KPMG

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Insights from the Board Leadership Center

April 2018

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#MeToo—a call to action

The Fed's recent quarter-point rate hike—and two more anticipated this year—is a good sign for growth. Tax cuts are fueling spending. Inflation is still low. And IPOs look poised to rebound. But many expect a bumpy ride, with markets continuing to "correct" and uncertainty about the potential impact of escalating tariffs on manufacturing costs, consumer prices, and, potentially, jobs. While companies and boards consider the implications of international trade developments, many are also grappling with a challenge much closer to home: corporate culture.

#MeToo and a wave of corporate scandals are a stark reminder—and a call to action—for boards to keep culture high on the agenda. In this edition of *Directors Quarterly*, we share insights on culture and other timely board issues from our 2018 KPMG Board Leadership Conference, and we take a closer look at how private companies can get ahead of sexual harassment risk. To dig even deeper, KPMG's Spring Director Roundtable Series—"Board Oversight of Corporate Culture"—will feature panel discussions on this critical issue around the country.

This quarter, we also explore the practical implications of institutional investors' messages on long-term performance and corporate purpose, the challenges of virtual shareholder meetings, the SEC's cybersecurity guidance, and key financial reporting and auditing developments that should be on the audit committee's radar.

Enjoy this edition, and we hope to see you at a KPMG Director Roundtable in a city near you.

Dennis T. Whalen
Leader
KPMG Board Leadership Center

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Board Oversight of Corporate Culture

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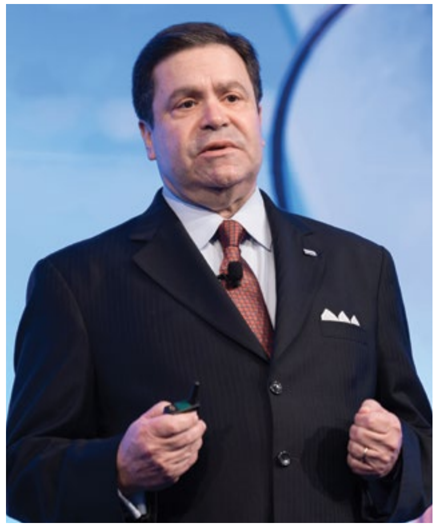
Navigating uncertainty: The long view

The demands on the board's time and agenda continue to mount as a host of critical issues—from business model disruption and uncertainty around economic growth, tax, trade, and infrastructure policies, to cyber risk and geopolitical tensions—collide and reshape the governance landscape. At the same time, expectations for board performance continue to grow in many areas, such as strategy, risk, compliance, culture, innovation, transparency, and more.

More than 225 directors, luminaries, and KPMG leaders gathered in San Diego January 8–10 to discuss the issues shaping boardroom and business agendas. Based on these discussions, it's clear that, as the business and risk environment becomes more complex, the board's ability to prioritize and devote enough time to substantive issues becomes more challenging. While the near term can't be ignored, whether it's uncertainty in Washington or responding to the crisis of the day, the message from investors and other stakeholders is clear: They expect boards to help keep companies focused on long-term strategy and growth.

"With major institutional investors growing in influence and continuing to emphasize long-term performance and value creation, the 'investor lens' has become an essential gauge for calibrating the board's agenda and, indeed, for reassessing the board's role in guiding the company forward," said Dennis Whalen, leader of KPMG's Board Leadership Center. How has the governance environment—and the expectations for companies and boards—evolved in recent years? How has the board's oversight evolved to keep pace? Is the board focused on the issues that are critical to the company's long-term performance and sustainability, and that are top of mind for investors? Is the right talent and culture in place—in the business and the boardroom—to navigate the disruption and uncertainty ahead? Does the company understand the expectations of shareholders, customers, and employees?

Dennis Whalen



Jose Rodriguez

Conference takeaways at a glance

- **The speed of disruption and change will continue full force, driven by technology and digital.**
- **Communicating the company's strategy for long-term growth and sustainability—and how it integrates environmental, social, and governance (ESG) issues—is increasingly a hallmark of good governance.**
- **Strengthen the board's line of sight into the company's culture, at every level.**
- **Build a board that is fit for purpose looking forward, recognizing that diversity and healthy turnover are key.**
- **Make shareholder engagement a priority—and consider how the company's disclosures can better tell its story.**

While financial reporting integrity continues to be job number one for audit committees, expectations for more forward-looking agendas "highlight the importance of leadership and talent in the finance organization, and focusing internal audit on key operational and strategic risks beyond financial reporting, including culture and tone at the top. Diversity at the committee level should also be considered as it drives better oversight and decision making," said Jose Rodriguez, executive director of KPMG's Audit Committee Institute.

Kicking off the event, Lynne Doughtie, KPMG LLP's chairman and CEO, introduced presidential historian and Pulitzer Prize-winning author Doris Kearns Goodwin and MSNBC national affairs analyst John Heilemann, who shared their insights on the near-term challenges facing the country and the pivotal forces that will shape the country's prospects in the longer term. They agreed that two defining features of American politics today—and among the greatest challenges facing the country—are "polarization and populism." And a key question is: How can we unify the country in the face of these forces driving division? Goodwin provided historical context, and recounted other times in history when the country experienced polarization and populism, and how the country's leaders guided the country through these times.

