

2018 Governance Outlook

PROJECTIONS ON EMERGING BOARD MATTERS

**A Publication of the National Association
of Corporate Directors and Partners**

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ABOUT THIS REPORT

2018 Governance Outlook: Projections on Emerging Board Matters is NACD's first publication of its kind, designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues likely to demand board focus over the coming year. The report begins with an introduction from NACD, highlighting survey findings about leading board priorities for 2018, and follows with six partner contributions that provide distinct insights and projections on the following themes: business risks, board evolution, litigation, workforce disruption, and cybersecurity.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2018, and (3) relevant implications and questions for boards to consider. *2018 Governance Outlook: Projections on Emerging Board Matters* is designed as a collection of observations to help corporate boards prioritize their focus in 2018 and increase their awareness of emerging issues, through both detailed topical analysis and coverage of broader governance implications.

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Executive Summary

Key Projections



Board Priorities

NACD

- Industry change, business model disruption, and changing economic conditions are among the top trends corporate directors expect to impact their companies in 2018.
- In light of major turbulence in the business environment, a majority of corporate directors indicate that it is critical to strengthen the board's role in strategy and risk oversight.

“Boards are in a unique position, given the diverse experiences of directors, to spot and clarify emerging patterns, connect the dots, and offer management actionable insights about how their companies can continue to thrive in a changing world.”



Business Risks

GRANT THORNTON LLP

- Risk management at many organizations needs an overhaul to be effective in an increasingly complex and volatile environment. Current enterprise risk management (ERM) approaches often struggle because they are too procedural and compliance driven.
- Boards should actively encourage more predictive risk management through scenario planning and use of advanced analytics.
- Directors must determine what level of foresight is needed to fulfill their responsibility to protect and grow value. “How do we avoid becoming the next Encyclopedia Britannica or Blockbuster?” is the oft-asked question.

“Boards that choose to ignore these risks, or adopt a wait-and-see attitude, may well find existing business models shaken and face disruption significant enough to jeopardize the organization itself.”



Board Evolution

SPENCER STUART

- Boards are enhancing disclosures about board composition, including director backgrounds, ages, tenures, and independence, among other attributes. These disclosures are generally accompanied by a description of the board nominating process.
- Boards are considering a wider variety of profiles for new director candidates by adding first-time public company directors, active executives below the C-suite, and women and minorities.

“Beyond board policies, slow board turnover has been driven by the traditional mind-set that directorship is a lifetime appointment. . . . The demands of the business and external forces, principally pressure from investors, are likely to change how boards think about composition and refreshment strategies.”

Litigation

KATTEN MUCHIN ROSENMAN LLP

- Most securities lawsuits have targeted alleged omission of information, as opposed to financial misstatements.
- Directors should consider gathering more information from senior executives and comparing disclosure practices with peer companies that may be disclosing more information.

“While omission-based litigation is becoming an unfortunate fact of life for many public companies, thoughtful and productive disclosure can significantly reduce the risks involved.”

AIG

- Although the number of public companies has declined, 2017 has the highest number of securities class action lawsuits filed since 2001.
- D&O litigation against private companies has increased dramatically over the past decade, and this trend is expected to continue as many private companies with high valuations delay IPOs.

“Board members should carefully evaluate the D&O liability insurance available to them, including ‘Side A’ options dedicated solely to protecting their personal assets.”

Workforce Disruption

DELOITTE

- Boards should confirm that senior management is moving the company beyond just technology adoption. Embracing digital technology means cultivating a digital mind-set and changing how people view work and business.
- Companies that are digitally mature value experimentation, embrace risk, and develop leadership structures that are less hierarchical and more distributed. These organizations are also more likely to use data in decision making.

“Many organizations in 2018 will need to revisit their long-term strategy around work, specifically from the angle of automation and digital transformation.”

Cybersecurity

PALO ALTO NETWORKS

- Regulators across the globe are trying to catch up to the growing threat and impact of cyberattacks, but their approaches will likely diverge across markets. Regulatory expectations will continue to evolve in 2018, becoming even more complex, more demanding, and potentially more prescriptive.
- The goal for directors should be to help their organizations focus on what matters—reducing cybersecurity risks to their most critical strategic assets.

“Board members need to ask the right questions designed to provide a deeper understanding of current and potential risk levels, and a stronger basis for taking action to protect against current and emerging threats.”

Public Company Board Priorities for 2018

By Friso van der Oord

MOST FREQUENTLY MENTIONED INDUSTRY CHANGES BY SECTOR

- **Energy:** Supply-chain volatility, geopolitical upheaval, and climate change
- **Financial Services:** Fintech disruption, industry consolidation, and regulatory change
- **Consumer Goods:** Digital disruption, industry consolidation, and changing demographics influencing consumer behaviors
- **Industrials:** Competition, tech disruption, and global economic volatility

Source: Data is from responses to the *2017–2018 NACD Public Company Governance Survey*.

What do public company boards believe the top business trends will be in 2018? In which governance areas must boards improve their performance next year? These are some of the questions we asked in our latest annual survey of almost 600 NACD members across different industry sectors and levels of market capitalization.

Over the past two decades, NACD has surveyed its membership to report on the prevalence of specific governance practices in a broad range of areas, helping boards of both public and private companies compare and contrast their approaches. More recently, in light of accelerating changes in the business environment, our quantitative analysis has focused on the collection of forward-looking data about emerging trends and board governance improvement priorities. While the full set of findings are available in our *2017–2018 NACD Public Company Governance Survey*, this essay will summarize the most relevant projections corporate directors shared with us.

Key Projections

Four key takeaways emerged from an analysis of survey data on the biggest trends affecting the business environment in 2018, according to directors:

1. **Significant industry change** was selected by **58 percent** of respondents as one of the five trends likely to have the greatest impact on their companies in 2018. When asked to break down the key drivers of change in their industries, respondents most frequently mentioned technology disruption, industry consolidation, and shifting regulations.

In light of major industry change, it is notable that industry experience is the most desirable attribute that boards look for in new director candidates. They will need to carefully assess if candidates' past industry experience is still relevant for the company's future needs.

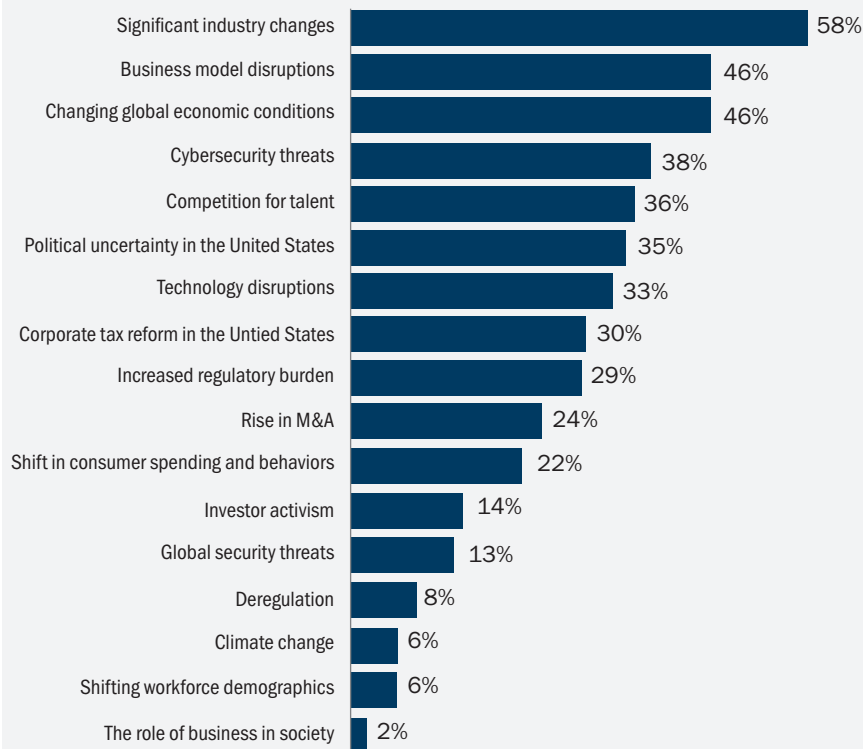
2. **Business model disruption and competition for increasingly scarce talent**—which contribute to major industry upheaval—are also ranked among the top five 2018 trends, suggesting boards are concerned about a dramatic transformation in how enterprise value is created and about their companies' ability to effectively adapt.

3. Similar to the results in last year's survey, very few boards consider **social and environmental issues** as top trends that will impact business performance over the next 12 months. Just **6 percent** of respondents selected climate change as a top five trend for 2018, while only **2 percent** believe the changing role of business in society is a key trend impacting their company. This suggests that most boards continue to see these challenges as peripheral to near-term business success, despite increased expectations about corporate sustainability from investors and declining trust in business among the broader public. In fact, only **24 percent** of respondents consider it important or very important that their board improves oversight of environmental, social, and governance (ESG) matters in 2018.

4. **Economic and political uncertainty**, which was one of the top trends in last year's *2017–2018 NACD Public Company Governance Survey*, continues to pose a challenge for corporate directors and their companies. **Forty-six percent** of respondents selected changing global economic conditions as a top five 2018 trend that will impact their business, while **35 percent** ranked the uncertain political environment in the United States as a top five 2018 trend. Perhaps not unexpectedly in light of the

What Five Trends Do You Foresee Having the Greatest Effect on Your Company Over the Next 12 Months?

(Respondents could select five of the 17 issues below.)



Source: 2017–2018 NACD Public Company Governance Survey.

Trump administration's focus on repealing or softening federal regulations, respondents' concerns about the **impact of the regulatory burden** dropped significantly, from **58 percent** in 2016 to just **29 percent**. However, a lower regulatory burden in the United States may be offset by proliferating compliance requirements and heightened regulatory enforcement in other markets—specifically in the European Union and China.

2018 Board Priorities

To understand how boards are planning to strengthen their governance practices in this volatile, uncertain business environment, we asked about their top improvement priorities over the next 12 months. Directors rated the following five areas as their most important opportunities for improving the performance of their board:

1. Board Contribution to Strategy: Possibly driven by the need to adapt their companies to a rapidly changing business landscape, **71 percent** of directors indicate that their boards must better understand the risks and opportunities that affect performance and drive strategic choices over the next 12 months. **Sixty-seven percent** of them report that their boards must improve their contribution to the development of the strategy, while the same number of respondents feel that

Many boards still struggle to move from a traditional review-and-concur approach to deep and continual engagement with strategy.

it is important for their boards to strengthen the monitoring of strategy execution.

