MAY, ISSUE 5

CG NEWS UPDATE

STHE CALM BEFORE THE STORM: FIVE THINGS EVERY BOARD SHOULD BE DOING NOW

May 10, 2019 By Bradley J. Bondi

With the economy in overdrive and the bull market continuing to run, it is difficult to envision, let alone discuss, a storm ahead. The S&P 500 and NASDAQ each recently closed at record highs; unemployment is low; and the gross domestic product report is strong. The administration and Congress have taken steps to lessen regulatory burdens, and the Supreme Court has been issuing rulings favorable to businesses. Securities class action litigation against the Fortune 500 is down as stocks generally are rising. So why speak of a brewing storm—and what type of storm?

As the old adage goes, all good things come to an end. The bull market cannot last forever and there already are warning signs that suggest a slowing economy in 2020. Regardless of who will be in the White House after next year's election, the regulatory pendulum is already swinging toward more enforcement, particularly in new areas such as cybersecurity, consumer protection, and antitrust—at both the federal and state levels. State Attorneys General have increased enforcement efforts in areas traditionally reserved for the Securities and Exchange Commission (SEC). Plaintiff-lawyers are getting more creative in bringing new, innovative lawsuits against directors and officers, and class actions will increase as soon as stocks take a negative turn. There are five steps that boards should be taking now, even when times are good. These steps are critical to fortifying a company against the inevitable threats on the road ahead.

1.Conducting a Cybersecurity Audit

Stephanie Avakian, co-director of the SEC's Division of Enforcement, has stated that "[c]yber-related threats and misconduct are among the greatest risks facing investors and the securities industry." Threats have become more sophisticated, and not even federal agencies, including the SEC, are immune to hacking. Odds are the protections that exist at your company already have become antiquated as the threats evolve.

Cybersecurity is no longer solely the responsibility of a company's head of information technology. Regulators are increasingly looking to hold officers and directors responsible, and company fines for improper oversight or failing to report have increased. For example, Altaba, formerly known as Yahoo!, agreed to pay $35 million to the SEC to settle charges that it failed to disclose a security breach.

CG NEWS UPDATE

Yahoo's management allegedly learned in 2014 that hackers had breached its system and stolen personal and account information for millions of its users, but Yahoo did not disclose the breach for almost two years. The SEC's co-director of enforcement, Steven Peikin, said that while the SEC will not "second-guess good faith" responses to a cyberincident, he cautioned that "a company's response to such an event could be so lacking that an enforcement action would be warranted."

Responses to cyber intrusions are not limited to regulatory actions. In 2014, hackers stole 56 million credit and debit card numbers from Home Depot. Shortly after the breach, dozens of banks and credit unions brought class action lawsuits against Home Depot for its alleged data security weaknesses, contending that it "had ignored red flags, expert opinions, employee warnings and industry standards." To settle these claims, Home Depot agreed to pay $25 million to plaintiffs and to improve its data security practices. Altaba and Home Depot are not alone in facing adverse actions following a cyberincident; for these companies, proactive actions surely would have been less expensive than the large settlements they paid.

Directors can minimize both the risk of a cyberattack and also their own individual liability by hiring outside counsel and technical advisors to conduct a cybersecurity audit.

Although perhaps not intuitive, outside board counsel is essential to ensuring that the review is protected by the appropriate privilege. Moreover, outside counsel can advise not only on vulnerability but also on the processes and steps it would be necessary for the board to take if there were a cyber intrusion. Understanding and confirming that the appropriate processes are in place now is imperative to being ready should an incident occur. And, importantly, merely undertaking this type of review can help to reduce liability for directors if that time should come.

2.Reviewing and Enhancing Compliance Programs

Best practices dictate that at least once every three to five years directors should independently engage outside counsel to review the compliance and anticorruption programs at their companies to ensure that they are state of the art. In recent years, for example, the SEC has mandated new procedures for dealing with whistleblowers and the Department of Justice (DOJ) has issued new guidance for dealing with matters related to the Foreign Corrupt Practices Act. It is also worth noting that within the past month, the Treasury Department released new OFAC guidance. These developments should be incorporated into every compliance and anticorruption program in order to stay relevant. This low-cost process of independently reviewing compliance programs can significantly decrease the potential liability of directors.

CG NEWS UPDATE

3.Evaluating D&O Insurance

Good times are the best times to evaluate director and officer insurance. Insurance coverage is evolving and new insurance products in the area of government investigations and cybersecurity are available for both companies and their directors and officers. Boards should engage a broker to evaluate on at least an annual basis the existing insurance coverage and to recommend any enhancements. This evaluation of insurance coverage is particularly important in the cybersecurity area because insurers regularly revise policy language for cyber-attacks.

4.Considering Stress Testing and Enhancements to Enterprise Risk Management

Enterprise risk management (ERM) became a household phrase following the last financial crisis. Businesses should accompany ERM with stress testing the balance sheet, income statement, and statement of cash flows. Boards should consider pressing management to present contingency plans in the event that significant downturns occur in the stock price, asset values, or liquidity. Laying out the worst-case scenarios can help prepare a company and its board for the next crisis—whether it be macroeconomic or company-specific in nature.

