CG NEWS UPDATE

IN 2020, DIRECTORS WORRY ABOUT BALANCING ECONOMIC DOWNTURN, BUSINESS-MODEL DISRUPTION

December 12, 2019
By Barton Edgerton

The 2019-2020 NACD Public Company Governance Survey, released this week, received responses from over 500 public-company directors to more than 80 survey questions. The questions discussed the trends most likely to impact organizations over the next year; areas in which boards would like to improve; the size, shape, and structure of boards and committees; and oversight of key areas of focus for the board, including strategy formulation, enterprise risk, cyber risk,human capital, compliance, and environmental, social, and governance (ESG) issues.

Overall, the survey results show that in the year ahead, boards face two conundrums: navigating a disruptive operating environment while preparing for a slowdown, and pushing forward with digital innovation while pausing to ensure a secure cyber environment. Directors also report important progress in two emerging areas of oversight: human capital and ESG risk.

Public companies face a conundrum navigating two divergent business forces.

Directors identify growing business-model disruptions (52 percent) and a slowing global economy (51 percent) as the trends most likely to impact their organizations over the next 12 months. While not contradictory, these divergent trends create a challenge for many public companies: how to balance a growth and disruption mindset to stave off competition while preparing for the impact of a potential recession.

CG NEWS UPDATE

More proactive and continuous board involvement in shaping strategy may be needed to navigate this conundrum. This includes recognizing the potential need for more frequent course corrections as conditions change. Boards should also work with management to create a shared short- and long-term picture to understand where the markets, industry, and competition are heading and what that means for strategy and growth prospects. Tools and tactics to do so can be found in the NACD Blue Ribbon Commission reports on preparing for the future and on adaptive governance.

Public companies must also confront growing friction between the need to digitally innovate and the effective management of cyber risks.

Companies have no shortage of opportunities to adopt emerging technologies in order to buttress their growth and respond to disruptive competitors.However, new technologies also come with risk, increasing opportunities for cyber-attackers and heightening exposure to data-privacy missteps. Boards must work with management teams to reconcile the need to transform themselves digitally with the need to ensure underlying data assets are properly secured. Sixty-one percent of directors report that they would be willing to compromise on cybersecurity to achieve business objectives, while 28 percent prioritize cybersecurity above all else.

Directors and boards can turn to the NACD Director's Handbook on Cyber-Risk Oversight to enhance their oversight practices and to the NACD report Governing Digital Transformation and Emerging Technologies to help ensure that the right balance between the two needs is maintained.

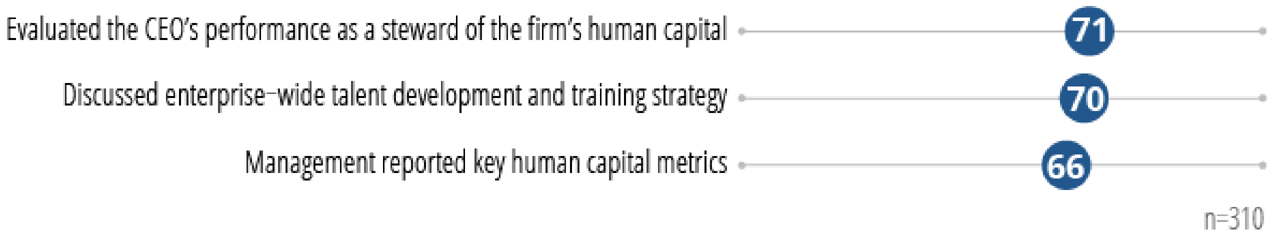
CG NEWS UPDATE

Board oversight of human capital is maturing.

Most directors (77 percent) are comfortable with their board's oversight of current and future talent needs, although just 43 percent said they have reviewed charters to ensure that talent oversight responsibilities are effectively allocated across the board. Additionally, only 34 percent responded that their boards have set clear expectations for what they require from management to effectively oversee human capital risk.

To address this issue, boards could expand the discussion of human capital and risk to ensure that it aligns with the overall strategy development process. They should consider updating their governance guidelines and committee charters to formalize human capital oversight responsibilities, as well as consider expanding the set of voices reporting on talent issues to include the information technology, audit, and operating business units. NACD's recent report Board Oversight of Human Capital Strategy and Risks provides boards with actionable guidance on how to improve their oversight of human capital.

Human Capital–Oversight Practices Performed Over the Past 12 Months
(percentage of boards)



ESG is becoming commonplace in the boardroom, though more work remains.

Nearly 80 percent of public-company boards now engage on environmental, social, and governance (ESG) issues in some meaningful way, according to the directors surveyed. Most focus on ensuring links to strategy and risk. Discussions with investors often center on elements of the "S"in ESG, with an emphasis on human capital (65 percent) and diversity (74 percent).