In a second keynote, Michael Lewis, financial journalist and author (*Moneyball*, *The Big Short*, *The Undoing Project*) shared his insights and lessons learned from his career as a journalist and writer. Of particular interest from a board perspective, Lewis talked about the work of the psychologists Amos Tversky and Daniel Kahneman, the subjects of *The Undoing Project*, about patterns of human irrationality that can distort decision making. According to Lewis, our minds are always making "probabilistic calculations, but without actual statistics." In other words, our biases and the stories we make up, rooted in our memories, effectively replace probability judgments. Our gut instincts and intuition are often wrong.

The message for directors: We have to undo much of what we have learned—including our biases—in order to make better decisions.

The economy, tax reform, and geopolitics

The United States is enjoying the benefits of a "snowflake economy: nearly perfect, but fragile," said Constance Hunter, KPMG chief economist. "We've got good growth,

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low interest rates, and low inflation, but it's difficult to sustain this level of perfect." Hunter identified a number of potential upside risks for 2018, including stronger global growth, corporate tax reform, and infrastructure spending—as well as potential downside risks, including trade protectionism, a substantial stock market decline, higher interest rates, weak wage growth, and a strong dollar. "The short-term growth outlook depends heavily on the pace of inflation and fed rate hikes, and long-term growth depends heavily on productivity dividends."

And while the true effects of the recent U.S. tax reform may not be understood for years, the reduction in the statutory rate—placing the United States in the middle of its country peer group—is expected to help drive growth.

While the economic outlook is good, the geopolitical outlook is far less promising, according to Eurasia Group's Ian Bremmer. "When global geopolitics becomes more important than global economics—and I believe it has—you know it's a challenging environment." The likelihood of a geopolitical crisis—a mistake could lead to a confrontation—has risen significantly. China's role in the world is big and getting bigger, its current president has more power than his predecessors, and the United States' "America First" policy is leaving a power vacuum that China is willing to fill. In 2018, China's economic influence will be greater than that of the United States, boosted by its investment in state-owned enterprises. While the potential for a trade or military war between the United States and China is low, technology is another story, in Bremmer's view. China has emerged as a "tech superpower," bolstered by heavy government investment in

John Heilemann and Doris Kearns Goodwin

Jeffrey Cunningham and Michael Lewis (right)

artificial intelligence and other futuristic technologies, while most United States investment in technology is through the private sector.

Long-term growth and sustainability

In a January 2018 post for the Harvard Law School Forum on Corporate Governance ("Engagement—Succeeding in the New Paradigm for Corporate Governance"), noted attorney Martin Lipton described an "accelerated interest in sustainability, ESG, corporate social responsibility, and investment for long-term growth and value creation" by a broad range of business leaders as well as by the policy positions of the three largest index fund managers—BlackRock, State Street, and Vanguard—as to what they expect in the way of governance and engagement.

Panel members discussed the expectations of the major institutional investors, including their expectations for companies to focus on long-term value creation and the factors driving it—strategy and risk, talent, research and development investment, culture and incentives, as well as sustainability and ESG issues, particularly climate change and board composition and diversity. Among questions for board consideration: Do we have a coherent long-term strategy? How closely do our short-term actions and targets connect with that strategy? Can the management team and members of the board articulate that connection? Do current and potential shareholders have a clear understanding of the connection to make informed investment decisions? Conference discussions also highlighted a fundamental question that many boards are wrestling with: Is ESG really an important business issue for companies and boards today, or is it more of a social "do good" issue or perhaps a reputation risk?

According to Stephen Brown, senior advisor, KPMG's Board Leadership Center, while some view ESG as a soft brand issue disconnected from core business processes, "I think it's fair to say that the tide is changing. More companies are realizing that a focus on ESG issues improves company performance and competitive position—and investors are pressuring companies to treat ESG as an important business issue." As panel members noted, major institutional investors continue to emphasize

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> — Stephen Brown, Senior Advisor, KPMG Board Leadership Center

the importance of ESG issues to corporate performance and long-term value creation and preservation. Large pension funds are also applying pressure by incorporating ESG analysis into their investment decisions—viewing ESG lapses as red flags signaling potential trouble.

Panel members agreed that ESG issues will remain a priority and perhaps even grow in importance as deregulatory efforts on environmental and social issues may drive investors to step in to fill the void. Panel members emphasized the following areas for board focus:

- Do we understand what ESG issues—risks and opportunities—are of strategic significance to the company, and are on the minds of investors, customers, and employees?
- How are we integrating these ESG issues into our strategy?
- Have we shaped the company's key ESG messages to investors and other stakeholders in the context of strategy and long-term value creation?
- Does the board have the right composition, structure, and processes to oversee ESG in the context of strategy and long-term value creation?

