MARKETS

The 2018 Board Must Prepare for Constant Evolution

Diversity, Collective Skills Are Both Key Requirements

MARTHA CARTER
Senior Managing Director, Teneo Governance

KARLA BOS
Managing Director, Teneo Governance

The business landscape is constantly changing. For the Board of 2018, governance issues will no longer be optional in the overall business strategy, but paramount in achieving its long-term goals. Boards that are complacent about this trend will be more prone to attacks from hostile interventionist shareholders, vote no campaigns and private advocacy. Conversely, boards that embed good governance throughout their organizations—from top to bottom—will generate goodwill, trust, and long-term value for shareholders.

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To cope with the wider range of demands that it will have to face, the Board of 2018 should be aware that the skillset required for effective stewardship is constantly expanding. For example, shareholder demands from the asset owner and asset manager communities have created the need for investor-savvy boards that understand requests for shareholder engagement and dialogue. Moreover, proposed regulatory changes in the US could mandate disclosure of cyber expertise on boards. Such pressures come alongside the growing expectation on boards to establish and present a clear and concise plan for the business through long-term strategy, responsible capital allocation and board refreshment. The Board of 2018 will need to be diverse, well-versed in communications, cyber risk and shareholder engagement, as well as conscious of the market's and society's changing expectations of business. The effective board must identify and then manage risks, as well as manage reputation as an asset.

Communicating Long Term Strategy

The rise of activist investors and the pressure to accede to their short-term demands has placed increased impositions on directors of public company boards. Shareholders no longer view CEOs as the only voices communicating long-term strategies. While this call for engagement places greater pressure on directors, it also offers them an opportunity to shape a company's narrative with Wall Street. They have a chance to show investors how the board is concentrating on a company's long-term goals, while managing the quarterly-focused dialogue that current corporate America demands.

To increase exposure to stakeholders, directors should ensure they communicate clearly and concisely. This is particularly pertinent for independent directors who should be educating investors about long-term strategy and future investments. And independent directors, whose jobs might be on the line, are particularly valuable when a company is attacked by an activist investor.

The Board of 2018 should create numerous opportunities to communicate directly to shareholders, including: annual letters from the independent directors, Q&A's on the company's website, director roadshows with investors and phone calls or individual meetings with investors. The board should also be creative in pursuing other methods of communication. Directors should participate in annual investor days which serve as an important validation of the board's involvement and priorities. These opportunities demonstrate that the board is active, engaged and willing to work effectively with management and shareholders. They also give the board a valuable opportunity to demonstrate how its composition, its governance framework and its executive compensation practices all align to create a strong framework for the long-term sustainability of the company.

While many CEOs would like to do away with quarterly reporting, the reality is that shareholders have a right to monitor a company's performance on a regular basis. Quarterly earnings should be looked at as an opportunity to place short-term performance in the context of a company's long-term strategy and goals, all while communicating higher priorities about capital allocation and investments. The shrewd Board of 2018 will realize that earnings releases do not need to be just updates on short-term performance. They should be reflective of one checkpoint on a company's long-term plan.

However, a long-term strategy does not mean a board should communicate the plan once, set it and forget it. The Board of 2018 should constantly engage on and reevaluate the strategic plan. If a company is honest about the challenges it will face while executing a strategy over the long term, and communicates it appropriately to investors, the benefits will be a clear, flexible plan for the future, an engaged board and investors that buy into the strategy.

CEOs and boards often face the greatest pressure when they do not manage expectations properly. Wall Street hates surprises more than anything. Boards should hold management accountable for appropriately communicating a strategy. Not everyone may like the strategy, but if a board is active and engaged in communicating what it believes is the right long-term approach for the company, there should be no surprises, even if an activist tries to alter the approach.

A Checklist for Long-Term Strategy Communication:

1. Get regular updates from the CEO, CFO and head of investor relations on shareholder interactions. Consider commissioning a shareholder perception study (on behalf of the board) to hear feedback directly from shareholders, without it being altered or shaped by management.

2. Actively communicate the board's position. Be willing to articulate the long-term strategy and why making investments in the business are often more important than short-term measures to prop up EPS.