In last year's survey, improving the board's contribution to strategy was also a top-ranked priority, suggesting that many boards still struggle to move from a traditional review-and-concur approach to deep and continual engagement with strategy. One obstacle to more robust board engagement with strategy may simply be insufficient time allocation. **Fifty-one percent** of respondents this year indicate that the lack of adequate time during board meetings for in-depth strategy discussions is an important barrier to effective strategy engagement, up from **44 percent** last year.

2. Board Oversight of Risk Management: Fifty-eight percent of respondents report that it is either important or very important that their boards improve the oversight of risk management across the next 12 months. Boards are not entirely sure that their executive teams are prepared to lead their companies through significant turbulence in the operating environment. More than half of board respondents (**54 percent**) are confident or very confident that management can appropriately address growing geopolitical risks to their business, while **61 percent** of directors have confidence that management can navigate rapidly shifting global economic conditions.

Only **49 percent** of board respondents are confident or very confident that management can effectively manage cyber risk. Not surprisingly, this threat receives the lowest confidence scores because cyber risks constantly mutate and technologies evolve, rendering existing controls quickly obsolete.

3. Board Operations: In light of the increased scope of board responsibilities and growing frequency of meetings, boards recognize the need to improve their operational effectiveness. **Fifty-six percent** indicate the need for improved rigor in board decision making, while **58 percent** say that their boards must get better in following through on recommendations that come out of board meetings.

For Your Board, How Important Are Improvements in the Following Areas Over the Next 12 Months?

(Top 10 most important board improvement areas based on % ranking improvement over the next year as "important" or "very important")



Source: 2017–2018 NACD Public Company Governance Survey.

4. Board Culture: In our survey, **58 percent** of respondents report that their boards should improve the candor of boardroom conversations over the next 12 months. Moreover, lack of candid feedback is seen as a major obstacle to making board evaluations more effective. Only **54 percent** of public company boards today actively discuss their boardroom culture and underlying problems in executive sessions.

5. CEO Succession Planning: Among survey respondents, 58 percent indicate that improving CEO succession planning is a critical improvement priority for 2018, up from **47 percent** last year. Discussing CEO and executive-team succession with investors also saw a large increase, from **8 percent** of respondents in 2016 to **19 percent** this year. One of the drivers behind this growth may be increased investor scrutiny of CEO performance and unexpected, forced departures of high-profile CEOs in 2017. (See graph on page 6.)

Proposed Board Actions

In sum, corporate directors of U.S. public company boards recognize the growing challenge of navigating their companies through a period of seismic changes in technology, industry, geopolitics, and economics that are all occurring simultaneously. The confluence of these changes is altering how companies must compete and create value in today's market place. And the stakes are high. What do we recommend that boards do? Although certainly not comprehensive or conclusive, the following are concrete actions directors should consider:

- **Develop a more intimate understanding of your changing business and industry.** Boards may have many years of collective industry experience, but much of that experience quickly becomes irrelevant in light of accelerating changes that render the drivers of industry competition obsolete. Directors should find opportunities to challenge their own conventional industry wisdom and learn in depth how their business is trying to adapt to change. Activities could include field trips to operational sites, R&D projects, or start-ups that unleash product innovations or new business models, while outside experts could offer contrarian perspectives on the future of relevant industries during board meetings.
- **Allow time for pattern recognition during and in between board meetings.** Deeply connected global capital markets, a shifting geopolitical balance, and the convergence of emerging technologies put many companies on the defensive. Management teams are constantly responding to the immediate impact of these external forces but have developed little foresight about the long-term risks and opportunities that major changes may create. Boards are in a unique position, given the diverse experiences of directors, to spot and clarify emerging patterns, connect the dots, and offer management actionable insights about how their companies can continue to thrive in a changing world. But time must be set aside during and between board meetings to focus directors on this task, while ongoing education will be important to strengthen their “sense-making” skills.

- **Rethink how your board engages with strategy.** This year's survey findings underlined the pressing need for many boards to improve their contribution to strategy. Our [Report of the NACD Blue Ribbon Commission on Strategy Development](#) from 2014 notes that boards should expect change and understand how it may affect the company's current strategic course, potentially undermining the fundamental assumptions on which the strategy rests. They should constantly engage with management on strategy issues, including early involvement when the strategy is forming or being adjusted. They should thoroughly evaluate strategy options and underlying assumptions in good times, as well as in times of change or crisis, and not be afraid to ask difficult, fundamental questions about the viability of the business.
- **Identify business practices that may become unacceptable.** It is striking to see that, according to this year's survey results, so few board respondents consider environmental and social issues as important to performance over the next 12 months, but the impact of ESG-related events could be dramatic and unexpected. Companies and their boards should constantly assess shifting demands of key stakeholders, including customers, advocacy groups, investors, and regulators, that may snowball and accelerate pressure to end or change existing business practices.
- **Scrutinize how risk resilient your enterprise is.** Major risk events now happen more often, and many of them are turning into serious crises. But many companies have not yet adapted their traditional enterprise risk management, and business continuity approaches. Although robust risk assessment and mitigation continue to be important, they must be supplemented with crisis readiness plans and a focus on allowing the company to restore itself quickly and emerge even stronger. Boards must evaluate whether their companies will be able to bounce forward after a crisis and consider scenarios that may trigger crises that were inconceivable even 12 months ago.



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The Future of Risk Management

By Bradley J. Preber

Corporate directors face serious challenges on multiple fronts. New technologies are creating new markets and disrupting business models. Tax reform could create windfalls or hamper international commerce. Weather events wreak havoc on regions and industries. Geopolitical volatility raises questions about whether to withdraw from, or invest in, global operations. Directors, therefore, see the current environment as highly risky—with good reason.

According to Grant Thornton research,¹ and our experiences in client engagements, corporate directors are most concerned about five risk areas going into 2018. Each of these areas warrant corporate directors' serious consideration as well as responses geared to the organization's exposure to these risks and opportunities to capitalize on them:

1. Overall risk management
2. Technology disruption
3. Growth and value creation
4. U.S. public policy uncertainty
5. Organizational culture

These areas present potentially greater risk exposure but, when they are proactively addressed, potentially greater opportunities. On that subject, owners and investors expect directors to exercise proper risk oversight and will hold them accountable for protecting and driving growth and value. Failure to respond to these expectations can result in ouster, social shaming, or hostile power plays.

1. Overall Risk Management

Since passage of the Sarbanes-Oxley Act of 2002, many organizations have taken a procedural approach to risk management, settling for risk management processes that emphasize form over substance. Organizational risks are listed, charted, graphed, and circulated. Signatures are obtained, trainings are logged, and boxes are checked for the necessary purpose of documenting compliance with regulatory requirements.

Other organizations have adopted enterprise risk management programs that treat compliance as one part of the larger process of controlling and managing risk. Such programs have occasionally led to over-decentralization of risk management across divisions, functions, and process owners, thus diffusing ownership of risk and making it hard to develop a coherent view of enterprise risk. In such cases, directors must ascertain that the potential downsides of decentralization have been addressed.

The Impact of Technology on Risk Management

Future risk management processes will feature real-time integration and enterprise-wide sharing of internal data, as well as data from social media, crowd sourcing, newsfeeds, and other external sources. Employees will have ready access to information on existing and emerging risks and to ongoing analysis of exposures. Risk exposures in excess of tolerances will be automatically addressed using

Owners and investors expect directors to exercise proper risk oversight and will hold them accountable for protecting and driving growth and value.

¹Grant Thornton LLP, *2016 Governance Risk and Compliance Survey*; Grant Thornton LLP, *2017 CFO Survey*.

The estimated cost of Hurricane Harvey was \$180 billion, according to [Fortune.com](#).

artificial intelligence (AI) to redirect resources, mobilize stop-gap measures, or shift sharable risks to third parties. Imagine expanding into a new country and having the international risks measured and reported, work flows and monitoring assigned to process owners, additional controls triggered, and insurance coverage put in place, all through technology-enhanced mechanisms. Organizations that are preparing for that future now will be those best positioned to compete in it.

Within the area of overall risk management, directors and senior executives expressed concerns about operations and compliance risks and underscored several specific operations risks:

Operations Risk

Operations risk encompasses all risks inherent in daily operations. These risks are typically managed through internal policies, processes, controls, and systems that reduce them to acceptable levels. In some industries, operations risk is subject to regulation.

Corporate directors and senior executives identified four top-of-mind operations risks:

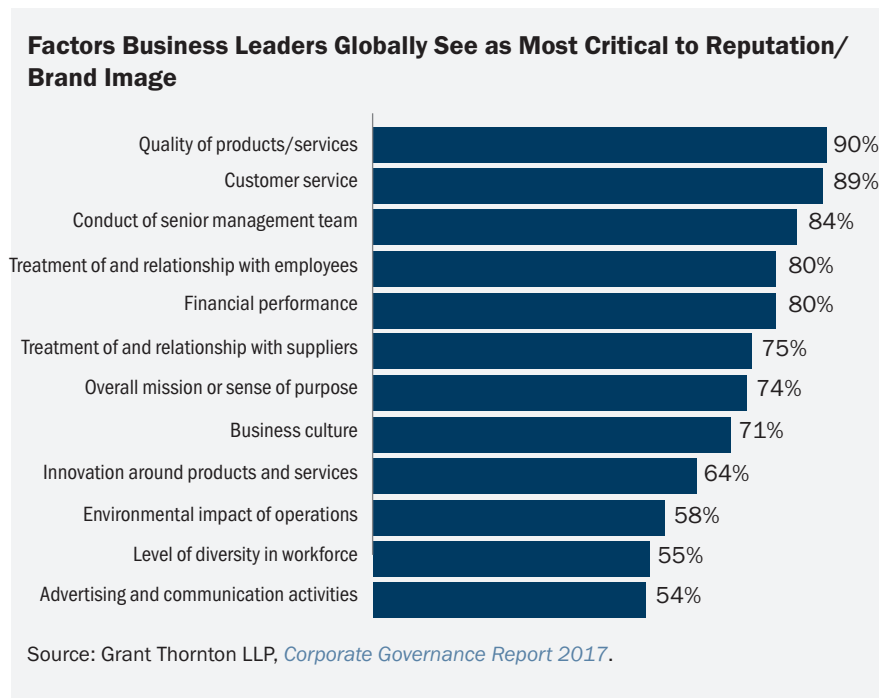
- **Cybersecurity Risk Becoming a Boardroom Staple:** Although cybersecurity has been a priority for years, concern has risen with widely reported breaches at a broad range of organizations. This risk will likely remain on board agendas permanently, with directors increasingly seeking clearer and more complete, relevant, and timely assurance regarding the organization's ability to identify, manage, and respond to cyber risks.
- **Business Interruption Concerns Are Accelerated by Recent Events:** Business interruption rose in importance due to damages inflicted by Hurricanes Harvey and Irma, the threat of war, skilled labor shortages, and political actions such as sanctions, embargos, and penalties for trade. These matters, along with changes in the underwriting of insurable risk, have many directors scrambling for ways to effectively oversee business interruption risks.
- **Accounting Changes Increase Risks for Fraud and Error:** With U.S. accounting changes soon taking effect, revenue recognition and lease accounting standards will become more susceptible to management judgment (and potentially fraud and error). These changes may also affect the way deals are modeled and challenge the expertise of financial specialists on the board. (See graph on page 11.)
- **Reputational Risk Is Rising:** Concerns continue over reputational risk and the resulting destruction or impairment of brand value. Lost customer trust can erode creditor confidence and shareholder value and draw bad press and social media coverage. As stewards of value, directors must understand this risk and management's methods of managing it.