Reputation risk

The #MeToo movement and headlines of sexual harassment scandals and allegations have rightly highlighted the importance of corporate culture as both a risk and a driver of long-term performance. Conference discussions about culture—what a company does and how it does it—focused on the importance of the board having a clear line of sight on the company's culture and various ways that the board might improve its line of sight. While culture starts at the top, the culture at all levels of the organization (the mood in the middle and buzz at the bottom) is also critical. Panelists and attendees discussed various methods boards can employ to help gain an understanding of the company's culture—particularly the behavior and culture in the middle that is so difficult for the board to assess. As one speaker said, "Feet on the ground can help verify what you are hearing from management about the culture. Trust but verify."

In addition to commonly used tools to assess culture—such as employee exit interviews, whistle-blower hotlines, input from internal auditors, engagement/satisfaction surveys, employee turnover rates, and visits to company locations outside of headquarters—other tools discussed

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included attending town hall meetings, holding director "office hours" open to all employees ahead of board meetings, and attending trade shows to get a sense of the company's reputation. In addition, speakers suggested considering feedback from external sources, such as recruiting websites and other sources of customer reviews and complaints, as part of the mix of information to supplement the board's view of culture.

Among key questions boards might consider: Do employees have the confidence to escalate bad behavior and trust it will get results? Are incentive structures aligned with strategy and do they encourage the right behaviors? Take a hard look at the board's own culture for signs of groupthink or discussions that lack independent or contrarian voices.

Disruption and innovation

"You can't talk about innovation without talking about disruption, because disruption is everywhere," said Mike Nolan, vice chair of Innovation & Enterprise Solutions for KPMG, who led a discussion on innovation and disruption. "There are no boundaries, and there's no industry or organization that's safe from the impact and pace of disruption," Nolan said. Developments such as artificial intelligence, blockchain, the Internet of Things, platform business models, and so many other trends that were not even in the conversation as little as a few years ago are disrupting business models today. These technology developments are all-consuming, as business leaders try to make sense of them—and then make the right decisions and investments to help their companies succeed.

In this environment, innovation is critical, and boards can play a key role as agents of change and champions of innovation. Nolan emphasized three ways that boards can support management teams in their innovation efforts:

1. **Be intentional.** Management needs to be intentional in its innovation vision, strategy, and execution, and boards can hold management's feet to the fire.
2. **Create a culture where innovation can thrive.** How can the board support and encourage the CEO to make an innovative culture one of his or her top priorities?
3. **Choose leadership talent that is right for the organization in its innovation journey.** Working with leadership, the board can help determine what sort of emphasis to place on innovation—whether it is central to the business strategy or an incremental priority.

Board composition and diversity

Given the demands of today's business and risk environment—not to mention the ongoing scrutiny of investors, regulators, and the media—a critical priority for most every board today is to align boardroom talent with company strategy, both for the short term and for the long term as strategy evolves. As one panel member said, "In building a board that is fit for purpose looking forward, boards need to recognize that diversity and healthy turnover are key."

During a preconference luncheon, Doughtie and nearly 100 directors and governance professionals gathered to discuss the challenges to diversifying corporate boards and defining what a diverse board means. Leaders representing the WomenCorporateDirectors Foundation, Ascend Pinnacle, the Black Corporate Directors Conference, Quorum, and the Latino Corporate Directors Association each introduced their organizations and goals.

From left: Susan Keating, S.K. Gupta, Lynne Doughtie, John Rogers, Jr., Susan Angele, David Chun, Esther Aguilera

"The discussion is no longer about whether diversity is important; it's about moving the needle," said Susan Angele, senior advisor, KPMG Board Leadership Center.

David Chun, CEO of Equilar, discussed efforts to build a diverse director database and some of the challenges to collecting diversity data, particularly around the identification of ethnicity, background, and orientation. Attendees acknowledged that progress on diversifying boards has been slow and offered a number of suggestions to accelerate progress:

- Measure and reward executives who drive diversity within their companies, including working with the CEO to identify diverse executives who may benefit from serving on outside boards.
- Advocate for diversity as part of board refreshment by highlighting companies with long-tenured directors.
- Require consideration of a diverse slate of directors for open seats of SEC-registered U.S. public companies (a "Rooney" rule for boards).
- Push for diversity on board committees, including committee chairs.
- Enhance "board readiness" training and education for current executives and senior leaders to help expand the pool of candidates.
- Consider whether/how the board appropriately mirrors the makeup of the organization, its customers, and other stakeholders.
- Insist on diversity among corporate service providers, including lawyers, bankers, accountants, and others.

Cyber risk and security

Not only is the cyber threat not going away, it's growing more sophisticated and aggressive, with implications for nearly every facet of the business. Hacks at Equifax and other prominent organizations punctuate the new reality that any system "on the grid" is vulnerable. Boardroom discussions should be moving from prevention to detection, containment, and response—and to addressing cyber risk as an enterprise-wide business issue impacting strategy and risk, compliance, product development, mergers and acquisitions, expansion into new geographies, and relationships with vendors, suppliers, and customers.