3. Share long-term performance goals and demonstrate effective management oversight.

4. Designate one or two independent directors to engage with shareholders on a regular basis.

Dialogue with Shareholders

The board-shareholder relationship has been transformed over the past decade. Gone are the days when institutional investors were expected to interact solely with the investor relations team and senior management. Significant changes in the governance landscape—including the frequency and scale of activist campaigns and an increasing focus on better and more effective governance practices—mean that many shareholders now expect to play a much more active role in the relationship. They want to comment on, discuss and influence the corporate governance of the companies in which they invest. They expect transparency and accountability from the board members elected to represent them. And they increasingly want to achieve this through direct communication with independent directors. Being responsive to one's shareholders in no way suggests a board should abdicate its business judgment or its duty of care and loyalty to the company. It simply means that the board must be an active partner in a meaningful dialogue with its shareholders.

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This dialogue starts with both sides speaking the same language. As a director, this means understanding the governance issues of the day and the proxy voting policies of the company's major shareholders. The board that does so will be best positioned to engage in a robust review of any governance-related request, to understand and incorporate shareholder views as appropriate, and to articulate the merits of the board's ultimate decision. Engaged boards understand that investors are not monolithic, that they have nuanced and multi-faceted views, and that these views will continue to evolve. The Board of 2018 should seek to understand these views. How the board chooses to navigate shareholders' competing interests is a challenge, and the board will need to ensure that its knowledge base is sound and current.

As a board works to build and maintain its governance knowledge, it should also decide how it can best communicate with its shareholders. The high-performing Board of 2018 will want to hear from its shareholders and will accept director involvement in this conversation as a given. The board should work with management to develop engagement protocols and training so that members of the Board of 2018 can comfortably conduct direct engagement with confidence. While direct engagement is the goal, boards should first undertake whatever preparation and training is necessary to meet with investors effectively.

Once direct engagement begins, it is important to recognize that, even with training and protocols in place, not every director will be an equally effective and comfortable communicator. It is likely and often desirable that engagement will rest with just a few members of the board. Accordingly, a board should incorporate the skills supporting shareholder engagement into its recruiting, evaluation and succession processes. The Board of 2018 should understand that suitable communication skills and knowledge of investor perspectives, just like any other critical board competency, may need to be developed and recruited for over time.

1. The Board of 2018 should also appreciate that, as valuable as direct two-way communication can be, engagement can be much more than just meetings and phone calls. It can occur through multiple formats, including proxy statements and the company's website, especially if the investor experience is personalized through letters, photos, videos or Q&A segments from the board or individual directors. A board may also consider whether one or more strong communicators within its ranks could serve

on one of the increasing number of governance and business forums. These groups provide additional platforms for highlighting the board's active engagement.

2. The effective board will also seek feedback on what methods and formats of communication work best. Directors should strive to present their views to investors through multiple avenues and, in turn, make it easy for investors to provide feedback. Despite the benefits of engagement, institutional investors will not always have the time or resources to meet with companies directly but will often have very clear views about the materials and formats they find helpful (or not). Most will not expect every suggestion to be incorporated, but they will appreciate the efforts of a board known for its creative, multi-faceted and continuous outreach to shareholders.

Continued Focus on Activism and Cyber Attacks

One of the primary activities that falls to all board members is overseeing risks to the company and protecting investments on behalf of its shareholders. Two key areas that will require continued focus from the Board of 2018 will be activism and cyber security risks.

Hedge funds have increasingly used activism as an investment strategy in a market with few other catalysts. According to Activist Insight, assets under management at activist hedge funds had reached more than $173 billion globally by the end of 2015, up from $90 billion in 2013, and activism affected 551 publicly traded companies in 2015. Activist Insight also notes that more and more companies are being targeted by first-time or "occasional" activists that engage management infrequently, representing 51 percent of activist campaigns in 2015. Activist investment strategies have become a significant threat to boards and one which occupies a great deal of focus in the boardroom.