Compliance Risk Persists

Failure to comply with internal policies and procedures or external laws, regulations, or standards creates compliance risk.

Yet wise management of this risk can create competitive advantage. In the future, organizations will achieve compliance while lowering costs and enhanc-

ing value through technology solutions and integrated risk management systems that shift compliance to process owners and even to customers. (Consider how often you are asked to enter your own data during a transaction.) Also, effective organizational cultures can lower compliance risks and costs further than purely policy-driven programs.



WHAT IS BLOCKCHAIN?

"It's a public ledger in which transactions are made in some form of crypto currency and are recorded chronologically on a public ledger."

JOEL WATERFILED
Managing Director
Grant Thorton LLP (USA)

2. Technology Disruption

The changes wrought by technology disruption on markets, consumers, employees, and service delivery are everywhere. Boards must keep abreast of these changes and of the possibilities of AI, Internet of things, and robotics as they continue to pose risks and opportunities to the organization.

Creating a Blockchain Risk Management Strategy

This summer, David Longdon, a senior director for federal advocacy at CompTIA, who handles emerging technologies, discussed how the U.S. government is considering using blockchain to give citizens easy online access to services. This followed the formation of a congressional Blockchain Caucus focused on (1) digital identity guidelines; (2) enrollment and identity proofing; (3) authentication and life-cycle management; and (4) federation and assertions. If the U.S. government sees potential value in blockchain, directors should probably be asking, "How can our organization determine the applicability of blockchain to our business and the risks of adopting or ignoring it?"

3. Growth and Value Creation

Directors must oversee growth and value creation within the organization, yet tra-

"How do we not become the next Encyclopedia Britannica or Blockbuster?" is the oft-asked question.

ditional business models, especially those depending on paid labor to drive value, are being undermined or upended. Therefore, directors are asking management to create innovative growth models that are less dependent on, or even independent of, existing modes of value creation. Emerging models include monetizing client-service intellectual property by charging for insights and ideas, using customer data to create and sell proprietary metrics, and entering joint ventures and alliances to match technologies with traditional sales delivery models.

Great Ideas: The Capital of the Future

This change generally requires organizations to identify and capture ideas, or intellectual capital, to be analyzed by experts for potential investment and commercialization. These efforts are breeding new consultancies and products to leverage creative approaches, such as crowd-sourcing, agile development, and "Shark Tank"-style knock-offs, to name a few.

Directors must determine what level of forward thinking is needed to fulfill their responsibility to protect and grow value. "How do we not become the next Encyclopedia Britannica or Blockbuster?" is the oft-asked question. Directors seeking answers will urge management to experiment with new forms of innovation, such as multiple small-scale pilot projects and rapid, iterative prototyping, to identify and develop new value streams and business models.

4. U.S. Public Policy Uncertainty

In the United States, directors face turbulence created by an uncertain legislative agenda and regulatory environment. This uncertainty increases risks for directors, who must assess potential impacts on their organizations, and direct senior management, who must prepare useful responses. It also adds to the difficulty of making long-term investment decisions.

Predicting and Modeling "What-Ifs" to Shape Public Policy

In response, new approaches to risk identification, assessment, and response are being devised to better forecast impacts and outcomes. Directors are looking to accountants, economists, lawyers, lobbyists, and other external advisers to prepare predictive models, perform tabletop exercises, and develop action plans to address issues in play. Not content to be victims or spectators, they are proactively and urgently crafting plans to anticipate and influence policy matters.

5. Organizational Culture

Effective risk management calls for directors to help shape and to oversee an organizational culture that drives performance. Culture comprises the values, attitudes, and behaviors that an organization exhibits in its operations and relations with employees, customers, and other stakeholders. It is the glue that holds the organization together and a key determinate of risk and success. As such, culture warrants ongoing monitoring and attention.

Accounting Changes Increase Risks for Fraud and Error



Source: Grant Thornton LLP, *Corporate Governance Report 2017*.

Culture Is Being Managed as a Risk by Corporate Directors

Presently, most directors cannot adequately describe their organization's culture. Values remain undefined and not linked to desired behaviors or expected outcomes. Performance metrics omit values and behaviors and focus only on achieving targets, at times, in ways that contradict cultural expectations.

Many boards are working to build and maintain strong, cohesive corporate cultures. They are using internal controls to monitor behavior and ensure compliance with expectations and are evaluating vendors and customers for their cultural fit.

In Closing

Corporate directors understand which risks are creating adverse exposure and which opportunities should be seized. The five risk areas identified here stand at the top of most boards' agendas.

To address these risks, directors are urging management to integrate operations and compliance risk management and embrace technology. They are exploring new ways to create value through novel business models and proactive approaches to federal policies. They are shaping the organizational culture to generate the right results in the right way.

Boards that ignore these risks or adopt a wait-and-see attitude may well find existing business models shaken and face disruption significant enough to jeopardize the organization itself. In this context, directors might ponder the following questions as they evaluate today's risks:

- **Current State:** How effective is your organization at (1) identifying emerging risks, and (2) preparing for and managing those risks?
- **Alignment With Strategy:** Is your risk management integrated and aligned with strategy? If so, how are you assessing management's alignment of risk management with strategy?
- **Culture:** What is your organization's "risk management culture"? If it has been defined, how are you assessing its soundness and effectiveness?
- **Compliance Versus Risk Management:** Is your management team striking the right balance between compliance and risk management? Is it devoting enough resources to strategic risk management?

"It is surprising to see environmental and diversity issues so low on the list, when you consider how much discussion there is around those two issues at the moment—particularly in relation to businesses and corporate social responsibility."

SIMON LOWE
Chair, Grant Thornton
Governance Institute
Grant Thornton UK

- **Cyber Risk:** Is your organization effectively integrating cyber-risk management into its overall risk framework? Is it exploring how to use cyber-risk management to strategic advantage?
- **Constant Change/Evolution of Risk:** Is your management team adopting practices to address evolving and emerging risks? Is it integrating risk management into real-time operations? Is your organization risk resilient?



Bradley J. Preber is the national managing partner for Business Risk Services (BRS). He also serves on Grant Thornton's Partnership Board. Mr. Preber specializes in complex claims and events, with a particular emphasis on commercial disputes and fraud claims. He frequently speaks, writes, and teaches on leadership, risk, accounting, and fraud-related matters. Wiley published his book *Financial Expert Witness Communication: A Practical Guide to Reporting and Testimony* and he co-authored *Data Analytics: Evaluating Internal Audit's Value* published in 2016 by the Institute of Internal Auditors Research Foundation.

Board Evolution: The Forces Driving Board Composition and Succession

By Julie Hembrook Daum

Board evolution historically has been driven by directors reaching retirement age and, periodically, by the emergence of a profound need for new perspectives on the board—such as financial expertise after the passage of the Sarbanes-Oxley Act and, more recently, digital and cybersecurity experience or diversity.

As a result, board turnover continues to be modest. In the 2017 proxy year, S&P 500 boards appointed 397 new independent directors, and 48 percent of boards did not appoint a new director.¹

S&P 500 boards today rely overwhelmingly on formal retirement policies to promote turnover. About three-quarters (73 percent) of S&P 500 boards report having a mandatory retirement age for directors, consistent with the past five years. And retirement ages continue to rise. Today 42 percent of S&P 500 companies with mandatory retirement policies set their retirement age at 75 or older, compared with 22 percent in 2012 and just 11 percent in 2007. And few boards have mandatory tenure policies. Only 24 S&P 500 boards (5 percent) set explicit term limits for non-executive directors, with a majority of the policies set at 15 years or more. Nearly two-thirds (65 percent) of boards explicitly state in their corporate governance guidelines that they do not have term limits.

Beyond board policies, slow board turnover has been driven by the traditional mind-set that directorship is a lifetime appointment. Historically, leaving or being voted off the board before reaching an age or term limit has had a negative perception—that the director did something wrong. The result of this mind-set and prevailing board policies is that boards turn over slowly and, when they do have an opening, tend to think in terms of finding director candidates able to check multiple boxes on the board's wish list and those who can bring skills and expertise that will be relevant for 10–20 years.

The demands of the business and external forces, principally pressure from investors, are likely to change how boards think about composition and refreshment strategies. The sheer pace of change today means that companies—and boards—are having to respond to market, competitive, technology, political, regulatory, and customer changes that are coming at them faster than ever. Companies increasingly will need agile boards with the energy and expertise to deal with emerging threats and opportunities. Investors have become more vocal that board composition reflects these strategic needs.

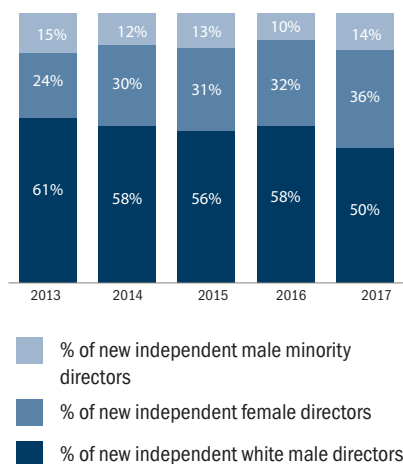
Preparing for 2018: Governance Developments on the Horizon

Here are some of the trends we believe will emerge or accelerate in 2018:

Investors will continue to push for more insight into how boards approach refreshment, and boards will respond with more detailed disclosure and increased engagement. Investor interest in board composition has never been higher. Today investors expect boards to have meaningful processes—beyond formal policies such as mandatory retirement ages—to refresh the board and maximize board effectiveness. They are requesting details on how boards review and evolve board composition and leadership in light of emerging needs. In response,

¹ Data throughout this article is gathered from the *2017 Spencer Stuart U.S. Board Index*.