5.Evaluating Succession Planning

Although succession planning is always important, it is particularly important during good times. Boards should evaluate key personnel, formulate a process of identifying new candidates, and pin down potential interim replacements in the event of a departure. Too often companies are caught flat-footed when a key officer unexpectedly leaves for whatever reason.

It is anyone’s bet when the next storm will hit, but history teaches us that it will happen. Boards should consider taking these steps now to prepare for the inevitable storm whenever and wherever it may disturb the present calm.

Ref:
https://blog.nacdonline.org/posts/the-calm-before-the-storm-five-things-every-board-should-be-doing-now

CG NEWS UPDATE

RAY GILMARTIN ON HOW TO BUILD A SUSTAINABLE GROWTH BUSINESS

May 14, 2019 By Christian Hildebrandt

What course of action does the board take when the company's growth stalls, changes implemented by the CEO are not working, and the board does not agree on future steps?
At the 2018 Summit Director & Officer Training Conference in Park City, Utah, Raymond V. Gilmartin, the former chair, president, and CEO of Merck & Co. who is now an NACD board member, described the typical response of boards in this situation and offered a better solution.

What Boards Do

Gilmartin described the scenario as "the director's dilemma," explaining that in this day and age of rapid change, every board will eventually face the challenge of the company becoming outdated, resulting in stagnant growth. What happens when a company faces this dilemma?

All too often, management blames the issues on external factors, failures in marketing and sales execution, or products that need to be reformulated and refreshed. The CEO moves to fix the identified weaknesses by revising assumptions, replacing the sales and marketing leadership, and refocusing research and development efforts. Despite these changes, growth remains below expectations, institutional investors become critical of management and the board, and activist investors move to take control.

The board is then left with one choice. They replace the CEO with an outsider to bring new perspective. New perspective, however, typically results in massive change. The new CEO often proposes high-risk transformation—such as a major restructuring or large acquisitions—to turn growth around. If done incorrectly, these actions consume rather than create value. The important question to consider, Gilmartin explained, is did the board have a lower-risk alternative available? With only one company in 10 succeeding at sustaining growth, a better understanding of the process of creating new growth is vital.

What Boards Should Do

If a leadership shakeup isn't the solution, then what is? Drawing on concepts from Clayton Christensen, a Harvard Business School professor and expert on disruptive innovation, Gilmartin described the path out of stagnancy through five key decisions:

1. What products should we develop?

New products and ideas are discovered by using a "jobs to be done" approach. Rather than perform traditional market segmentation based on customer

CG NEWS UPDATE

attributes, companies should segment the market by the jobs to be done. The nature of the market is that customers “hire” products to perform certain tasks. Therefore, if companies can develop products that customers want to hire, they will achieve far greater growth.

2. How can we beat the competition?

Disruptive innovation, not sustaining innovation, is the way to climb ahead in the market. What’s the difference between the two? Sustaining innovation offers high-end customers better performance through incremental or breakthrough technology by leveraging the existing capabilities and business model. This type of innovation is most successful for companies starting from a strong market position. Contrast this with disruptive innovation, which requires new capabilities, enabling technology, and an innovative business model. However, this type of innovation is successful against everyone, including market leaders.

3. How can we get the details of a winning strategy right?

The strategy development process for sustaining innovation is a deliberative one, which is systematic and scripted. This type of strategy development, however, does not work for disruptive innovation. Gilmartin recommends a “discovery-driven” process, where the company quickly launches a product to market and dynamically adjusts its strategy over time.

4. How should we finance the new venture?

Gilmartin described a difference between “good money” and “bad money” for start-ups. Good money is patient for growth but impatient for profit, meaning growth doesn’t usually materialize as quickly as expected, but costs and overhead must be kept low. Contrast this with bad money, which is impatient for growth and patient for profit, resulting in large losses from big spending on artificially inflated growth. Inevitably, new-growth ventures based on bad money shut down in tough times.

5. What is the best organizational structure for the new venture?

The organizational structure for the new venture should be based on the selected business model and organizational capabilities. The elements of a business model are a value proposition, resources to deliver the value proposition, processes to transform resources, and the profit formula. Organizational capabilities are developed through recurrent tasks done successfully while executing the business model. Therefore, although sustaining innovation leverages the existing capabilities and business model in the existing organization, disruptive innovation requires new capabilities, a new business model, and the creation of a new business unit.

CG NEWS UPDATE

After considering these five key decisions, Gilmartin explained that it is important for the CEO and board to agree on their roles in the innovation process. He proposed the following:

1. the CEO manages the creation of new growth, and the board oversees the process of creation;
2. the CEO and board agree on what theories to follow when creating new growth;
3. the CEO identifies and eliminates organizational impediments for the new venture; and
4. the CEO and board should ensure that new ventures take priority over core businesses when allocating time and attention.

Gilmartin concluded by saying that the process of creating successful, sustainable growth relies on these decisions, and that boards who consider the message and questions he shared will find greater success as they return to the path of growth.

Ref:
https://blog.nacdonline.org/posts/gilmartin-build-a-growth-business