LAW IN THE BOARDROOM: WHAT KEEPS YOU UP AT NIGHT?

A 2016 NYSE GOVERNANCE SERVICES/FTI CONSULTING SURVEY

NYSE Governance Services

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WITH MUCH OF THE POLITICAL, REGULATORY, AND ECONOMIC GROUND SHIFTING under corporate America midyear 2016, the relationship between CEOs, boards, and general counsel has never been more critical. Increased SEC enforcement, investor oversight, corporate litigation, and legal liabilities are intensifying the roles of boards and GCs, putting unparalleled pressure on the quality and dynamics of communications and good governance within organizations.

Given this backdrop, 354 directors and general counsel told us, in our annual Law in the Boardroom survey conducted earlier this year, which challenges are most acute, where their responsibilities are shifting, and in which areas they feel most (and least) confident about their ability to oversee risk. The results point to four prominent issues: regulatory compliance, disruptive innovations, third-party risk, and shareholder activism.

While cybersecurity and an uncertain economic and political climate have also emerged as major themes, boards and management are countering these concerns by putting renewed energy and emphasis on efficient and timely communications—both internally and externally. In fact, more than half (58%) of the directors we surveyed characterize the quality of presentation and information they receive from the head of internal audit and general counsel as exemplary, with an additional 40% saying it is at least adequate.

Still, there are gaps. A fifth of the directors surveyed say they never, or only occasionally, receive presentations from their company's head of internal audit or general counsel, enough to be at least a tad alarming, given all the risks for which directors must stay apprised and the responsibility bar that's been set by investors. Noted one director of this dilemma, "The frequency of presentations is at management's discretion, so you never know what you are not aware of."

On the whole, however, most directors know they must receive quality information to act independently and fulfill their fiduciary responsibilities—which means not rubber stamping management but considering all issues using a well-reasoned process. Nine out of 10 directors reiterated the need for boards to be independent and push back on management assumptions when warranted, demonstrating clear consensus that challenging management is essential for good governance.

The survey results presented here highlight the challenges directors and general counsel currently face as they oversee risks in the current environment.

KEY TAKEAWAYS

- Ninety-three percent of directors and GCs report being "confident" or "very confident" in the effectiveness of their company's internal anticorruption ethics and compliance programs.
- Nearly half (43%) of respondents say their fear of potential action from regulatory agencies against their company has increased over the past 24 months.
- While cybersecurity continues to top the list of concerns for directors and GCs, fears seem to have somewhat subsided, dropping 34 and 29 percentage points respectively over the past 12 months, from 90% and 86% in early 2015.
- Half (47%) of directors and general counsel share an emerging concern over disruptive innovations.
- Only 28% of directors acknowledge being concerned or very concerned about shareholder activism/litigation, compared to 36% last year.
- The great majority of directors (84%) say they have assessed the vulnerabilities that might make their company a target for activists—up from 69% last year.
- More than half (54%) of directors say either they don't have or don't know if they have a formal plan in place to address activism in the event it occurs.

TOP OF MIND: THE KNOWN AND THE UNKNOWN

Once again this year, cybersecurity tops the list of concerns that keep directors and general counsel up at night (Figure 1), which is no surprise, given the increasing emphasis on cybersecurity and the role of the board coming from nearly every corner. It is interesting to note, however, that directors' and GCs' level of concern has dropped 34 and 29 percentage points respectively over the past 12 months, from 90% and 86% in early 2015. In fact, three-quarters of the directors and general counsel surveyed say they now have a good understanding of the cyber risks for their company (78% collectively), as well as what constitutes their "crown jewels" (76% collectively) (Figure 2).

This increase in confidence could be explained by the fact that 77% of directors say the reports they receive from management allow them to provide effective counsel, 74% have received training on cybersecurity awareness, and the majority (53%) believe their company to be very well prepared in the event a cybersecurity breach were to occur. All of these are steps in the right direction toward better oversight and governance related to cyber issues.