Percentage of New Female and Minority Independent Directors in the S&P 500 (2013–2017)



more boards will disclose their rationale for their composition based on the strategic priorities of the business. A growing number of boards, for example, are including a detailed composition matrix that summarizes director backgrounds, ages, tenure, and independence at a glance. Others provide descriptions of the board nomination process, including an explanation of how director candidates are identified, the process for reviewing nominations and the number of new directors the process has produced in the recent past. We also expect that boards will increase their engagement with large shareholders on key governance topics, including composition. In our 2017 S&P 500 governance survey, 82 percent of respondents said management or the board proactively reached out to the company's large shareholders; board refreshment was one of the top three investor outreach topics, with 43 percent saying their board or management team proactively communicated with investors about it.

We will continue to see new faces in the boardroom. Boards are casting a wider and deeper net to identify qualified candidates, and we expect they will continue to consider a wider variety of profiles when recruiting new directors in 2018. In the 2017 proxy year, for example, we saw the largest influx of first-time directors on S&P 500 boards; 45 percent of new directors were joining their first outside public corporate board. These first-time directors are more likely than other new directors to be actively employed (64 percent versus 42 percent). They also are less likely to be C-suite executives and more likely to have other executive experiences such as division/subsidiary leadership. More than half (55 percent) of the first-time directors are women or minorities.

The pace of director retirements will increase. U.S. boards are aging, which inevitably will spur more retirements. The average age of S&P 500 directors today is two years older than a decade ago, 63 versus 61, and 19 percent of S&P 500 directors are 70 to 79 years old.

Boards will face more pressure on gender diversity. With research showing that companies with more diverse boards perform better, more investors will push harder on boards to increase diversity.² State Street Global Advisors now “expects boards of Russell 3000 listed companies to have at least one female board member.”³ And BlackRock said in a recent quarterly report, “Ideally, we believe boards should commit to adding at least two women directors.”⁴ During the 2017 proxy season, State Street announced that it voted against the chair or most senior member of the nominating and governance committee of 400 all-male boards,⁵ and BlackRock voted against nominating committee members of a few boards

² Christopher P. Skroupa, “Gender Diversity On Boards—A Driver Of Value,” *Forbes*, June 27, 2016.

³ State Street Global Advisors, “Proxy Voting and Engagement Guidelines: United States,” 2017.

⁴ BlackRock, *Investment Stewardship Report: Americas: Q2*, June 30, 2017, p. 9.

⁵ Emily Chasan, “After Fearless Girl, State Street Puts Men-Only Boards on Notice,” *Bloomberg*, July 26, 2017.

for failing to address investor concerns about boardroom diversity.⁶ In explaining its decision, BlackRock said diverse boards “make better decisions.”⁷ Boards are taking steps to enhance boardroom diversity. Half of the new S&P 500 directors in the 2017 proxy year are women and/or minorities. Female representation among new directors rose to 36 percent in 2017, a 20-year high, while 20 percent of new independent directors are minorities, defined as African-American, Hispanic/Latino, or Asian.

The Implications for Your Board

As these forces gain steam in 2018 and beyond, we believe boards will increasingly establish mechanisms to refresh themselves more frequently and embrace a continuous improvement mind-set. In particular, forward-looking boards will think about board composition in terms of an ongoing refreshment strategy, recognizing that business is moving fast and different kinds of people will be needed at different times. With this in mind, we have identified four best practices for board composition:

View director recruitment in terms of ongoing board succession planning, not one-off replacements.

Investors expect that boards evaluate board composition holistically, in the context of the company’s long-term strategy, the current business environment, and the diversity of stakeholders. Led by the nominating/governance committee, boards should periodically review the skills and expertise on the board to identify gaps based on changes in strategy or the business context. The annual board assessment is a natural platform for the full board to review its composition and discuss the expertise that it will need in the future.

Embrace a continuous improvement mind-set.

As they reduce reliance on mandatory retirement to drive turnover, more boards will embrace individual director assessments to understand the contributions of directors and whether their skills continue to be relevant given the current and future needs of the business. In 2017, just over one-third (37 percent) of S&P 500 companies reported some form of individual director assessments in their evaluation process, a small increase from 34 percent in 2016. But the recently published *2017–2018 NACD Public Company Governance Survey* indicates that the practice of assessing individual directors appears to be gaining momentum in boardrooms; 60 percent of respondents said their board includes individual director performance in the evaluation process, up from 41 percent the prior year. Most individual director evaluations are conducted annually (89 percent). High-performing boards also will assess the culture and dynamics in the boardroom to identify ways to operate more effectively, and, increasingly, they will adopt a continuous

One way boards can combat the perceived stigma attached to leaving a board before the mandatory retirement age kicks in is to set term expectations when new directors join.

⁶Emily Chasan, “BlackRock Puts Its Votes Behind Proposals to Get Women on Boards,” *Bloomberg*, July 13, 2017.

⁷BlackRock, “Our engagement priorities for 2017–2018,” 2017.

feedback loop, where they spend a few minutes at the end of every meeting asking themselves questions like, “How did that go? What could we have done better? Did we make a meaningful contribution?”

Set expectations for appropriate tenure at both the aggregate and individual levels.

One way boards can combat the perceived stigma attached to leaving a board before the mandatory retirement age kicks in is to set term expectations when new directors join. Long-standing board members often are surprised when they are asked to leave because things have been left open-ended. Setting expectations at the outset reduces the element of surprise. Furthermore, individual directors should be encouraged to think critically about their own contributions and whether the experience they bring is as relevant today as when they joined the board. The best boards create an environment where directors are willing to candidly consider whether their skills still match the company’s strategy each year and acknowledge when the board would benefit from bringing on different expertise. Thinking about director tenure in this light also will be important for attracting younger directors. The next generation of directors isn’t interested in staying on a board for the long term; they want to be valuable over a period of time and then leave.

Proactively communicate the skill sets and expertise in the boardroom, as well as the roadmap for future board succession.

Investors are looking for a well-explained rationale for why the group of people and each individual sitting around the board table are the right ones based on the strategic priorities of the business. They also want assurances that the board has processes in place to continue to evolve board composition in light of emerging needs. More broadly, investors want to understand the board’s approach to board renewal and that it regularly evaluates the contributions and tenure of current board members as well as the relevance of their experience. Sharing the board’s thinking about the types of expertise needed on the board—and how individual directors provide that expertise—is increasingly considered best practice. Publishing a skills matrix is one way some boards are providing that detail.

Five Questions for Board Composition

1. Do we regularly conduct a side-by-side comparison of directors’ skill sets and experiences against the company’s strategic agenda?
2. What mechanisms are we using to ensure board refreshment?
3. Have we fostered an environment that encourages individual directors to think critically about their contributions and the relevance of their skills to the company strategy?
4. Are we using our annual board assessment and regular executive sessions to assess the culture and dynamics in the boardroom and identify ways to operate more effectively?
5. Have we clearly communicated with investors the boardroom processes in place to ensure we continue to have the best group of people on the board?

Conclusion

Given the pace of business change today, companies increasingly need agile boards with the expertise to guide the company amid emerging threats and opportunities. And investors increasingly expect that boards will embrace rigorous practices to ensure they have the right expertise in the boardroom to respond to evolving market and competitive demands. The highest-performing boards will adopt a continuous improvement mind-set, ensuring that their composition evolves in light of new strategic imperatives.

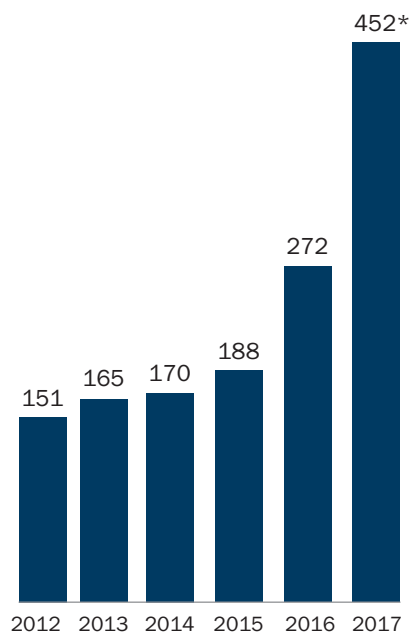


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Sometimes It's What You Don't Say That Gets You in Trouble

By Bruce Vanyo, Jason Vigna, Christina Costley, and Richard Zelichov

Federal Securities Fraud Class Actions Filed per Year



*Estimated 452 in 2017 (226 by June 30)

When one looks at any list of prominent securities fraud lawsuits, it will probably be dominated by companies such as Enron, WorldCom, Cendant, and Health-South, which were charged with misleading investors by actively misstating financial results. The reality, however, is that most securities suits are premised on alleged omissions of material fact, and not the sorts of misrepresentations that capture headlines.

As detailed in this article, Section 11 of the federal Securities Act and Sections 10 and 14 of the Securities Exchange Act can all create liability (including potentially for corporate directors personally) for misleading omissions. Moreover, those provisions are being invoked more frequently, even as the number of public companies in the United States continues to decline.

In 2006, for example, there were 5,133 publicly traded companies listed in the United States, 110 (2.14 percent) of which were named as defendants in federal securities fraud class action lawsuits. Ten years later, there were only 4,331 U.S.-listed companies, but 272 (6.3 percent) were named as federal securities fraud defendants. In 2017, the number of federal securities fraud filings is expected to have jumped yet again, this time to a staggering 452 cases (complete numbers were not available at the time this article was written). Accordingly, more than 10 percent of America's corporations can now expect to be sued for securities fraud in a given year—most likely for something they allegedly didn't say.

As a securities fraud lawsuit can often create a corporate crisis distracting management from critical tasks (such as addressing the business setback or corporate transaction that likely triggered the suit) and costing hundreds of thousands or millions of dollars to defend, it is increasingly important that directors are familiar with the risks involved and proactively consider ways to minimize liability. This article provides an overview of the current trends in omissions-based securities litigation.

Section 11: A Trap for the Tight-Lipped

"Better to remain silent and be thought a fool than to speak and to remove all doubt." Unfortunately, that axiom does not hold true under Section 11 of the Securities Act, which imposes strict liability for damages caused by securities registration statements that "contain[] an untrue statement of a material fact *or omit[]* to state a material fact required to be stated therein or necessary to make the statements therein not misleading" (emphasis added).

Section 11 claims underpin approximately 20 percent of all securities class action lawsuits (excluding M&A cases) filed in the past six years—a startlingly high figure, given that such claims are limited to statements made in connection with public offerings, which ordinarily are vetted by the U.S. Securities and Exchange Commission (SEC) before release. Most of those complaints plead omissions.