To provide effective oversight, boards need to ensure a common definition of ESG across the organization. This definition should be used by management to identify and prioritize ESG risks and opportunities, and it should be presented to the board in the context of the company's strategy. Guidance is available in NACD's handbook Oversight of Corporate Sustainability Activities.

Ref:https://blog.nacdonline.org/posts/2019-2020-public-company-survey

CG NEWS UPDATE

IDENTIFY, ASSESS, AND ADAPT: HOW DIRECTORS CAN PROACTIVELY OVERSEE ESG RISKS

December 10, 2019
By Veena Ramani and Hannah Saltman

A slew of headlines from the past year identify a critical business reality: Environmental, social, and governance (ESG) risks have financial consequences.

PG&E Corp.'s bankruptcy earlier this year, for example, was dubbed "the first climate-change bankruptcy" by The Wall Street Journal. In 2018, for the first time ever, more CEOs in the United States were fired because of "ethical lapses" than over financial concerns. And in 2017 alone, up to $941 billion of revenue from global public companies still depended on commodities linked to deforestation.

What does all this mean? First, ESG issues are increasingly having a material impact on the corporate balance sheet. Second, there is no longer any place to hide: In the current era of increased shareholder and stakeholder attention to these issues,
companies and their boards will face the consequences of unaddressed ESG risks, some of which can materialize quite suddenly.

Given this new reality, boards have a choice. They can react to ESG crises as they arise, or they can work proactively with management to keep companies resilient in the face of these risks.

Ceres' newest report, "Running the Risk: How Corporate Boards Can Oversee Environmental, Social and Governance Issues," provides boards with a roadmap to transition from a reactive to a proactive approach to ESG risks. Built from interviews with over two dozen corporate directors, "Running the Risk" provides boards with actionable recommendations, leading practices, and questions to ask management.

As the report highlights, directors need to focus on three core areas when integrating ESG issues into their risk oversight role:

- **Risk identification:** ESG issues pose traditional business risks, potentially impacting a company's operations, supply chain, workforce, and reputation. Boards need to ensure that these issues are factored into enterprise risk management processes, including sourcing information about relevant risks from shareholders, stakeholders, and external experts.

CG NEWS UPDATE

As an example, AstraZeneca combined its safety, health and environment, compliance, and sustainability departments into one Global sustainability team to better surface how ESG risks impact multiple areas of the business.

How do ESG factors fit within mainstream risks?

Type of risk	Example	ESG Factors
Governance risks	Board decision-making including CEO selection, executive compensation and board composition	• Growing shareholder focus on: - Diversity of the board - Recruiting directors with ESG or climate expertise with the ultimate goal of building "climate competent boards" - Linking executive compensation to ESG factors • ESG risk impact on directors' and officers' insurance
Board approval risks	M&A, divestiture, major capital expenditures, new product lines	• ESG performance as a factor in mergers and acquisitions-related valuations • Access to capital impacted by ESG performance • Growing consumer focus on ESG solutions
Enterprise risks	Reporting risks, operational risks, human resources/ labor risks, compliance risks, reputational risks, litigation risks	• Fines and penalties arising from ESG violations • ESG regulations • ESG-based litigation • Extreme weather events disrupting operations • Workplace injuries or deaths • Sexual harassment • Data privacy and data security breaches • Market devaluation from an ESG liability - Loss of liability insurance coverage - Loss of assets, reduced profits and reputational damage - Diminished likelihood of business receiving services and capital from financial institutions
Emerging risks	New technologies, economic/regulatory policy change	• Impacts from growth of artificial intelligence technology on job creation and local economies • Genetic engineering and nanotechnology impact on product development and human health

- **Risk assessment:** Identified ESG impacts are often incorrectly deemed immaterial or are thought of as only occurring over the long term. Boards need to engage management on how ESG risks are assessed, which could include using a materiality lens to consider whether and when the issues surfaced could significantly impact the company's performance.

CG NEWS UPDATE

- Additionally, scenario analyses can be used to understand the impacts of various ESG risks on the company and the organization's ability to address them. A positive example is Nestle's 2018 materiality assessment, which included ESG risks alongside other financial risks.

- **Action to mitigate or adapt to risks:** Once ESG issues are appropriately identified and assessed, the board plays an important role in working with management to keep the company resilient. Options include using internal prices on ESG factors to drive business decision-making about capital allocations, diversifying risks through mergers and acquisitions, using insurance to offset risks, and having proactive policy engagement to address risks in a more systemic way. For example, PepsiCo reports that it considers environmental sustainability criteria for assessing capital expenditure requests over $5 million.

Risks are risks, whether they arise from climate change or currency fluctuations. Boards that take proactive steps to identify, assess, and adapt will create resilient, long-term value for their shareholders and stakeholders, and they won't run the risk of being caught well behind the starting line in a crisis.

Ref.

https://blog.nacdonline.org/posts/proactively-oversee-esg-risks