Although it is encouraging to see a majority of directors and general counsel report confidence in their cybersecurity awareness, Scott Corzine, managing director at FTI Consulting, cautions leadership to avoid falling into a false sense of security. "Cybersecurity," he explains, "represents a significant risk to companies across all types of industries. Not only is there a significant liability risk associated with breaches of sensitive consumer or financial data, there is also a worrying increase in cyberattacks against infrastructure, which can affect regional public safety, process continuity, and mission assurance."

As boards and legal departments continue to tighten their grip on cybersecurity risk and gain a better understanding of the right questions to ask, there appears to be growing concern across the board on something even more elusive: disruptive innovations. While 62% of all respondents say they hold regular, productive discussions of enterprise risk management and three-quarters believe they spend enough time discussing risk oversight matters as they relate to the overall strategy of the company, nearly half (47%) report being concerned or highly concerned with business disruption and innovations.

While innovation can be a tremendous opportunity for growth, it can also be an immense threat to organizations, particularly in an era where emerging technologies can make or break a market share advantage practically overnight. Disruptive innovations are new methods or technologies that gradually disrupt an industry to the point where established market leaders are challenged.

Boards are often advised to adopt a more forward-thinking attitude to better prepare for, or even become, the disruptors before they are disrupted. The challenge, however, is to grasp the unknown. To be able to question management's long-term strategy assumptions and identify potential disruptors, directors need to invest time and effort into understanding not only the future landscape of the industry, but also

FIGURE 1

WHAT KEEPS YOU UP AT NIGHT?

DIRECTORS:

IT/CYBER
56%

BUSINESS INNOVATION/DISRUPTION
44%

ERM
35%

SHAREHOLDER ACTIVISM/ENGAGEMENT
28%

GOVERNMENT INVESTIGATIONS
22%

GCs:

IT/CYBER
57%

BUSINESS INNOVATION/DISRUPTION
50%

GOVERNMENT INVESTIGATIONS
49%

SHAREHOLDER ACTIVISM/ENGAGEMENT
41%

ERM
38%

FIGURE 2

BOARDS OVERSIGHT OF CYBERSECURITY RISKS

DIRECTORS:

Our board has a good understanding of the risks related to cybersecurity for our company

77% AGREE

Our board understands what constitutes our company's "crown jewels"

83% AGREE

GCs:

Our board has a good understanding of the risks related to cybersecurity for our company

79% AGREE

Our board understands what constitutes our company's "crown jewels"

70% AGREE

current and potential niches. In their early stages, disruptive innovations are often overlooked by established companies because they don't cater to their market's current needs. However, organizations are advised to look beyond their established customer base to unknown markets if they are to stay one step ahead of the innovations game.

FRONT AND CENTER: SHAREHOLDER ENGAGEMENT

Without doubt, 2016 is shaping up to be a groundbreaking year for shareholder activism, with investors becoming more closely involved in every aspect of corporate governance and strategy. For their part, boards have sat up and taken note—with most understanding that the new breed of shareholder activist is here to stay and is likely to have a strong voice going forward.

With respect to shareholder activity, surveyed directors have shown an uptick in confidence since last year. Only 28% acknowledge being concerned or very concerned about shareholder activism/litigation risk, compared to 36% the year prior, perhaps due to a related finding that shows the vast majority (84%) say they have assessed the vulnerabilities that might make their company a target for activists—up from 69% last year (Figure 3).

While GCs' concerns over shareholder activism/litigation have remained steady, (43% concerned or very concerned in 2015 vs. 41% in 2016), the number of general counsel who say they have assessed the vulnerabilities that might make their company a target for activists has increased from 76% to 89% year over year. Furthermore, 89% of directors and 86% of GCs say they continually monitor shareholder concerns to determine if problems are brewing, with 90% and 87%, respectively, rating their monitoring efforts as "good," "very good," or "excellent" (Figure 4).