For plaintiffs, the appeal of Section 11 is that its strict liability is a throwback to the time before the Private Securities Litigation Reform Act (Reform Act) was enacted in 1995 to reduce "abusive practices" by the plaintiffs' bar. Among other things, the Reform Act stays discovery "during the pendency of [a] motion to dismiss," in an effort to prevent high discovery costs from "forc[ing] innocent parties

to settle frivolous actions.”¹

Although this discovery stay does apply to federal Section 11 cases, it provides less protection to them than to other securities actions, because Section 11 claims are easier to plead. If the disclosure of any fact causing a stock drop in the three years following a public offering plausibly could have been disclosed earlier, a court is more likely than not to uphold a plaintiff’s inevitable allegation that it should have been. Indeed, in 2015 the Supreme Court held in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund* that even an honest statement of opinion can be actionable under the omissions prong of Section 11 if the issuer fails to disclose material facts weighing against the opinion. Although the Court did temper this by writing that a statement is “not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way,” it left undefined what sorts of “facts cutting the other way” must be disclosed and which may be left unsaid, creating a difficult standard for early dismissal in cases alleging “facts cutting the other way” were not disclosed.

In the past three years, moreover, plaintiffs have found an even more effective method of getting Section 11 cases past the pleading stage: bringing suit in state court. Since 2014, about 33 percent of all Section 11 claims have been brought in California superior courts, where—despite the Reform Act—many judges allow plaintiffs to take discovery before their allegations have been tested. Although the legality of this practice is currently indirectly under review by the Supreme Court in *Cyan, Inc. v. Beaver County Employees Retirement Fund* and by the Ninth Circuit in *Ellis v. Natera, Inc.* (which concern whether Securities Act claims should be maintainable in state court at all), until those cases are decided, defendants will face the same unpleasant choices they did before the Reform Act: pay to settle an unmeritorious case, or spend potentially millions of dollars on discovery before a court even decides a claim is viable.

Section 11 also allows plaintiffs to exert greater settlement pressure by expanding the pool of defendants. Unlike Section 10(b) of the Securities Exchange Act, which limits liability to those who “spoke” (often just the company, the CEO, and its CFO), Section 11 permits plaintiffs to sue outside directors and underwriters as well. In more recent cases, plaintiffs have even sued major investors—primarily venture capital funds. This dramatically increases a defendant company’s out-of-pocket costs because, in most cases, the company has agreed to indemnify at least the underwriters but either has not bought or could not buy insurance for them.

Although plaintiffs’ ability to maintain Section 11 claims in state court should be judicially limited in 2018, we do not expect that to decrease the overall number of filings or the range of omissions alleged.

Section 10(b): A Never-Quiet Area of the Law

You may have heard that “silence, absent a duty to disclose, is not misleading under Rule 10b-5.” While the Supreme Court’s famous statement in *Basic, Inc. v. Levinson* might sound reassuring, it leaves unanswered the critical question, what duties to disclose are there?

Since 2014, about 33 percent of all Section 11 claims have been brought in California superior courts, where—despite the Reform Act—many judges allow plaintiffs to take discovery before their allegations have been tested.

¹ 1 H.R. Conf. Rep. No. 104-369, at 37 (1995).

As discussed, the Supreme Court held in *Omnicare* that a subjectively believed statement of opinion can create Section 11 liability if facts about the issuer's inquiry or knowledge are not included. Although many thought that holding should be limited to the strict liability context of Section 11, some courts (including the Ninth Circuit, whose jurisdiction covers many western states) have held that it also applies to Section 10(b), the intent-based fraud statute applicable to securities transactions more generally. In those courts, honestly believed statements in press releases, analyst calls, or SEC filings can create liability if they do not fairly align with undisclosed information possessed at the time.

The Supreme Court may also soon decide whether Item 303 of Regulation S-K (the rule governing Management's Discussion and Analysis of Financial Condition and Results of Operations, whose alleged violation underpins many Section 11 and SEC complaints) imposes a duty actionable under Section 10(b). Significantly, the United States filed a "friend of the Court" brief arguing that it should (though the case presenting the issue was then taken off-docket). If the Supreme Court decides the issue and agrees with the government, one can expect an outpouring of creative complaints alleging that companies failed to disclose known trends or uncertainties reasonably likely to impact continuing operations.

Even without those changes, corporate speakers have long been duty-bound under Section 10(b) not to make statements that are so incomplete as to create an impression of a state of affairs that differs in a material way from the one that actually exists. But the contexts in which that duty is invoked are constantly expanding. In the past two years, federal trial courts have been asked in motions to dismiss the following questions:

- Are otherwise accurately stated financial results misleading if the issuer fails to disclose that they were achieved in part through payments to foreign officials in violation of the Foreign Corrupt Practices Act?
- Are risk disclosures that state an event might affect a company's operations misleading if they do not acknowledge that the event has already occurred—even if it has not yet affected operations? What if the event that has occurred is similar to the risk disclosed but not identical?
- If the company has discussed regulatory or sales issues, does it also need to describe regulatory changes applicable to its customers that might affect its own sales? What if the customers do not acknowledge the changes could affect them but the company thinks they might?
- If a company has expressed optimism about receiving regulatory approval for one of its products, must it also disclose any interim concerns the regulators may have raised? What if those concerns addressed a subject the company has specifically discussed, such as regulatory compliance, manufacturing standards, or testing results?

Many of these questions have been answered affirmatively by at least some courts, making it clear corporate speakers (including directors) do not have as much freedom to "remain silent" as *Basic Inc. v. Levinson* might at first suggest.

Section 14: From a Whisper to a Roar

Materials soliciting shareholder votes—particularly for proposed corporate mergers—are also increasingly generating federal claims for allegedly failing to provide sufficient information.

Historically, such claims were the province of state (primarily Delaware) law. In 2014, for example, over 90 percent of all public company mergers faced allegations that sell-side directors breached state fiduciary duties by issuing insufficient proxy statements, among other perceived wrongs. Recognizing that many of those suits were frivolously filed in the hopes of a quick—and, for the lawyers, lucrative—settlement, in 2016 the Delaware Court of Chancery ruled that it will no longer approve disclosure-only settlements unless the disclosures are “plainly material.”

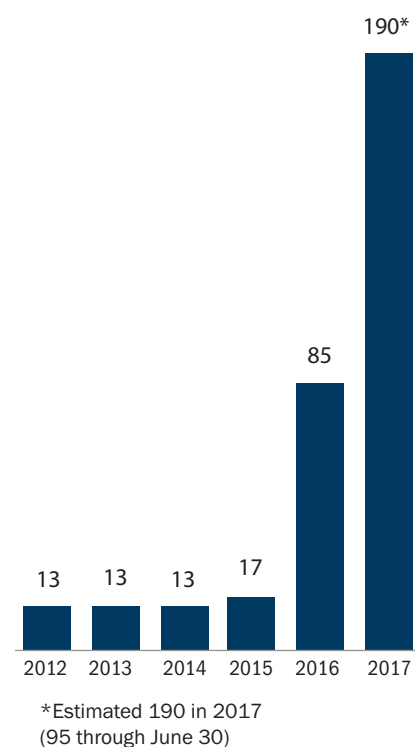
Rather than cut down on filing questionable lawsuits, plaintiffs responded by seeking other, primarily federal, venues for their complaints. In just the first six months of 2017, 95 merger objection lawsuits were filed in federal courts, compared with 13 in all of 2014.

SEC Rule 14a-9, the asserted basis for plaintiffs’ federal suits, provides that no shareholder solicitation may be made “containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading[.]” Because corporate directors generally approve solicitation materials, directors may be (and often are) concurrently sued personally under Section 20(a) of the Exchange Act, which states, “Every person who, directly or indirectly, controls any person liable under any [relevant SEC] rule. . . shall also be liable jointly and severally . . . , unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation[.]”

Such federal claims are subject to defenses that state law claims are not. For example, because Rule 14a-9 only requires disclosure of information “necessary in order to make the statements therein not false or misleading,” a shareholder cannot just allege a proxy requires more information to permit a fully informed vote. To avoid dismissal, the complaint should be required to show particular omitted information that rendered an affirmative statement misleading. Moreover, under the Reform Act, the complaint must specify *why* the statement is misleading and all facts on which that belief is based. Plus, this must be done without discovery, which, as noted, the Reform Act generally bars before resolution of a motion to dismiss. Unless the plaintiff already knows the allegedly omitted information, then, it may be impossible to satisfy these standards.

Rather than challenge the deluge of federal merger complaints in 2017, however, most defendants simply agreed with plaintiffs to issue supplemental disclosures and terminate litigation before their deals were placed at risk. We expect that to change somewhat in 2018 and for certain defendants to push early dismissal motions showing that “tell me more” merger litigation is poorly suited to federal law.

Federal Class Actions Involving M&A Transactions Filed per Year



Speak Up: Questions Directors Can Ask to Reduce the Risk of Liability

In light of the increasing frequency and scope of securities lawsuits challenging what corporations don't say, today it is often better for companies to speak—thoughtfully and clearly—about issues that may affect their businesses than to stay silent. To help them do so (and to establish a good-faith defense, should directors be sued personally), directors should be asking themselves, their general counsels, and their management teams the following questions:

- Do we understand the issues affecting the company's trends, risk factors, sources of revenue, products, suppliers, regulatory dialogues, and other matters that could cause the company's stock price to decline and, therefore, be the topic of a future lawsuit?
- Have we gathered necessary information from sources in addition to the CEO and CFO (for example, by reading "verbatim" of complaints made to company hotlines)?
- Is the company providing shareholders sufficient information on each of the highlighted subjects (and any other material matters) to make a reasonably informed investment decision?
- Are other companies disclosing more information about these subjects than we are?
- Has the company made specific and complete risk disclosures about them?
- If particular information discussed among the board has not been disclosed to investors, has an adequate justification been vetted by legal counsel?
- If the company has chosen to speak on a subject, has it disclosed all relevant material information, including information necessary to put the statement in context?
- If the company has chosen to offer an opinion or forward-looking statement on a subject, has it disclosed known inconsistent information and/or the limits of its knowledge?
- If the company is announcing news likely to drive its stock price down, can it do so in a way that echoes earlier risk disclosures, making it harder for plaintiffs to argue that material information was previously omitted?
- Can adequate insurance be obtained to cover omission claims against the company, its officers, its directors, its underwriters, and its arguably controlling shareholders?

Conclusion

While omission-based litigation is becoming an unfortunate fact of life for many public companies, thoughtful and proactive disclosure can significantly decrease the risks involved. Outside corporate and litigation counsel can play important roles in crafting such disclosures and should particularly be consulted when negative facts may soon emerge.