Recent media reports have emphasized some of the challenges facing hedge funds and activist investors this year—even some of activism's biggest stars—including low returns, high fees, and announcements of divestments by a few key asset owners. As of July 2016, billionaire activist investor William Ackman's Pershing Square Holdings fund was down nearly 18 percent. At the same time, Barry Rosenstein's JANA Partners experienced some of its worst performance in 15 years, with its main fund posting negative returns in 12 of the prior 19 months. The nation's largest public pension fund, the California Public Employees' Retirement System (CalPERS), eliminated its hedge fund investments in 2015, followed in 2016 by others in the public pension sector like the Illinois State Board of Investment and the New York City Employees Retirement System (NYCERS). Research firm eVestment reported that nearly $28 billion flowed out of the hedge fund industry in the first half of 2016.

However, whether activists' current performance is a signal of a long-term trend or an aberration in performance, the coffers of hedge funds are rich with investors, who continue to be eager for outsized returns. Some activists have heard the clamor of complaints regarding their short-term investment horizons and have tried to distinguish themselves from the wolf pack by emphasizing a longer term investment strategy and management-friendly approach. Nevertheless, even the highest-performing boards can quickly come under fire from an activist and risk losing board seats in a proxy contest or settlement if they are not keenly in touch with the broader investor sentiment. The Board of 2018 should not only establish an effective method of identifying and addressing shareholder concerns, but also be prepared with an action plan that assesses its vulnerabilities and acts to shore up any perceived weaknesses.

A Checklist for Managing Activism Risk:

1. Assess and understand the potential white paper and fight themes that an activist could employ.

2. Ensure that the board creates preparedness documents, including fact sheets and rebuttal statements to meet sudden attacks by an activist.

3. Evaluate the board's engagement with shareholders and design a program that enhances credibility with them. Ensure the Board is receiving a broad range of unfiltered shareholder views.

4. Plan for possible activism scenarios, with actions to be taken.

5. Create a strategic plan for communications to key stakeholders and the media, in the event of activism, and to ward off activist attacks.

The risk of cyber attack is not just on the minds of financial institutions. It is a risk for all companies. No one is immune to attack. Companies, shareholders, employees, and regulators should all understand the high stakes in overseeing risk, and businesses must create a plan to mitigate attacks. Awareness of the issue is growing at a faster rate in the US than anywhere else. In PwC's 2016 CEO Survey, 88 percent of CEOs voiced concern over cyber threats. KPMG's 2015 report on cyber security, however, found that only 50 percent of CEOs had current plans to appoint a cyber executive or team.

One of the recent pieces of US legislation is the proposed Cybersecurity Disclosure Act of 2015, introduced in December 2015 by Senators Reed and Collins. The bill's goal is to "strengthen and prioritize cybersecurity at publicly traded companies" and it asks each public company to include "information on whether any member of the company's Board of Directors is a cybersecurity expert, and if not, why having this expertise on the Board of Directors is not necessary because of other cybersecurity steps taken by the publicly traded company."

In addition to understanding cyber risks and taking steps to reduce them, the Board of 2018 will, regardless of any legislative requirement, need to communicate and disclose to its investors the actions it is taking to protect the company and ultimately, their investments. Numerous studies have cited a gap between the discussion in the board room on cyber activities and the disclosure expected by shareholders. The Board of 2018 should avoid falling foul of this.

A comparison of PwC's 2014 Investor Survey and Annual Corporate Directors Survey highlighted the gap between the expectations of institutional investor respondents with more than $11 trillion in aggregate assets under management and the boardroom practices of public companies served by the 863 director respondents:

- Nearly three-quarters (74 percent) of investors responded that it was important for directors to discuss their company's crisis response plan in the event of a major security breach. Just over one-half of directors (52 percent) reported having such discussions.
- Almost three-quarters (74 percent) of investors advocated that boards boost cyber risk disclosures in response to the SEC's guidance, while only about half as many (38 percent) of directors reported discussing the topic.
- Similarly, 68 percent of investors urged directors to discuss engaging an outside cybersecurity expert, but only 42 percent of directors had done so.
- Fifty-five percent of investors responded that it was important for boards to consider designating a chief information security officer, if their companies did not have one in place. Only half as many directors (26 percent) reported discussing such a move.
- Finally, 45 percent of investors were in favor of directors discussing the National Institute of Standards and Technology (NIST)/Department of Homeland Security cybersecurity framework, while only 21 percent of directors reported their boards had done so.