Boardroom discussions should be moving from prevention to detection, containment, and response—and to addressing cyber risk as an enterprise-wide business issue.

As the threat landscape evolves, boards should consider whether the company's cyber risk and response plan has kept pace. Speakers emphasized the importance of having a clear plan and robust escalation processes to respond quickly and effectively when an incident occurs.

Threats should be presented to management and the board "quickly and in a way they can understand," said one director. "Internally, know who manages what, and which information is conveyed and when."

Speakers offered the following additional takeaways for boards:

- View cyber as a risk and a governance issue. From a privacy standpoint, boards should ask, "Is what we are doing what the customer expects?" From a security standpoint, boards should ask, "How are we protecting data that we collect from third parties?"
- Be aware of specific groups that present the most dangerous and persistent threats to the organization.
- Have a plan in place for becoming compliant with the General Data Protection Regulation (GDPR), effective in May 2018. GDPR applies to companies that collect data on citizens in European Union (EU) countries (even those with no business presence in the EU). Even if a company isn't subject to GDPR, one speaker noted, "Customers may ask if you are compliant."
- Build and leverage relationships with law enforcement. "Understand what you need, and how they can help."
- Expect ambiguity. "The language around cyber is not intuitive. Get used to hearing complicated concepts. Computer forensics can be spectacularly slow. Executives will want answers right away, but getting them takes time."

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– Get educated at a high level on what new technologies, such as blockchain, big computing, artificial intelligence, cognitive computing, and mass computing, mean. "Understand the risks of new technology for your company. Look at how the world is changing with respect to your data."

Audit in focus

Frank Casal, KPMG Vice Chair of Audit, moderated a panel on audit quality, and panel members discussed the state of audit quality today, areas of possible improvement in the near and longer term, the use of data and analytics (D&A) in the audit, the PCAOB's new auditor's reporting model, and the need for transparency around the audit committee's oversight of the external auditor. The PCAOB's standard on the auditor's reporting model (approved by the SEC in October) will require the auditor to communicate in the auditor's report any critical audit matters (CAMs) arising from the current period's audit or to state that the auditor determined that there were no CAMs. Since the requirement to communicate CAMs is not effective until audits for fiscal years ending on or after June 30, 2019 (for large accelerated filers), panel members suggested audit committees use that time to discuss the new reporting requirements with their auditor and to develop appropriate protocols. The panel also discussed ways that companies are using D&A in their financial reporting, internal audit, and finance functions, and how external auditors are incorporating the use of D&A into their audits, as well as some of the challenges they face.

Financial reporting

Claudia Allen, senior advisor, KPMG Board Leadership Center, moderated a panel on financial reporting and disclosure hot topics, which focused on the financial reporting implications of the Tax Cuts and Jobs Act (TCJA), implementation of the FASB's new revenue standard, as well as other accounting changes on the horizon, the use of non-GAAP financial measures and other operating metrics, and the SEC's new pay ratio rules and other proxy disclosures. Since companies are required to recognize the effect of tax law change in the period of enactment, the effects must be recognized in companies' 2017 financial statements. Whalen discussed how the tax law changes could impact the tax provision and financial statements for 2017. Thomas Kim, partner at Sidley Austin, reminded audit committee members to consider how the TJCA might affect Management's Discussion and Analysis and risk factor disclosures in 2017 10-Ks. As to implementation of the new revenue standard (effective January 1, 2018 for calendar year public companies), panel members recommended two broad areas of focus for audit committees. First, understand how management has determined the transition impact of adopting the new standard—which must be disclosed in the company's 2017 10-K as a Staff Accounting Bulletin (SAB) 74 transition disclosure. What has the external auditor done to evaluate the transition impact? What are the external auditor's recommendations regarding the adequacy of the SAB 74 disclosure? Second, discuss with management and understand the company's readiness to operate and report under the new standard in 2018; key areas of focus include the impact on internal control over financial reporting, the standard's new disclosure requirements, and the impact on disclosure controls and procedures.

The conference concluded with small group peer exchanges, which offered attendees the opportunity to engage in candid, off-the-record discussions about the challenges and emerging issues driving the agendas and practices of audit, compensation, and nominating/governance committees. For insights from the peer exchanges and additional details on the conference, read *Navigating uncertainty: The long view.*

Financial reporting & auditing update

The accounting and reporting impact of U.S. tax reform as well other accounting and financial reporting developments potentially affecting your company in the current period or in the months ahead, are summarized below. (For more, read KPMG's *Quarterly Outlook*.)

Current Quarter Financial Reporting Matters

U.S. Tax Reform. H.R. 1, originally known as the Tax Cuts and Jobs Act, was enacted on December 22, 2017, and is expected to significantly impact companies' accounting for and reporting of income taxes and the related processes and controls. Also on December 22, the SEC staff issued Staff Accounting Bulletin (SAB) No. 118, which allows companies to record provisional amounts during a 'measurement period'. The measurement period is similar to the measurement period used when accounting for business combinations under ASC 805. It ends when a company has obtained, prepared, and analyzed the information necessary to finalize its accounting, but cannot extend beyond one year.