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nationally recognized leader in defending securities class actions, stockholder derivative cases, M&A litigation, proxy disclosure suits, and SEC investigations and enforcement actions. With a deep bench of securities litigators located in New York, Chicago, Los Angeles, and Washington, D.C., Katten attorneys have defended more than 300 major securities actions, including some of the largest and most significant cases in the field. Mr. Vanyo, the group's co-head, was selected by Legal 500 in 2017 as one of the 25 Leading Lawyers in Securities Litigation.

Trends in D&O Exposures and Insurance Solutions

By Nora McGee

Securities class actions make up approximately 50 percent of D&O claims against AIG's public company D&O insureds.

Key Observations and Projections

By Q3, it's already clear that 2017 will end with the highest number of securities class action lawsuits filed against publicly traded companies since 2001.¹ This high frequency of claims comes despite a decline in the overall number of public companies.

Although all sectors are vulnerable, life sciences and developmental stage biotech companies comprised approximately 25 percent of securities class action lawsuits filed in 2016.² High-tech companies, particularly those with high valuations driven by product expectations, have proven to be alluring targets as well.

The cost (i.e., severity) of D&O securities class action claims is also up, with 10 of the top 100 largest settlements ever coming in 2016, the highest being \$1.575 billion.

Securities class actions are an increasingly global threat: non-U.S. based companies listed on U.S. exchanges are being pursued in U.S. litigation, and collective investor actions in Europe are on the rise.

Regulatory actions and derivative lawsuits remain significant and costly threats to directors and officers.

New Perils for Private Companies

AIG has seen directors and officers (D&O) litigation against private and non-profit organizations increase 450 percent in the past decade, and the trend is expected to accelerate with the changing nature of private companies.

Private companies are increasingly becoming household names. They are delaying IPOs, relying instead on venture capital and private capital market funding. As valuations soar, these "unicorns" (i.e., private companies with valuations exceeding \$1 billion) are attracting the attention of the U.S. Securities and Exchange Commission (SEC), as well as litigation by shareholders. For example, two class action lawsuits were filed against high-profile companies in 2017, perhaps marking the beginning of new risk terrain for private companies.

Lawsuits arising from bankruptcy are also proving particularly costly for private companies. Bankruptcy was the cause of loss on the majority of the 45 claims in excess of \$1 million that AIG saw in its private D&O book in 2016, as trustees sought to tap all of the company's assets, including D&O insurance policies, to meet creditor demands.

Other notable trends in D&O claims for private companies include consumer class actions arising out of misrepresentation and lawsuits alleging unfair, anti-competitive business practices. For example, a consumer products company may market its products as "hormone-free," but a consumer group might challenge the scientific basis for that claim. A class action lawsuit could result where consumers allege the company and its directors and officers misled customers in its marketing campaign.

¹ Kevin LaCroix, "Cornerstone Research: First Half Securities Suit Filings at Record Pace," *The D&O Diary*, July 25, 2017.

² Kevin LaCroix, "2016 Securities Lawsuit Filings Surge to Record Levels," *The D&O Diary*, January 2, 2017.

Broader Director Concerns

Fiduciary liability should be on the radar of directors and officers at both public and private companies. Recently we've seen an uptick in "excessive fee" claims brought by employees contending that the fee charged by their retirement plan's third-party administrator is substantially higher than the market average. Higher education institutions, which pay investment management fees on large assets held within their 403(b) retirement plans, have come under scrutiny in particular. Any board members who might wear dual hats, serving as both a company director and a plan fiduciary (with fiduciary responsibility under the Employee Retirement Income and Security Act [ERISA]) are at risk.

The severity of employment practices claims persists, led by several multi-million dollar discrimination class action settlements in 2016. Class actions alleging age discrimination continue to be AIG's biggest employment practices liability (EPL) payout followed by gender discrimination class actions. These allegations, age and gender, make up more than 48 percent of our EPL class action payouts, with the expectation of an increase in gender cases for 2018. Wage and hour class settlements topped the severity charts, with a \$240 million settlement filed in Indiana and covering 20 states, by a shipping company accused of worker misclassifications and overtime failures. Many are awaiting the decision on the U.S. Department of Labor's revised salary thresholds as they relate to the overtime exemption, in the news as "FLSA Overtime Exemption Rule."

With the preponderance of high-profile harassment claims coming from the media and entertainment industries (and in historically plaintiff-friendly geographies such as California), the climb in severity shows no signs of abating. Companies should be reviewing their human resource policies regarding the handling, investigating, retaliation protection, and allegations in all claims, with specific attention paid to harassment-related concerns.

Cybersecurity is a prominent concern. Organizations of all types, whether they hold employee, consumer, or company/trade data, have a growing recognition of the high cost (averaging \$3.62 million in 2016³) and complexity (including both financial and tangible assets, first- and third-party damages) of responding to cyber-breach incidents, as well as the damage these incidents can cause to an enterprise's reputation. Companies may also be exposed to regulatory actions (such as the impending E.U. General Data Protection Regulation, which impacts even U.S. companies with European consumer data), privacy litigation, and consumer litigation as a result of a breach. And while theft of personally identifiable information is still a major concern, cyber events can also lead to substantial disruption to a company's business through ransomware and other threats.

As directors and officers begin to realize the potential impact that a cyber incident can cause to their organization, they need to understand how their property casualty insurance portfolios will respond to such an incident and to ensure that both financial and tangible assets are protected. New coverage options have been introduced recently, including AIG's CyberEdge Plus, to provide affirmative coverage for physical losses (such as bodily injury, property damage, and business

Companies should be reviewing their human resource policies regarding the handling, investigating, retaliation protection, and allegations in all claims, with specific attention paid to harassment-related concerns.

³IBM, "Cost of Data Breach Security," 2017.

interruption), as have new channels for purchasing cyber coverage, to provide affirmative coverage via traditional property and casualty channels.

A Focus on Individual Accountability

The SEC and U.S. Department of Justice (DOJ) remain focused on individual accountability and targeting individuals for corporate malfeasance. Earlier this year, newly minted SEC Chairman Jay Clayton stated, “I firmly believe that individual accountability drives behavior more than corporate accountability.”⁴ Building on the DOJ’s “Yates Memo” issued in September 2015, regulators are encouraging companies to investigate malfeasance by executives and provide evidence of such.

An example of this is the DOJ’s Foreign Corrupt Practices Act (FCPA) pilot program, which encourages self-reporting by companies in return for leniency. FCPA-related enforcements reached new heights in 2016 (21), as did the cost for a company to thoroughly investigate allegations, particularly those of local country managers and executives who may have committed or encouraged the bribery and corruption in exchange for revenue gains for the company.

Major Implications for Board Members

For board members, the major implications of the increased cost and volume of D&O liability lawsuits, coupled with the current regulatory environment, are two-fold.

First, directors should assess the likelihood of their companies facing litigation in the aforementioned areas, and then determine steps to mitigate those risks.

Directors may consider the following steps:

- Assess the top causes of litigation for companies within your peer group (entity type, size, and industry sector). What vulnerabilities might make your company an attractive target for plaintiffs?
- Determine what business practices, if any, you can alter to decrease the risk of litigation. For example, has the board discussed its role in the oversight of sexual harassment, asked for data from management on cultural indicators such as employee surveys, and made adjustments to company policy and practices in this area?
- Perform an extensive assessment of the effectiveness of the company’s enterprise risk management (ERM) to determine that risks are well controlled across the organization. Does the company offer appropriate ERM training and have policies and procedures in place to identify, report, and minimize ERM exposures? Is there accountability for implementing risk management? Is the right team in place to provide oversight?

⁴Dave Michaels and Andrew Ackerman, “SEC Chairman Nominee Jay Clayton Calls for Scaling Back Regulations to Encourage IPOs,” *The Wall Street Journal*, March 23, 2017

Second, individual directors and officers must be certain that D&O insurance is in place to protect their personal assets.

With the increased volume and severity of lawsuits, primary D&O liability limits shared between individuals and organizations may be spread too thin. In shareholder claims, for example, both the entity and individuals are typically named in litigation. After protecting the company's balance sheet, there may not be any coverage left to protect individual directors and officers.

Along with the depletion of limits, there are other situations in which the organization cannot or will not indemnify an individual director or officer, despite the presence of indemnity agreements. This includes when the company is financially insolvent or in the case of derivative lawsuits.

Board members should carefully evaluate the D&O liability insurance available to them, including "Side A" options dedicated solely to protecting their personal assets. Side A Difference-in-Conditions (DIC) coverage has been the go-to solution for individuals. These policies provide broader coverage than a traditional "ABC" D&O policy's coverage (which protects both individuals and the company for its obligations to indemnify individuals, as well as claims against the company itself (subject to particular policy limitations), and dedicated limits that can't be eroded when paying for the company in claims.

Moreover, a DIC feature provides a mechanism for the Side A coverage to "drop down" to pay defense and indemnity costs for individuals when an underlying D&O carrier fails or refuses to pay a claim under its own policy.

Recently, insurers have updated excess Side A DIC coverage to respond to key emerging issues such as growing multinational exposures and regulatory scrutiny of individuals, and to ensure individual directors are adequately protected. This is done through improved choice of counsel provisions, which allow individual directors to choose their own counsel without first demonstrating need based on conflicts of interest with other insured persons, as well as through optional dedicated limits available to individual directors, so they are assured they have limits available that cannot be exhausted on behalf of any other insured person.

AIG has also taken this vital Side A protection a step further, introducing its Side A Match Edge Endorsement (SAME), which can attach to an AIG Primary D&O policy when the company also purchases Side A DIC limits with AIG. This SAME endorsement provides greater consistency of coverage for non-indemnifiable losses of individuals throughout D&O insurance purchase. Instead of limiting the broad DIC features to the Side A only limits purchase, the SAME endorsement incorporates these extensions through the ABC tower as well. The net effect is greater consistency in coverage for individuals throughout the program.

When weighing D&O coverage, board members should consult an experienced D&O insurance broker who can advise on the track record, claims philosophy, and expertise of specific insurance carriers. Boards should also be aware of who will be defending them in the event of a claim. Does the insurer offer a panel of qualified securities defense attorneys at preferred rates? It's prudent for individuals to investigate these firms and meet with selected attorneys before they need to retain their services.

The current litigious environment is expected to continue, but most D&O policies were not priced with today's frequency and severity of claims in mind. Rate increases on D&O insurance should be expected.

The current litigious environment is expected to continue, but most D&O policies were not priced with today's frequency and severity of claims in mind. Rate increases on D&O insurance should be expected. Directors and officers should be wary of coverage offered by carriers without an experienced claims team with expertise handling these unique types of lawsuits, which could leave the directors and officers vulnerable.