Discrepancies between directors' and GCs' opinions began to arise, however, when we probed respondents about their communications protocols and knowledge of their investor base. Three-quarters of directors say they have adopted formal communications protocols and that, at any given time, they know which investors are moving in and out of their portfolio. GCs, on the other hand, answered these questions with a little more caution, with 58% saying the company has formal communications protocols and 57% agreeing with the idea that their board knows which investors are moving in and out of the portfolio.

When it comes to agreeing on acceptable topics of discussion with shareholders outside of the annual meeting, our survey groups are more aligned. While general counsel report not being comfortable with directors discussing political spending, crisis preparedness, and cybersecurity issues in an informal manner, directors say those matters rarely come up. Rather, the top three areas of conversation for directors and shareholders remain financial performance (69%), capital strategy (53%), and executive compensation (49%) (Figure 5).

FIGURE 3

VULNERABILITY ASSESSMENT FOR SHAREHOLDER ACTIVISM

DIRECTORS:

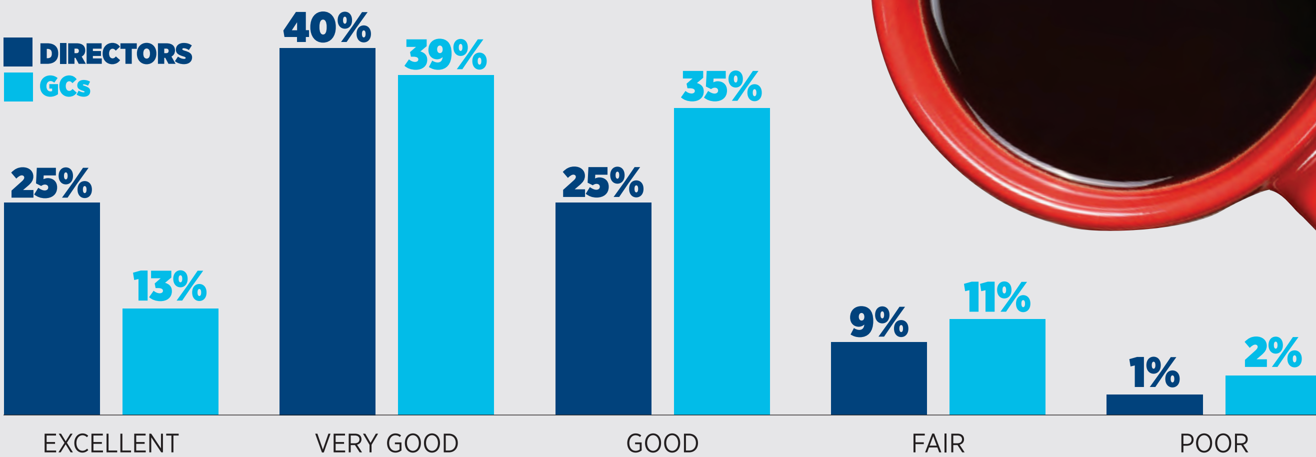
2016	2015
84%	**69%**

GCs:

2016	2015
89%	**76%**

FIGURE 4

QUALITY OF EFFORTS TO MONITOR SHAREHOLDER ACTIVIST ACTIVITY



In a mostly positive finding, 63% of directors surveyed say their board has taken steps to improve its ability to communicate with shareholders by undergoing specific training, and of those, the vast majority found it to be worthwhile. A quarter of the directors say they have not received any such training and do not intend to do so.

Ironically, the number of directors who believe they would benefit specifically from activism defense training dropped from 63% in 2015 to 43% in 2016, even though shareholder activism is the area where directors say they are the least prepared in the event of a crisis, with 5% admitting they are “not at all” prepared for an activist movement. What’s more, half (54%) say either they don’t have or don’t know if they have a formal plan in place to address activism in the event it occurs, showing that clearly there is room for strides to be made in this area of preparedness.

ON THE RADAR: ERM and THIRD-PARTY RISK

Since we began surveying directors nearly a decade ago, the issue of enterprise risk management has always risen to fore as a top concern.

