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US Corporate Governance: Turning Up the Heat

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U.S. public companies face a wide array of challenges, from greater market volatility and increasing economic and geopolitical uncertainty to disruptive technologies, artificial intelligence, social media and cybersecurity incidents. The new year also began with a shutdown of the federal government and a divided government, reflecting deep societal schisms on numerous and varied questions that may impact the environment in which companies and boards operate.

Public companies face traditional challenges regarding long-term financial performance and earnings growth, as well as newer ones presented by a range of topics that fall within the umbrella of environmental, social and governance, or ESG. The "E" and "S" topics include items such as sustainability, climate change, use of plastics, water management, human capital management, gender pay equity, diversity, supply chain management, political and lobbying expenditures, the opioid crisis and gun control. For some, these issues raise fundamental questions about the role of corporations and businesses in society.

The common denominator among all of these items is risk. The increased level of risk will result in investors seeking to better understand a company's business strategy; how the company manages and mitigates these risks; and whether the company's board of directors is well-suited — including in terms of skills and experiences, diversity of viewpoints and fresh perspectives — to oversee management's execution of that strategy and mitigation of those risks. The questions investors pose will not be new, as many have been asked with increasing frequency over the past decade. But with U.S. corporations entering a period of increased risk and volatility, companies and boards should expect these questions to be asked with greater frequency and urgency, and should expect lackluster responses to be met with less patience and increased demands for change — in strategy, management and even board composition.

The Role of Corporations, Business Strategy and the Rise of ESG

The level of ESG-focused investment exceeds $20 trillion of assets under management, and new ESG funds and investment vehicles are being launched with increasing frequency. None of those factors changes the fundamental premise that investments are made to achieve financial returns. In its 2018 annual letter to CEOs, titled "A Sense of Purpose," BlackRock reiterated its request that companies publicly articulate their strategic framework for long-term value creation, noting that a company's strategy must include a path to achieving financial performance.

The challenge companies, investors and policymakers face is to better understand and account for the nexus (if any) between various ESG matters and long-term value creation. As articulated in BlackRock's 2018 letter:

> Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

Along those lines, in 2018, Sen. Elizabeth Warren, D-Mass., introduced the Accountable Capitalism Act, which

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would require companies with more than $1 billion in revenues to obtain a federal charter stating the company's "purpose of creating a general public benefit," defined as "a material positive impact on society resulting from the business and operations" of the company. While this legislation is unlikely to be enacted, the bill reflects the larger debate regarding the role of corporations in society and calls into question the fiduciary model of shareholder primacy that governs corporations organized under the laws of Delaware and many other states.

Larger philosophical questions aside, investors are increasingly focusing on ESG matters as part of their investment theses, whether seeking superior returns from companies positively addressing environmental or social issues, factoring ESG into their analyses of risk-adjusted returns or divesting from sectors viewed as presenting long-term risks that outweigh current returns. The increase in ESG investing has, in turn, resulted in a corresponding increase in ESG ratings and requests for companies to increase and improve their ESG disclosures, including calls to comply with the many frameworks developed by assorted groups and a petition for the Securities and Exchange Commission (SEC) to require ESG disclosures.

Importantly, in a December 2018 speech, SEC Chairman Jay Clayton reminded companies and investors of two key principles: that companies should focus on disclosing material information that investors need to make informed investment and voting decisions, and that investors should focus on each individual company's facts and circumstances. Although these principles represent important guideposts, the level of ESG disclosures by companies has increased significantly, often in the form of sustainability or similar reports posted on websites and, to a lesser degree, in proxy statements, annual reports and other investor presentations. All signs point to the continuing growth of ESG disclosures so that companies can better control the narrative rather than cede the space to ESG raters and other third parties.

The 'New' Risks: Cyber, Human Capital and Company Culture

As noted above, companies will continue to face all of the traditional business risks, including those relating to the economy, trade issues, a competitive and dynamic marketplace, technological disruption, and changes in consumer tastes and spending patterns. In addition, less traditional risks continue to emerge and evolve.