Key Questions for Boards

Five questions can serve as important guideposts for directors and officers navigating the current D&O liability environment:

- What is the board doing to oversee and mitigate its organization's risks, particularly risks that may attract litigation? What have been the top targets for litigation in our industry and/or among our company type?
- How is the board documenting due diligence on ERM and business decisions?
- Does the company's D&O liability insurance program include coverage for the costs of the entity to respond to increasingly common regulatory actions?
- Is the company's D&O liability insurance program structured to effectively protect both the organization and directors and officers, including adequate Side A limits for individuals?
- Has the company secured the latest Side A options available to protect individuals, as well as the commitment and claims-paying history of any proposed D&O carrier?



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Workforce Disrupted: Radically Rethinking the Workforce and Digital to Become Future Ready

By Erica Volini, Jeff Schwartz, and Anthony Abbatiello

Every business in every industry today faces unprecedented disruption in terms of technology and the rapid evolution of business models. As a consequence, the composition, demands, and expectations of the workforce are shifting dramatically. Given the board's critical roles in overseeing risk and strategy, directors in 2018 should seek to understand the impending disruptions and opportunities that stem from future human capital trends.

How can you capitalize on the widespread disruption taking place and help management prepare the workforce for the dramatic changes ahead? Start with an understanding of how work will be performed in the future. Organizations that fail to both proactively address changes in the workforce and embrace digital and cognitive capabilities risk being leapfrogged by their competitors.

What the Future of Work Looks Like

Conversation about the future of work typically involves common themes such as the need to become a digitally focused organization and the value you can get from machines, from robotics to cognitive technologies. The impact of changing demographics also features heavily in discussions on today's workforce, as do changing views on work and careers, with the "gig" economy (in which laborers conduct freelance, contract, or single-task work, rather than permanent jobs) on the rise and the disappearing notion of "lifetime employment."

In mass media, at conferences, in boardrooms, and beyond, the future of work has emerged as a top business topic, but one that is often fragmented. The following framework provides a more integrated view that highlights areas likely to have the greatest impact—starting with the roles of technology and the rise of alternative work arrangements, as well as the implications for people, organizations, and governments. (See graph on page 32.)

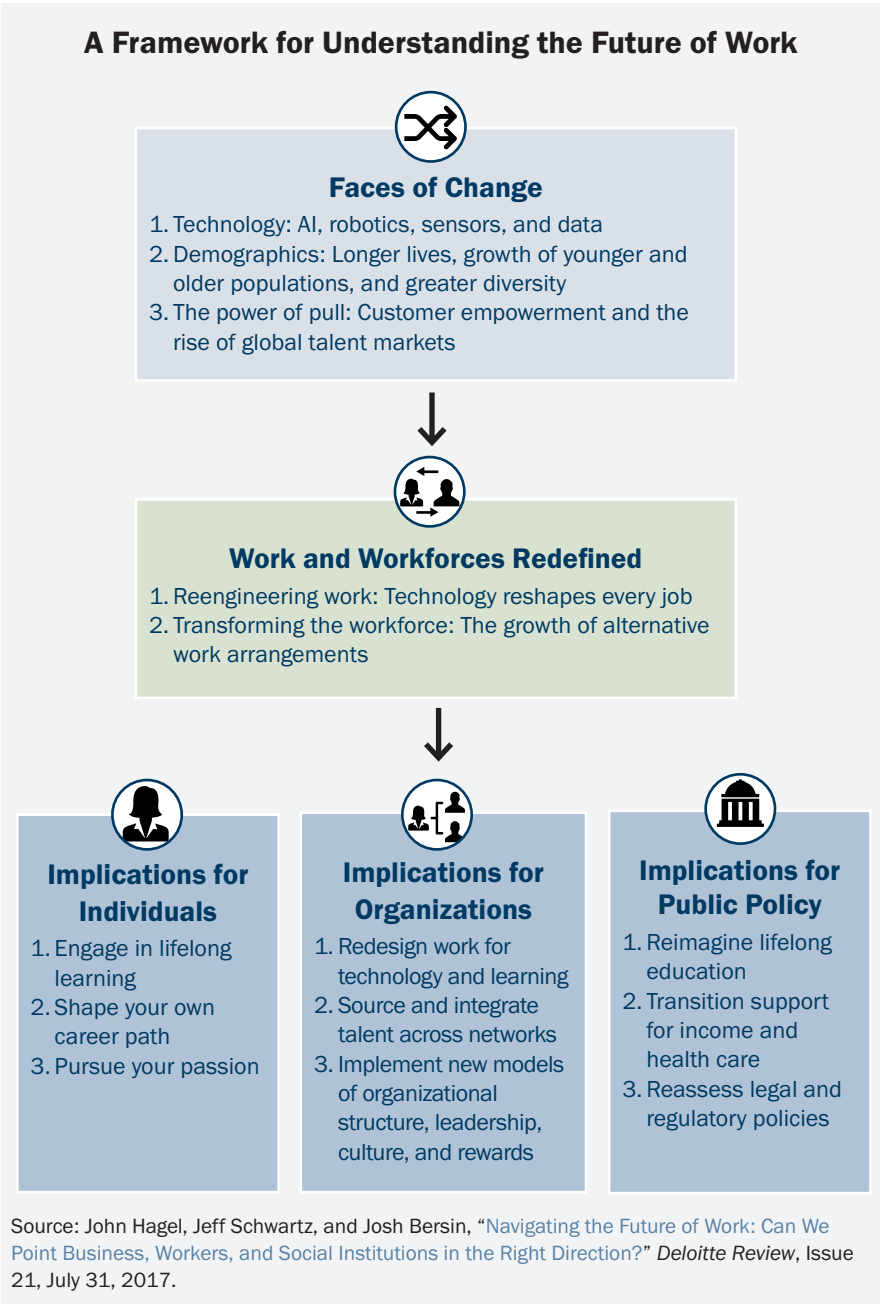
Many organizations in 2018 will need to revisit their long-term strategy around work, specifically from the angle of automation and digital transformation. Automation capabilities, meanwhile, are on the rise as organizations in every industry streamline and simplify their business processes with new digital and cognitive tools.

Embracing a Digital Mind-Set

Organizations that plan to survive and thrive in the future understand that digital must be a significant part of the plan. What does that mean? It means management must go beyond merely adopting digital technology. Embracing digital means cultivating a digital mind-set, changing how people view work and the business as a whole.

This effort begins with the board and management assessing what Deloitte refers to as the organization's "digital DNA"—23 traits that Deloitte research has shown characterize digital maturity and "being digital." How does the organization measure up against these DNA traits? What strengths and gaps does the evaluation reveal? In a similar vein, digital talent is not strictly about "techies" and people who know how to use, build, or invest in new disruptive technologies. Rather, digital

talent includes employees working in any department, who are excited about the potential of digital technologies, exponential disruption, and new ways of working. They are agile risk-takers, intentionally collaborative and customer centric. They want to learn fast and apply this learning and excitement in their daily work—in an environment that supports and enables this way of working.



A Digital Edge

What does digital maturity look like and why does it matter? A series of reports by Deloitte and *MIT Sloan Management Review* has examined this question in depth, studying organizational practices that differentiate digitally mature companies from those that are less developed. Key findings of the report include:

- **Digitally mature companies value experimentation and speed.** They embrace risk and create distributed leadership structures. They also foster collaboration, and they are more likely to use data in decision making. Nearly 80 percent of digitally maturing entities surveyed are actively engaged in initiatives that will bolster risk-taking, agility, and collaboration.¹
- **Digitally mature companies surveyed also place a strong emphasis on innovation.** They are more than twice as likely to invest in innovation, compared with early-stage entities—87 percent versus 38 percent. More than 80 percent of digitally maturing companies plan to develop new core business lines in the next three to five years in response to digital trends. Only about half of early-stage companies have similar plans.²
- **Digitally mature companies are also talent magnets.** Employees and executives are highly inclined to jump ship if they feel they don't have opportunities to develop digital skills. For example, vice president-level executives without sufficient digital opportunities are 15 times more likely to want to leave within a year than are those with satisfying digital challenges.³

Where to Start

Regardless of where an organization is along its journey to embrace workforce and digital disruptions, directors can ask management four important questions to spur discussion in 2018:

- **What is this organization's current digital DNA, and how should management move us toward digital maturity in a way that advances company strategy?** Is the company just “doing digital” to check a box, or has the company aligned the elements of the organization to be digital? “Being digital” requires an investment for the long term—an ongoing transformation that should be executed on a continuous, iterative basis, rather than a one-and-done event.⁴
- **How well will this company's workforce operate in the digital future?** Does the company have the right talent and the skill sets to thrive? If not, how will senior executives build the needed workforce? Will they develop the

¹ Gerald C. Kane, Doug Palmer, Ahn Nguyen Phillips, David Kiron, and Natasha Buckley, “Aligning the Organization for Its Digital Future,” *MIT Sloan Management Review* and Deloitte University Press, July 26, 2016.

² Ibid.

³ Gerald C. Kane, Doug Palmer, Ahn Nguyen Phillips, David Kiron, and Natasha Buckley, “Achieving Digital Maturity,” *MIT Sloan Management Review* and Deloitte University Press, July 13, 2017.

⁴ Ibid.

current workforce, recruit a new one, or some hybrid of both tactics? Will top leaders be retained or replaced?

- **How could this company use automation and cognitive capabilities to complement the workforce?** Where can you augment human roles with automation and machine intelligence? Where is a human essential to the business? Understand how automating (or not automating) a task can help improve the customer experience and set you apart from the competition. For example, if your sales force is a high revenue generator, could you augment that job with technology that automates parts of the job or provides data and insight to better anticipate and serve customer needs?
- **Have we assembled the right mix of leaders to address future workforce trends?** Planning for the future of the workforce goes far beyond human resources and technology considerations. The CEO will need a strong chief human resources officer and chief information officer. The finance and procurement functions should also be part of discussions as the company plans for new investments and looks for new sources of value.



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How Can Board Members Help Turn Cyber-Risk Reduction From a Goal Into a Reality?

Hint: Use Their Leadership Roles to Keep the Focus on Risk, Not Just Compliance

By Ryan Gillis

Digital transformation—incorporating and adopting technology advancements and innovations—is important for organizations to make business operations more efficient, agile, and profitable. This is the practical importance of buzzwords, such as “Internet of things,” “cloud computing,” and “enterprise mobility.”

They all share another characteristic: they have the potential to raise and expand organizations’ cyber-risk profiles. Each new application of digital technology opens up exciting business opportunities, but each also serves as a new point of entry for hackers, bots, rogue cybercriminals, disaffected employees, and countless others.