Because most of the provisions of the new law were effective date January 1, 2018, companies have begun to estimate the law's effects on their annual effective tax rates. This includes evaluating whether expenses that were historically deductible before January 1 remain deductible, applying the new rate provisions of the law, determining the effects of the new interest expense limitations, and forecasting whether the company will be subject to new taxes on foreign earnings and payments.

Companies' analyses and interpretations of the new law and of how ASC 740 should be applied continue to evolve. As companies obtain, prepare, or analyze additional information about facts and circumstances that existed at the enactment date, they will need to adjust the balances recorded provisionally as of December 31, 2017 for the effect, if any.

Companies also must dedicate appropriate time and attention to disclosures related to the new law and the recorded provisional amounts. The disclosures should be sufficiently detailed for a user to understand the significant effects of the law, the nature of provisional amounts and the previously provisional amounts for which the accounting has been completed during the period.

Public companies adopt the revenue recognition standard. In the first quarter of 2018, public companies were required to adopt and apply the requirements of the revenue recognition standard. Adoption of the standard requires new and expanded qualitative and quantitative disclosures. Public companies also are required to adopt the new accounting guidance about derecognition of nonfinancial assets and in-substance nonfinancial assets in transactions with noncustomers, which is effective concurrent with the revenue recognition standard.

The objective of the disclosure requirements in the revenue recognition standard is to provide financial statement users with sufficient information to understand the nature, amount, timing and uncertainty of revenue, certain costs and cash flows arising from contracts with customers. Rule 10-01 of Regulation S-X and Financial Reporting Manual Section 1500 require companies to provide both annual and interim disclosures in each quarterly report in the year of adoption, i.e. the first, second and third quarter Form 10-Q filings. As a result, when a company adopts a new accounting standard in an interim period, it is expected to provide both the annual and the interim period financial statement disclosures prescribed by the new accounting standard if those disclosures do not duplicate information previously provided in the annual financial statements.

Financial instruments guidance about recognition and measurement becomes effective. The FASB's standard about recognition and measurement of financial instruments (financial assets and financial liabilities) became effective in the first quarter of 2018 for public companies. The most significant operational changes likely will relate to the new guidance for investments in equity securities measured at cost because the fair value is not readily determinable. The new standard allows companies to measure these equity securities at fair value, or use a new measurement alternative that requires the investor to adjust the cost basis for impairment and observable transaction prices for identical or similar securities of the same issuer.

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Other changes for 2018. In the first quarter of 2018, calendar year-end public companies are adopting not only the revenue recognition and financial instruments recognition and measurement standards, but also several other standards intended to simplify or clarify accounting requirements. The new accounting standards include classification of cash receipts and cash payments (ASU 2016-15), accounting for income taxes on intercompany transfers (ASU 2016-16), restricted cash (ASU 2016-18), clarifying the definition of a business (ASU 2017-01), presentation of net periodic pension cost and net periodic postretirement benefit cost (ASU 2017-07), and scope of modification accounting (ASU 2017-09).

New Standards and Guidance

FASB finalizes and proposes various amendments to the leases standard. The FASB has finalized and proposed various amendments to the leases standard to address implementation issues raised by stakeholders, including an optional transition relief. Even with this relief, the time and resources required to obtain all information to implement the standard will remain significant, and the 2019 effective date for public companies is quickly approaching. Companies are spending more time than expected identifying their lease population and extracting the data required to comply with the standard. They also are finding that some contracts may contain embedded leases that were not identified as leases under current U.S. GAAP.

Implementing the credit impairment standard. The FASB's new credit impairment standard will be effective in 2020 for public companies. Companies should be analyzing the implications of adopting this standard and considering the adequacy of their disclosures about the expected effects of adoption. Although the standard is not effective until 2020, those companies that will be most affected by its requirements should be making significant progress toward adoption. The nature and extent of preparations will vary, but companies will need to thoroughly evaluate the effect of the standard and determine what changes will be necessary. Companies may need to collect more data, and significantly change their systems, processes, and internal controls to comply with the standard.

SEC Developments

SEC addresses disclosures about cybersecurity. The SEC issued interpretive guidance that addresses public companies' disclosure obligations under existing law for cybersecurity risk and incidents. It stresses the importance of maintaining comprehensive policies, including disclosure controls and procedures, related to cybersecurity risks and incidents. The guidance also reminds registrants about broader prohibitions against insider trading and making selective disclosures about cybersecurity risks or incidents. The guidance became effective on February 26.

SEC updates FRM guidance on new accounting standards. In December, the SEC Division of Corporation Finance updated its Financial Reporting Manual (FRM) to revise guidance on the pro forma effect of adopting new accounting standards; to address the adoption of new standards after an entity loses emerging growth company status; and to clarify the effective dates of the revenue recognition and leases standards for certain public business entities.