Cybersecurity

Varied forms of cybersecurity risk remain an ongoing corporate issue. In addition to cyber intrusions, hacking and theft of confidential or personal information, the SEC reminded companies in October 2018 that many are victimized by cyber fraud in the form of "business email compromises": fraudulent emails that appear to come from a senior executive to an employee or from a vendor to the company, and directing payment of funds to a particular account. SEC guidance earlier in the year, followed by enforcement actions, also reminded companies of the need to consider disclosure obligations in connection with cyber incidents and to consider closing securities trading windows for employees in the wake of potentially material cyber incidents.

Human Capital Management

Consistent with an economy in which a corporation's significant assets are in the form of people who can walk out the door, investors have increasingly focused on "human capital management," which includes topics ranging from employee health and safety to workplace diversity to employee training and development. Although many of these historically may have been viewed as topics for management and not the board, investors have expressed an expectation that boards of directors be engaged in oversight of a company's human capital management as part of the board's oversight of business strategy and risk management. In one of the latest manifestations of investor focus on these topics, in December 2018, the New York City pension funds and New York City Comptroller Scott M. Stringer called on portfolio companies to end "inequitable employment practices" such as mandatory arbitration for employment-related claims and nondisclosure requirements in settlement agreements relating to claims of unlawful workplace harassment.

Company Culture

More broadly, various instances of alleged sexual harassment by senior executives and alleged improper or unethical workplace or business practices have caused investors to focus on the question of the board's oversight of company culture. Beyond setting the right tone at the top in terms of legal compliance, many have recognized that lack of a healthy corporate culture can present a significant business risk. As a result, the emerging expectation is that boards will exercise increasing oversight to make sure that company culture is aligned with and supports the company's long-term business strategy.

Board Composition

Increased investor scrutiny of business strategy and risk oversight, as well as investor questions regarding board composition and, if problems arise, management competency, should be anticipated. Certainly, activist investors have not shied away from agitating for changes in management and board composition at targeted companies. In addition, traditionally less vocal investors also are adopting more activist strategies for certain of their investments. Also, index funds, which often view themselves as "permanent capital," have increasingly focused on whether the "right" directors are in the boardroom — in terms of director skills, diversity and tenure.

Following the 2018 proxy season, the New York City comptroller announced that his "Boardroom Accountability Project 2.0," launched in September 2017 to make boards "more diverse, independent and climate-competent," had resulted in more than 85 companies adopting improved processes and increasing transparency regarding board quality, diversity and refreshment. The comptroller has continued to advocate for such changes, sharing examples of disclosures his office views favorably concerning board skills, diverse director candidate searches and board self-evaluation processes.

Director tenure remains an issue in that it feeds investor concerns regarding staleness of director skills and lack of board diversity. Tenure can be viewed in various ways — as the average number of years directors serve on a board, the percentage of directors perceived as having "lengthy" tenure or the amount of time lapsed since the addition of new board members.

Although the number of all-male boards of directors continues to decrease, gender diversity remains a top priority for many institutional investors. Vanguard describes its concern over this issue as an economic imperative, and BlackRock's voting guidelines state that it expects to see at least two female directors on every board. Proxy advisory firms Glass Lewis and Institutional Shareholder Services will start recommending against nominating committee chairs of all-male boards in 2019 and 2020, respectively. Companies headquartered in California face the prospect of fines if they fail to meet board gender quotas by the end of 2019. Further, investors are looking beyond the number of female directors to whether those women have leadership roles on the board, for example as lead independent directors or as committee chairs. Investors also expect that boardroom diversity will lead to C-suite diversity, and investors may be likely to inquire further where they see a lack of diversity among the management ranks.

Advice to Companies: Be Proactive, Engage and Communicate

Similar to the questions from investors, the advice to boards of directors and companies is not new but takes on greater urgency. On all fronts — business strategy, ESG, risk oversight and board composition — companies and boards should be proactive in analyzing the company through an investor lens, anticipating investors' questions, and preparing to respond in a way that reflects the board's awareness and attention to investor concerns. Investors continue to expect direct engagement with directors (coordinated through the company) where they have concerns regarding items such as board refreshment or executive compensation.

Finally, companies should take a fresh look at their various forms of investor communications, including for example proxy statements, investor day presentations and sustainability reports, to ensure that the company is articulating: its business strategy, its oversight of risk, its approach to relevant ESG matters, and the board's active engagement on, and understanding of, these matters.

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