This year, ERM holds the third-place slot for issues directors lose sleep over, while a related finding also shows the topic top of mind, with two-thirds of respondents indicating their boards hold regular, productive discussions on ERM. But it’s the other third that is cause for concern: 28% report that the board discusses ERM “when time allows” and 7% say they rarely, if ever, discuss ERM. These findings roughly correspond to the three-quarters of directors who affirm they spend enough time on discussions of risks as they relate to the company’s overall strategy—and the 25% who do not.

FIGURE 5

AREAS OF CONVERSATION BETWEEN DIRECTORS AND SHAREHOLDERS

	DISCUSSED BETWEEN DIRECTORS AND SHAREHOLDERS	APPROVED BY GCs
Financial performance	69%	57%
Capital strategy	53%	42%
Executive compensation	49%	63%
Board composition/tenure	42%	60%
M&A	41%	39%
CEO succession	30%	45%
Proxy access	30%	45%
ESG issues	26%	34%
Splitting the role of chairman and CEO	21%	60%
Internal audits and controls	21%	42%
Cybersecurity	18%	34%
Crisis preparedness	15%	24%
Political spending	4%	29%

FIGURE 6

LAST REVIEW OF CRISIS MANAGEMENT PLAN BY BOARD AND MANAGEMENT

DIRECTORS AND GCs

LESS THAN ONE YEAR AGO

53%

ONE TO THREE YEARS AGO

24%

MORE THAN THREE YEARS AGO

2%

NEVER/NO FORMAL PLAN IN PLACE

14%

UNSURE

7%

Given their different roles and perspectives, GCs and directors don't always share the same concerns regarding other risks. For instance, half of the general counsel we surveyed report the threat of government investigations as a top concern, while the majority of directors (58%) have little to no concern with this issue.

Similarly, GCs appear to be more concerned with third-party risk than directors (32% vs. 17%). While GCs showed the same level of concern last year, fully double (34%) of directors reported being "somewhat" or "not at all" confident in their handling of third-party risk in 2015.

There are multiple risks that can emerge from third-party relationships, particularly in a global environment. Because boards can be held accountable for improper oversight of a third party, not only from a monetary standpoint but also in terms of corporate reputation, it is part of the board's role to ensure that the company's vendors comply with regulations, as well as with the organization's policies on risk management, including information security.

Mike Pace, head of FTI Consulting's Global Risk & Investigations Practice, had this to say: "Companies should be careful that their implementation of compliance programs does not stop at their front door. With increased regulatory scrutiny on a global level, a good compliance program must go beyond an internal perspective on compliance and address the business practices of third parties. Conducting background and integrity investigations of third-party partners helps mitigate the risk of bad actors operating outside company walls. This proactive approach to compliance is key to protecting companies from the sort of monetary and reputational damage that can occur when a third party engages in unethical behavior."

Companies also need to ensure that in their dealings with third parties, they don't neglect their crisis management strategy. In our survey, 14% of all respondents acknowledged that their company has no formal crisis management plan in place or has never reviewed it with management (Figure 6). There is no reason for companies to neglect developing and regularly revising their crisis management plans to counter potential disruptions to the supply chain, whether caused by an internal event or through a third-party affiliation.

COMPLIANCE OUTLOOK: ETHICS AND ANTICORRUPTION

One of the most important roles of the board and executive management is to set the correct tone at the top for exemplary ethical and compliance conduct throughout the organization.

FIGURE 7

CONFIDENCE IN EFFECTIVENESS OF INTERNAL ANTICORRUPTION ETHICS AND COMPLIANCE PROGRAMS

"In my conversations with directors and executive management," comments Neal Hochberg, the global leader of FTI Consulting's Forensic & Litigation Consulting segment, "I have found that they are most successful addressing global ethics and compliance issues when their companies have worked to build a corporate culture based on openness, trust, and high ethical standards from top to bottom."

An impressive 95% of directors and 90% of GCs report being "confident" or "very confident" in the effectiveness of their company's internal anticorruption ethics and compliance programs—a positive sign during a year that saw SEC enforcement actions increase by 7% year over year (Figure 7).