Although the credit impairment standard is not effective until 2020, those companies that will be most affected by its requirements should be making significant progress toward adoption.

The SEC cybersecurity guidance:

Takeaways for boards

In light of recent interpretive guidance issued by the Securities and Exchange Commission, boards should review how they discharge their oversight of cyber risk.

Amid increasing cyber threats and recent massive breaches, the SEC issued interpretive guidance on cybersecurity disclosures that applies to public companies registered with the Commission.

The 24-page document published in February reinforces and expands on guidance issued in 2011 by the Division of Corporation Finance. It also addresses two topics not addressed in the prior guidance: the importance of cybersecurity policies and procedures and the application of insider trading prohibitions in the cybersecurity context.

The guidance emphasizes the importance of informing investors in a timely fashion about material cybersecurity risks and incidents. To that end, the guidance notes that disclosure controls and procedures are crucial to a public company's ability to make any required disclosures in the appropriate time frame.

Federal securities laws require public companies to include in their proxy statements a description of how the board administers its risk oversight function. To the extent cybersecurity risks are material to a company's business, that description should include the nature of the board's role in overseeing the management of that risk. "We believe disclosures regarding a company's cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues allow investors to assess how a board of directors is discharging its risk oversight responsibility in this increasingly important area," the guidance states.

According to the SEC, the development of effective disclosure controls and procedures "is best achieved when a company's directors, officers, and other persons responsible for developing and overseeing such controls and procedures are informed about the cybersecurity risks and incidents that the company has faced or is likely to face."

While most public companies have insider trading policies, the guidance encourages companies to consider whether those policies adequately address cybersecurity incidents that have not yet been publicly disclosed. Shortly after issuance of the guidance, the Department of Justice and the SEC announced insider trading charges against a former chief information officer alleged to have exercised options and sold shares after learning of a major cybersecurity breach and before the breach was publicly announced.

In addition to reviewing the sufficiency of disclosure controls and procedures related to cyber risks and incidents, companies may want to take a fresh look at their disclosures with respect to cyber in the following areas:

- Risk factors
- Management's discussion and analysis
- Description of business
- Legal Proceedings
- Financial statement disclosures
- Board risk oversight

The guidance notes that companies also may have disclosure obligations under Regulation Fair Disclosure (which prohibits selective disclosure of material, nonpublic information) in connection with cybersecurity matters.

SEC chairman Jay Clayton said the staff will continue to monitor cybersecurity disclosures as part of their selective filing reviews and the Commission will continue to evaluate developments in this area and consider feedback about whether further guidance or rules are needed.

The latest flashpoint in the governance wars:

Virtual shareholder meetings

by Claudia H. Allen

Virtual-only annual meetings—shareholder meetings held solely online, rather than at a physical location—have become the latest flashpoint in the governance wars.

The move from a physical to an electronic meeting seems natural. Few stockholders attend uncontested annual meetings, such meetings are typically brief and pro forma, and corporate America is undergoing a digital transformation.

From the company perspective, virtual-only meetings may be an attractive option since they are less expensive (a company need not rent a space, or incur security and similar costs), allow a greater number of retail and institutional investors to attend, and permit such investors to participate without incurring travel expenses.

Since shareholders participating remotely can vote during the meeting until the polls close, one downside for companies is the potential for greater unpredictability of outcomes—which is relevant when contested issues, approval of a major transaction, or contentious shareholder proposals are on the ballot. Thus, virtual-only meetings may not be well suited for certain situations.

Investor concerns

Opponents of virtual-only meetings have raised concerns that such meetings eliminate face-to-face interaction with the board and management and could be structured to limit shareholder participation—for example, by allowing a corporation to avoid answering difficult questions. The New York City Comptroller announced that the NYC Pension Funds would vote against directors on the governance committee at companies holding virtual-only meetings during 2018.[1] Evidencing the pressure brought to bear on companies holding virtual-only meetings, both ConocoPhillips and Union Pacific announced that they would no longer hold virtual-only meetings after investors objected to the virtual-only format used in 2017.[2]

The Council of Institutional Investors (CII) maintains that virtual meetings should only be used to "supplement" traditional in-person meetings, and not as a "substitute".[3] The combination of a virtual and physical meeting is often referred to as a "hybrid" meeting. For issuers, a downside of hybrid meetings is that they do not offer the cost saving of a virtual meeting, effectively requiring double-track logistics. Moreover, some companies that experimented with hybrid meetings subsequently moved to virtual-only meetings when few shareholders attended the physical meeting. According to Broadridge, of 24 companies that held a hybrid meeting in 2016, 50 percent switched to virtual-only meetings in 2017.[4]

While some investors have strong reservations about virtual-only meetings, views vary widely. Institutional Shareholder Services (ISS), the proxy advisor, received the following feedback from investors when updating its voting policies for 2018:[5]

- 19 percent found both hybrid and virtual-only meetings acceptable, while 8 percent did not support either alternative format
- 32 percent found hybrid meetings and virtual-only meetings acceptable, provided the virtual meetings offer the same shareholder rights as a physical meeting and
- 36 percent of investors found hybrid meetings, but not virtual-only meetings, acceptable.

