their large institutional investors. Yet, not many have prepared a formal shareholder engagement or activist response plan. Despite how much we've talked about this over the past five or six years, only a little more than half of the largest 20 public companies in the U.S. disclose details about a shareholder engagement that includes information about the frequency of meetings, type of shareholders met and topics discussed. The prevalence of such disclosure sinks as you move down the Fortune 500 list. So, public company boards will have their work cut out for them in 2018 with activism continuing to dominate the corporate governance landscape.

everything you do needs to work on a three-year time horizon, then you're competing against a lot of people, but if you're willing to invest on a seven-year time horizon, you're now competing against a fraction of those people, because very few companies are willing to do that." Now consider that two-thirds of CEOs have an average tenure of less than nine years while the average tenure of a board is nine years, and you begin to understand how critical the board's role is to ensure that management is future-proofing the business through investing in compelling innovations and transformations for the long term.



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## Aligning Executive Pay With Company Performance

From an executive compensation perspective, boards have an important duty to pay executives appropriately in line with the underlying performance of the company. The age-old issue of paying for performance seems more complex than ever—and more highly scrutinized!

The design of short-term and long-term incentive programs needs to align with a company's business strategy, and contain goals that have sufficient stretch, to incent value creation without creating an excessive risk scenario. These programs also need to focus on the most appropriate financial measures to properly align with desired company performance. In deciding how performance should be defined, should these incentive plan goals be based upon growth or return measures, using GAAP, or materially adjusted non-GAAP figures? Or should setting pre-established goals be avoided entirely by using stock price growth, plus dividends, (i.e., Total Shareholder Return, or TSR) either on an absolute or relative basis?

The types of long-term incentives now available also provide a range of possible outcomes and incentive focus. Should stock-based incentives reward only for share price appreciation (like a stock option), or provide a retention aspect by providing the initial underlying stock value plus appreciation (like restricted stock), or should equity grants be earned only if pre-established financial goals are achieved over a specified performance period? And if performance goals are to be used in the long-term incentive plan, how should they relate to, or be different from, the goals used in the short-term incentive plan?

The probability of your pre-established incentive programs being fully aligned with future company performance on a consistent basis is always at risk due to the wide range of unexpected events, which can impact an otherwise well thought out design and goal-setting process. External market scrutiny comes in after the fact, where the conclusions are known and opinions are easy.

Thus, boards need to spend the time, and conduct the proper amount of diligence, in designing executive compensation incentive programs and in selecting and establishing the right financial goals and targets to increase the odds that the pay for performance connection is consistently valid and properly aligned.





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Stephen Giove is a Partner in Shearman & Sterling, a leading global law firm. He is a leading corporate governance lawyer who routinely advises boards, their committees and senior management teams on a full range of corporate governance matters, including board structural and process matters, annual board self-evaluations, fiduciary duties, proxy access, shareholder proposals, activism and dealing with external constituencies, including proxy advisory firms, shareholders and regulators. He is a frequent speaker, and author of articles, on a wide variety of corporate governance topics. He is a current member and co-founder of the firm's Corporate Governance Advisory Group.

## Underinvestment in Crisis Management

There is not a single risk that is the biggest one for all companies. Like most things in governance, one size does not fit all. While cybersecurity is top of mind for many companies, others are more concerned with other risks stemming from areas as varied as regulatory and compliance matters, environmental laws and policies, supply chain problems, shareholder activism, the competitive landscape, natural disasters and terrorism, the company's compensation philosophy, manufacturing problems and product recalls, and, of course, reputational risks, to name a few. Two things all of these risks have in common is that they can have a dramatic negative impact if they come to pass, and they are unpredictable. While it is often not possible to significantly influence the likelihood of a particular risk, companies and boards can often reduce the negative consequences through effective crisis management.

Companies and their boards invest in crisis management to different degrees for a variety of reasons. These include the difficulty in preparing for many of these potential events, the sheer number of potential events that could occur, and concerns over spending precious management and board time on events that could have a significantly negative impact on the company despite a low likelihood of occurring and high cost of engaging in contingency planning, especially for multiple events.

However, crisis management can play a significant role in helping the board and senior management set the company's risk appetite at the appropriate level in light of the company's long-term business strategy. A company that is too risk-averse may fall behind its competitors in its practices and incur unnecessary costs, which could negatively impact its ability to compete. A company that is too risk tolerant may not only be inviting legal, regulatory or compliance problems, but also could alienate its customers, suppliers or employees. A meaningful part of analyzing business decisions from a risk management perspective is looking at what happens if the risk actually occurs and assessing the severity of the potential problem—an analysis that is only complete if it is understood how such risk could be dealt with from a crisis management perspective.