Importantly, PwC's 2015 Annual Corporate Directors Survey of 783 public company directors on cybersecurity practices reflected a notable increase in several areas of boardroom discussion, including that of cyber risk disclosures, designation of a chief information security officer, and the NIST/Department of Homeland Security cybersecurity framework.

Case studies of cyber attacks at large companies have highlighted the positive effects of robust disclosure to investors regarding the actions taken by the board before, during and after a cyber-attack. They have also highlighted the benefits of discussing the preventive measures businesses have in place so that shareholders understand future risks. As well as having a board member responsible for cybersecurity, the Board of 2018 will be credible and upfront about any crisis that does occur, including quantifying the damage from a cyber-attack and engaging with concerned shareholders.

A Checklist for Overseeing Cyber Risk and Managing Possible Attacks:

1. Be aware of cyber threat intelligence. Ensure that the board has knowledge of possible threats, including how all data is stored and protected.

2. Understand the organizational structure and reporting lines, particularly key for audit and risk committees.

3. Develop a full assessment and conducting scenario planning, making sure to regularly report findings back to the board.

4. Establish periodic updates and refreshments, given that the technology and landscape in this risk area changes quickly.

5. Communicate cyber risk management policies and procedures to shareholders.

Benefits of Variety and Diversity

Increasing the diversity of boards is seen as a business imperative around the world, with many countries adopting quotas to enforce gender and racial diversity in recent years. A report released by McKinsey in January 2015 found that 15 percent of companies in the top quartile for gender diversity, and 35 percent of companies in the top quartile for ethnic diversity, are more likely to financially outperform their peers. A board that is diverse in its composition and its ideas will be better placed than others to generate sustainable growth. Crucially, the composition of the board, underpinned by members with different backgrounds, should lead to a diversity of opinion and help stave off groupthink.

The skillset of the board will be viewed as a sum of its parts, rather than on an individual basis, and will include a diversity of views and experience that is aligned to the corporate strategy. In that regard, boards should seek out talent in both traditional and non-traditional places – whether it is from the C-Suite, active executive experience, public or private sectors – in order to create a mix of talent and experience. Ideally, the Board of 2018 will contain a balanced mix of directors with generalist and expert knowledge, as well as a variety of perspectives and ideas.

Boards should review their own effectiveness regularly and critically, being aware of investor views, such as the recent trend towards questioning independence of a director serving over a decade on a board. Board evaluations and board refreshment are an ongoing process. If evaluations are conducted with close consideration of corporate governance trends and the identification of potential reputational risks, the board will be in a stronger position to preempt threats, such as activists, and create long-term value.

A Checklist of Board Diversity:

1. Cultivate a broad set of skills, including engagement and investor skills.

2. Develop policies to ensure director candidate pools are as diverse as possible, including potentially applicant quotas.

3. Undertake a holistic review of composition and structure of the board, and assess key experience and expertise needed for succession planning.

4. Create a communication plan that provides shareholders with transparency related to board skills, succession and changes.

The Key Role of Reputation

Three decades ago, as much as 95 percent of the average company's value consisted of tangible assets. By 2010, a report found that 75 percent of a corporation's value is intangible. The importance of a company's most crucial intangible asset—brand and reputation—will continue to increase. The Board of 2018 will need to understand that trust in a company is established through a good reputation and that reputation is, in turn, protected and enhanced by using digital media, as well as conventional channels.

The fostering of brand trust and the mitigation of reputational risk need to be embedded at every level of a business' operations. The Board of 2018 must ensure that the way the business operates—and crucially, is perceived—is in keeping with the standards set by the global market and by society. Paying taxes, having anti-bribery policies, and lobbying transparently, are as vital to a business' reputation (and therefore its balance sheet) as a proper media strategy. Businesses should also monitor the environment in which they operate as an equally important step in protecting reputation. In order to foster trust, companies must understand society's expectations of them as businesses and the wider social context in which they operate.