ISS has not yet adopted a formal policy on virtual-only meetings in the U.S., although in Europe, it will support hybrid meetings and oppose virtual-only meetings.

Proxy advisor Glass Lewis argues that virtual-only meetings may curb the ability of a company's shareholders "to meaningfully communicate with the company's management." As a result, beginning in 2019, it will recommend voting against the governance committee at companies planning to hold virtual-only meetings, unless the company provides robust disclosure assuring the same participation rights and opportunities as at an in-person meeting.[6]

Statistics

Delaware, the home of over 60 percent of the Fortune 500, changed its corporate law in 2000 to permit virtual meetings and many other states followed suit.[7] The number of companies employing virtual meetings has been small, but has been increasing. According to Broadridge, 187 companies held meetings in 2016 allowing stockholders to participate electronically, of which 155 (83 percent) were virtual-only; the remainder were hybrid. Of the 155 virtual-only meetings, 149 (96 percent) used live audio and six used live video. In 2017, 236 companies held virtual meetings, of which 212 were virtual-only—representing a 37 percent increase. Similar to 2016, 205 (97 percent) were audio-only. Audio-only meetings are much like analyst calls and pose fewer technological and logistical challenges than video meetings. Broadridge estimates that it will host an aggregate of approximately 300 virtual-only and hybrid meetings in 2018.[8]

Ongoing developments

Key questions are whether there are transparent virtual-only meeting practices that will satisfy the concerns of opponents, and whether investors will get more comfortable with virtual-only meetings as usage increases and technology improves (and becomes less expensive).

In 2012, a group of investors, public companies, and proxy and legal service providers formed a working group to explore best practices for online participation in annual meetings. While the group was not able to agree on when virtual-only and hybrid meetings should be used, it outlined general principles.[9] The Working Group emphasized that companies should not use technology to avoid opportunities for dialogue, and recommended that companies adopt and publish principles for online participation, including guidelines for questions from shareholders. The Working Group is planning to issue updated guidance for the 2018 proxy season.

CII published its own tips for companies "looking to convene a shareholder-oriented shareholder meeting."[10] No company is known to have utilized all of the recommendations, but they provide useful insights, including on the sensitive issue of "cherry picking" questions.

In view of the sensitivity surrounding the treatment of stockholder questions, requiring that all questions be submitted in advance is likely to raise concerns about a company's motivations. Reflecting that potential pitfall, Broadridge noted that 98 percent of companies using virtual technology allow questions to be submitted online during the live meeting, approximately 10 percent permit questions to be presented live by phone, and approximately 11 percent allow questions to be submitted online in advance of the meeting. Additionally, if time does not allow all questions to be answered, some companies will post all remaining questions together with answers to underscore their commitment to transparency.

Given the controversy surrounding virtual-only meetings, companies considering virtual meetings should gauge the sentiment and voting policies of their stockholders, understand the potential negative votes that may be cast (and related negative publicity), analyze whether a hybrid meeting is an attractive middle ground, and continue to monitor developments.

1 New York City Retirement Systems, Corporate Governance Principles and Proxy Voting Guidelines, amended April 2017, p. 20.

2 Emily Chasan, "Investors Opposing Virtual Shareholder Meetings Notch Wins," Bloomberg, January 9, 2018.

3 Council of Institutional Investors, Policies on Corporate Governance, updated September 15, 2017.

4 Broadridge, Virtual Shareholder Meetings: 2017 Facts and Figures.

5 ISS, 2017-2018 ISS Global Policy Survey, Summary of Results, September 25, 2017.

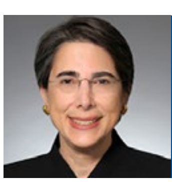
6 Glass Lewis, 2018 Proxy Paper Guidelines at 43.

7 Thirty states allow virtual-only meetings, while 12 permit hybrid (but not virtual) meetings. Companies contemplating virtual meetings should examine the law of the state where they are incorporated, and whether such meetings are permitted by their organizational documents (or whether amendments would be required).

8 Broadridge, Virtual Shareholder Meetings: 2017 Facts and Figures.

9 Guidelines for Protecting and Enhancing Online Shareholder Participation in Annual Meetings, June 2012.

10 CII, Build a Better Meeting, October 2017.



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Private Company Perspective

Getting ahead of sexual harassment risk

by Susan M. Angele

Discussion about board oversight of sexual harassment issues often comes up only after public allegations have thrown the company into crisis. But, as #MeToo continues to raise awareness of the prevalence of sexual misconduct in the workplace, the KPMG Board Leadership Center has heard from board members of private companies as they assess how their boards can get out in front of the issue, even if their company has not yet been directly impacted.

As a private investor recently shared with me, "Given the number of executives and employees across our portfolio, if we are not crystal clear regarding our expectations on these issues, that's on us." Boards have been and will continue to be held accountable, at least in the court of public opinion. If a serious issue arises, "We didn't know" or "We were going to look into it" are not sufficient responses.