As a result, cyber-risk discussions now take up more time, energy, and attention for board members. Additionally, board members know that security incidents can often lead to regulatory compliance issues and a wide range of other negative outcomes, including lost productivity, stolen intellectual property, fines, horrible publicity, and the loss of consumer confidence and trust.

The regulatory environment in this space is global and complicated as governments around the world continue to issue rules around cybersecurity. This will continue to evolve, becoming even more complex and demanding—and potentially more prescriptive—in the coming year. Unfortunately, as well intentioned as many regulatory bodies and government agencies are in laying down rules for cybersecurity, those regulations can potentially become onerous and even counterproductive to real-world security. This is a major issue for board members—one that must be dealt with immediately and not overlooked.

With a deluge of information about cyber risk and regulatory demands out there, it can be hard to make sense of it all. However, the common goal and focus for all board members, organizations, employees, customers, partners, government agencies, and regulatory bodies should be straightforward: reduce cyber risk. Often rooted in compliance and legal issues, reducing cyber risk is much more about ensuring the long-term vitality, competitiveness, and solid financial footing of the organization.

The goal for directors is clear: help their organizations focus on what matters—reducing cybersecurity risks to their most critical strategic assets, not just ensuring compliance to avoid fines or the hassle of failing audits.

Key Projections

Whether an organization is selling consumer packaged goods, building skyscrapers, distributing electricity in emerging markets, or handling complex financial transactions, it experiences cyber risk. And although each organization’s risk profile can be dramatically different, all board members must take into account a few unquestionable facts when helping organizations reduce their cybersecurity risks.

First, regulatory requirements will continue to proliferate in 2018, and board members will need to help their organizations stay focused on cyber-risk reduction. This task will be particularly true as the game-changing General Data Protection Regulation (GDPR) of the European Union comes into effect in May 2018. GDPR is a truly groundbreaking regulatory initiative for several reasons:

- Its scope is massive. The GDPR applies to entities established both inside and outside the European Union that offer goods or services to, or monitor the behavior of, residents within the European Union. In practical terms, this means any provider of services that processes E.U. residents' personal data must be compliant.
- It carries potentially massive fines for noncompliance. How massive? Maximum fines top out at 20 million euros or 4 percent of global revenue.
- The GDPR mandates that, in the event of a breach of personal information, a report must be made "without undue delay, and where feasible, within 72 hours."
- It is likely to act as a model for other personal data protection regulatory mandates in other regions of the world in the coming years.

Other examples of recent or emerging cybersecurity regulations are the New York State Department of Financial Services regulation governing security requirements in the financial services industry; the European Union's Network and Information Security Directive, a cybersecurity law also coming into effect in May 2018; China's Cybersecurity law, which went into effect June 2017; and Singapore's Cyber Security Act, still being finalized as of press time. Regulatory efforts such as these are undoubtedly well intentioned, and directors and executives alike must take all necessary steps to ensure compliance with them.

It's essential to keep in mind, however, that being compliant is not necessarily synonymous with being properly protected against cyber risk, as many blaring headlines in just the past year remind us. New regulations may result in confusion, conflict, and inefficiencies that actually increase cyber risk, rather than reduce it, by diverting valuable resources from threat detection and prevention toward reporting and accounting. Take, for example, the lessons learned from the implementation of the original U.S. Federal Information Security Management Act of 2002. This regulation required U.S. federal agencies to produce hard-copy binders on the status of the security of their networks, essentially diverting scarce IT and security personnel and resources away from actually securing those networks in favor of recordkeeping. This is a vital lesson learned for more effectively identifying and implementing common goals in cyber risk reduction and threat prevention among all parties—boards, executives, customers, trading partners, industry groups, regulators, and governments. Being "secure" is not a static end state that lends itself to inflexible compliance checklists; it requires a constant evaluation of risk relative to a rapidly evolving cyber-threat landscape.

Second, risks will increase in volume, variety, and velocity. In fact, many cyber risks will come in the form of automated attacks, making it impossible for organizations to identify and block them all without new defense strategies. Companies must gird against this threat environment with strategies that maximize the use of automation for defense, more effectively leverage security personnel, streamline internal processes, and adopt interoperable security technologies that work together to holistically prevent threats. Board members must understand how this will impact their organizations' budgets, use of security personnel and other resources, end-to-

end security best practices, and, importantly, the shifting roles and responsibilities for the CIO, CISO, and others charged with reducing cyber risk. Undoubtedly, this threat environment is already changing the approaches directors take in helping their organizations identify and reduce cyber risk.

Third, attackers will become more emboldened, stealthy, insidious, and ingenious in their attack methodologies. This will up the ante for CIOs, CISOs, and other executives responsible for security and call for board members to ask executives tougher, more actionable questions, with new yardsticks for measuring success and ensuring accountability. Remediation will remain vitally important to ensure business continuity and reduce the financial impact of a breach, but boards must ensure their organizations are spotting potential risks early and preventing them from getting inside the gates as their first order of business. After all, no board member would be satisfied with practices that only dealt with mitigating the after-effects of risks, such as employee theft, natural disasters, or brand erosion. Similarly, no executive should simply strive to report promptly that their organization's sensitive employee or customer data—or intellectual property—has been stolen by a cybercriminal. Especially as cyberattacks become increasingly destructive and the potential for physical damage proliferates, it becomes clearer that only by persistently driving for better prevention in the first place can organizations avoid these untenable scenarios.

Major Board Implications

For 2018, the inevitable changes in global regulatory requirements will be at the heart of most organizations' risk mitigation efforts, and board members play a crucial role in helping identify and mitigate cyber risks. Among the key issues for boards are first to agree on and define the company's most valuable assets, and then understand how to help organizations shape their strategies toward the goal of reducing cyber risk without micromanaging their relationships with the CIO, CISO, and others charged with pursuing that goal.

Certainly, board members have been asking those executives important questions in meetings and other communications, but board members must move from a somewhat passive, detached approach to security oversight and instead take a more proactive stance. Take the results from the [2017–2018 NACD Public Company Governance Survey](#) about cyber risk. The survey asked board members, "Which of the following cyber-risk oversight practices has the board performed over the past 12 months?" The following are the top four answers:

- Reviewed the company's current approach to protecting its most critical data assets (82 percent)
- Reviewed the technology infrastructure used to protect the company's most critical data assets (74 percent)
- Communicated with management about the types of cyber-risk information the board requires (69 percent)
- Reviewed the company's response plan in the case of a breach (61 percent)

Steps to “review” and “communicate,” as important as they are, do not go far enough to identify and act on the best ways to reduce cyber risk, especially with a strategy predicated on preventing attacks. One important step directors should undertake is to ensure their technical, IT, and security teams can articulate how their defensive deployments of people, processes, and technology reduce threats to the organization. Resource decisions made by the board should be applied to protect what matters most to the organization. Boards cannot be expected to be technical cybersecurity experts, but they can drive the prioritization of defense and become true partners in helping executives and technical security professionals fortify their defense plans.

This also means board members must accelerate their own education on cyber risks, both in general and as it specifically pertains to their organizations. For instance, in the *2017–2018 NACD Public Company Governance Survey* of directors, only 12 percent of respondents said their boards had a “high level of knowledge” of cybersecurity risks. Clearly, to both fulfill their fiduciary responsibility as directors and make good on their requirement to understand and support their executives’ risk prevention, board members need to become even more conversant on cyber risks and engage the executives as they identify the right solutions for the unique requirements of their organizations.

Whether that means utilizing outside cybersecurity consultants as board advisors, putting a cyber-risk specialist on the board, or taking other steps is the board’s call, but it’s a call that must be made. After all, a study conducted by Nasdaq pointed out that “91% of board members...are unable to interpret a cybersecurity report.”¹

Additionally, directors must keep in mind that the very nature of their roles makes them attractive targets to bad actors looking to learn more about organizations’ intellectual property, competitive strategies, M&A targets, or any other sensitive information routinely discussed at board meetings. This means board members should pay strict attention to their own cybersecurity hygiene on devices they use to discuss board business, applications, and cloud services they access and networks to which they’re connecting.

Of course, board members should also step up recent efforts to hold executives accountable for providing better intelligence on cyber risk and delivering better results. Data from Osterman Research indicates that 85 percent of board members believe IT and security executives need to improve the way they report to the board, and 59 percent say one or more IT security executives will lose their job as a result of failing to provide useful, actionable information.²

Board Oversight Questions

To facilitate a more robust and effective strategic plan for reducing cyber risk, board members need to ask a new set of questions designed to provide a deeper understanding of current and potential risk levels and a stronger basis for taking action to protect against current and emerging threats:

¹“Grading Global Boards of Directors on Cybersecurity,” Harvard Law School Forum on Corporate Governance and Financial Regulation, 2016.

²Bay Dynamics, “How Boards of Directors Really Feel About Cyber Security Reports,” Osterman Research, May 2016.

- **What people, processes, and technologies are we currently using to defend our network?** Your CIO and CISO must also be able to tell you what your organization is already doing to spot risks before they are weaponized, as well as where they believe the next attacks are likely to occur. This information must be aligned with a thoughtful, open discussion on how, where, and when resources are being deployed for the processes of threat identification and protection.
- **What additional resources are needed in people, processes, and technologies to limit risk?** No one is going to give the CISO a blank check, so ask tough questions to determine where the greatest financial efficiencies can be gained by making smarter, not necessarily bigger, investments.
- **What threat intelligence services is our organization using, and how are they performing?** It's vitally important to know the demonstrable effect of these services to help the organization spot and protect against risks before they pierce defenses.
- **How do our organization's security training programs need to change to reflect the new realities of cyber risk?** Should existing education programs for users, partners, and even customers be modernized, overhauled, or scrapped in favor of approaches that better reflect the coming threats?
- **Can our legal and compliance officers identify all existing regulations that apply to cyber and information security, and do they understand which new mandates are under consideration or in development?** How will those emerging requirements affect your organization's threat profile? Should your representatives become more involved in the process of framing those mandates as they are developed and implemented to ensure they really do help reduce risk, rather than just become another checkmark on the compliance to-do list?
- **Are representatives from the security team included in every business planning meeting being held?** This is an extremely important mind-set shift for organizations, and boards need to be in front of this transformation away from "security as an afterthought" to "security by design." This applies to everything from new product development and supply chain management to marketing programs and customer retention—not just compliance or data governance.



Ryan Gillis works with governments, companies, and organizations around the world to develop and implement strategies, policies, and operational partnerships that prevent successful cyberattacks. He oversees Palo Alto Network's involvement in public-private cybersecurity exercises and is responsible for expanding cyber-threat information sharing relationships with various government organizations. Additionally, Gillis leads Palo Alto Network's global public policy efforts and oversees government affairs around the world.

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