Currently, a director's ability to look at reputational risk holistically is often underrated. Too often, boards do not explicitly address the role reputation plays in a company's strategy or acknowledge the damage the media, especially social media, can cause to a business or a brand's reputation. While managing a company's reputation is often left to the purview of management, the company's reputation can have a profound impact on an organization's ability to execute its strategy, as well as its overall valuation. A company's reputation, and that of its directors, can also play a key role in whether or not directors are personally attacked, be it from an activist shareholder, a competitor, or even a politician.

The Board of 2018 should have a solid understanding and appreciation for this heightening digital media landscape. Furthermore, it is critical that the board sets the right tone for the organization and analyzes how gaps in understanding and monitoring new media can undermine efforts by the company to build a consistent message and image. Given the role that media and social media can play in a company's success, and how much it can undermine a company's reputation, directors should have the requisite skills and appreciation for media management. Furthermore, they should appreciate that managing a company's reputational risk is just as important as managing financial or operational risk.

In particular, social media engagement is essential and can have a profound impact on all aspects of a company's business, including: corporate strategy, risk management processes and crisis communications planning. Failing to adopt social media practices is no longer an option. A single social media post can go viral in seconds and wreak havoc on a company's reputation, destroying significant shareholder value. To address this, the Board of 2018 will need to take a proactive approach and ensure social media is used to the company's advantage, offsetting potential liabilities and enhancing the company's reputational value.

An activist—be it an investor or an environmental opponent—can use social media to attack a company fairly easily. There are numerous stories of short sellers using tweets to erase billions of dollars in shareholder value. All too often, companies are underprepared for these types of attacks and do not even have adequate monitoring capabilities in place. Notable activists and funds that have used social media extensively include Carl Icahn, GAMCO Investors, California Public Employee's Retirement System (CalPERS), CtW Investment Group, and Paulson & Co.

Overall, the Board of 2018 should ensure that the company's management team is aware of and taking an active role in how a company is perceived on social media and check that the company is shaping any misperceptions. It will understand that the risk posed by social media is the same as any other material risk affecting the company's balance sheet. Having dedicated directors with these skill sets can often help. If not, a board could retain experts in the field as advisors so they are aware of the potential risks from the new media landscape.

As always, a company's CEO and its executives should narrate the brand story and aim to exert a higher degree of influence over the discussion about their company. They will also need to encourage and enforce the proper use of social media because of its abundance and difficulty to control.

A Checklist for Managing Media and Reputation:

1. Take a holistic approach to managing reputational risk as an asset, by focusing on reputation as an input to, as well as an outcome of, strategy, operations, and culture.

2. Ensure that reputation is a core area of risk analysis and the management team is appropriately planning for crisis/social media dangers. It is important for the board to receive the right insight, intelligence, and indicators to oversee the reputational risk.

3. Strengthen accountability by integrating reputation into existing reporting structures. Consider conducting an audit to assess preparation and reporting.

4. Ensure the board has the right skills and expertise to handle the role the media plays in shaping a company's reputation. Consider enhancing the board's skills and knowledge, if needed, on topics related to social media and the new media landscape.

5. Establish the right tone for the company and ensure the board and management carry it out through all elements of a company's operational plan.

6. Assess the company's procedures and policies needed to manage a crisis.

Constant Evolution

The Board of 2018 must evolve to contend with changing dynamics in the marketplace, within its organization and among its own shareholder base. Threats from activists are just the latest in a list of challenges for boards that were not present even a decade ago. Board composition should be diverse enough in perspective and experience in order to adequately recognize and respect the needs of key stakeholders and the vulnerabilities that must be managed.

Whether the topic is strategy, capital allocation, governance, succession or reputation, the effective Board of 2018 will not only be well-advised and highly skilled, but will also be able to offer an original set of ideas and perspectives and possess the adaptability and foresight to continue to focus on the long-term growth of an organization. Investor-minded, media-strong and engaged with the latest trends, it will be a board with the stature and presence to draw on all of its members' collective skills. Most importantly, it will be a board that is able to constantly evolve to meet the new issues and challenges that are surfacing every day.