Last year, 47% of directors and 51% of GCs said they were concerned about FCPA/anticorruption issues. These numbers dropped to 16% and 28% respectively in 2016, despite the fact that there are headlines daily related to FCPA enforcement. Richard Buchband, senior vice president, general counsel, and secretary at ManpowerGroup, thinks the drop may have more to do with other aspects of risk that are more acute for directors and GCs at present.

"Economic volatility and political uncertainty, compounded by recent equity market gyrations and even terrorist activities, may seem to have temporarily crowded out anticorruption as a cause for concern for global companies," Buchband explains. "[But] in today's global environment, ethics and compliance continue to remain top of mind for all well-managed companies."

Indeed, Buchband's reasoning aligns with other survey results that show a third of directors and half of GCs say their fear of potential action from regulatory agencies against their company has increased over the past 24 months (Figure 8). While GC's main worry revolves around the threat of cyber-related sanctions and lawsuits, with 65% of GCs foreseeing an increase in that area, directors are slightly more concerned with anticorruption issues.

To assuage concerns of being blindsided, 87% of directors say they receive regular reports from their ethics and whistleblower hotlines, a best practice, according to governance gurus and regulatory officials. In fact, the code for NYSE-listed companies clearly states that an effective compliance program must contain provisions encouraging reports of illegal or unethical behavior. For those 13% who do not demand such reports, however, the ramifications could be severe. In fact, should compliance violations come to light, a lack of reporting whether the program was adequately resourced and promoted could be a significant factor in determining the sentence.

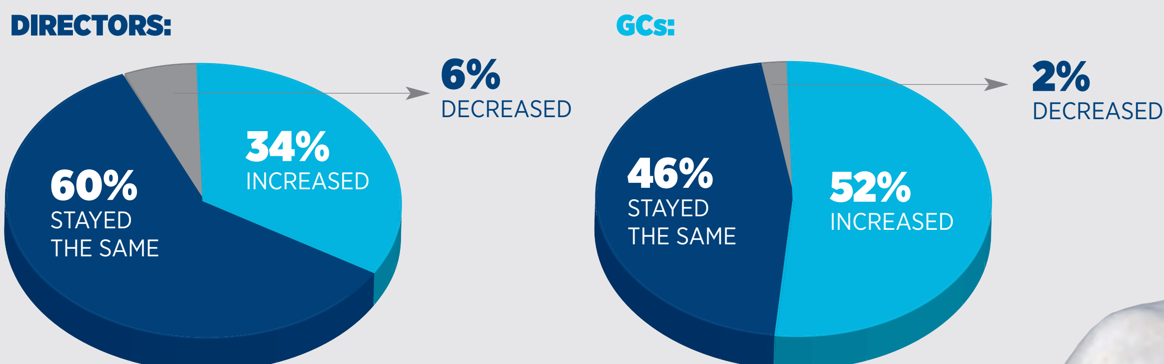
Says Buchband: "Ethics data and hotline reports are an important part of the monitoring process, but setting the tone from the top and throughout the organization is critical." He adds that while ethics and compliance may sit within the legal department as a formal responsibility, companies need to rely on their people to be the front line against inappropriate practices.

PREPARING FOR CHANGE

If managing risks is one of the most daunting tasks of corporate directors and officers, discerning the unknown can undoubtedly appear nearly inconceivable. Yet, in this global, tech-driven environment, companies can no longer afford to ignore potential disruptions coming up fast in their rear-view mirrors. The marketplace is more open to new ideas than ever, and the formulas that have been working for decades can become obsolete in a matter of months. Add to this the pressure of shareholder activism, the perpetuation of new rules and regulations, the complexity of third-party affiliations, and the cyber risks of the digital age, and the challenges of public directors become all the more daunting.

FIGURE 8

FEAR OF POTENTIAL ACTION FROM REGULATORY AGENCIES



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