Here are a few suggestions to consider:

Emphasize values.

If boardroom conversation focuses exclusively on goals, plans, and results, this would be a good time to add company values and culture into the mix. Setting the tone at the top and encouraging management to communicate it down through the organization will go a long way. Of course, words alone are not enough. The board should expect management to model positive company values and to have no tolerance for misconduct.

Assess prevention measures.

As tracked by *Harvard Business Review (HBR)*, allegations have been made against at least 100 men in power in the past year. Given the wide scope of the problem, no board should assume that the company has no issues just because nothing has come to its attention. Every board should be asking about the company's policies, training, outlets for employees to complain, and practices with regard to investigation and follow-up action. The board of an investment company should also be asking whether members of management who participate on portfolio company boards are asking similar questions at the portfolio company level.

Encourage speaking up.

For an organization to find and respond to misconduct, it must be clear that speaking up is welcomed, complaints will be taken seriously, and those making good faith allegations will be protected from retaliation. Requiring that management immediately notify the board of any complaint against an executive is also a good practice.

Follow smoke, stamp out fire.

Many of the incidents that have hit the headlines were ultimately not a surprise to people close to the situation. In some instances, rumors had been swirling for decades. Directors need to become students of the company's culture—routinely get to know employees below the C-suite level, review employee engagement surveys, and read social media comments about the company by current and former employees and other stakeholders. If concerns are expressed, dig deeper. If a serious issue is uncovered, it should be addressed decisively by management or the board—whether the person at fault is an up-and-coming star performer, a shift supervisor in the factory, or a powerful and entrenched CEO.

Expect balance.

The current environment raises tough questions. Where is the line between conduct resulting in termination and conduct resulting in lesser consequences? How much evidence is enough to merit terminating the accused, potentially destroying that person's career? What if some men do not want to work with women for fear of unsubstantiated accusations? As societal expectations continue to evolve, the board can help management consider the right balance and set the right tone.

As an *HBR* article noted: "This is not a fight between men and women. It's a fight over whether a small subgroup of predatory men should be allowed to interfere with people's ability to show up and do what they signed up for: work." Companies that proactively and thoughtfully work to prevent and address sexual misconduct will benefit in the long run by reducing risk and removing a barrier to attracting and retaining top talent.

This article originally appeared in the March/April 2018 issue of NACD Directorship magazine.

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Investor Intelligence and Insights

Making sense of A Sense of Purpose

by Stephen L. Brown

Heading into proxy season, the January letter from BlackRock chairman and CEO Laurence Fink to CEOs has captured the attention of the business community. Entitled A Sense of Purpose, the letter urges corporations to focus on their social purpose and long-term strategies.

As head of the world's largest asset manager, Fink made clear BlackRock's expectation for a new model of shareholder engagement, "that strengthens and deepens communication between shareholders and the companies that they own." His words were applauded by those focused on driving greater corporate social responsibility; others called his views "misguided" or merely wishful and without teeth, honing in on BlackRock's position as an index fund manager. Whether or not directors agree with Fink's views, boards would be well-advised to read the letter and consider how to respond to it in the context of their own companies.

Major takeaways

First, recognize that Fink's message is consistent with his prior letters—full-throated attacks on short-termism, reminding boards regarding their obligation to pursue the long-term interest of the patient capital which he represents. But his use this year of the phrase "social purpose" has conjured up myriad feelings from readers—including the fear of discounting profit-making for social initiatives. This fear is unfounded. Fink makes it clear in his letter that today, in order to sustain financial performance, companies must protect their license to operate, which means showing positive contributions to society.

Second, "passive" funds are no longer passive with their proxy votes. Fink's letter notes that investors' increasing use of index funds has driven a "transformation in BlackRock's fiduciary responsibility and the wider landscape of corporate governance." His letter urges corporations and their leaders to do exactly what he is doing in response to macro trends. "[As a result of government and market failures]," he writes, "society increasingly is turning to the private sector and asking that companies respond to broader societal challenges." There is immense pressure on asset managers to use private ordering and to demonstrate their positive contributions to society. Through the letter and follow-up communication, Fink and BlackRock are demonstrating their own accountability. It makes business sense.

Third, Fink is doubling down on this new model of shareholder engagement to go beyond casting proxy votes. He expects companies and boards to have meaningful engagement with shareholders. "If engagement is to be meaningful and productive—if we collectively are going to focus on benefitting shareholders instead of wasting time and money in proxy fights—then engagement needs to be a year-round conversation about improving long-term value." Fink notes he is doubling his engagement staff (already the largest in the business) to fill the expected uptick in meetings.

How should boards respond?

Boards should embrace the tenets of the letter. It is a declaration for long-termism over short-termism. Fink believes that firms make bad short-term decisions and sacrifice long-term value creation when they have poorly articulated or simply suboptimal strategies. "[A] central reason for the rise of activism—and wasteful proxy fights—is that companies have not been explicit enough about their long-term strategies," writes Fink.

Boards should:

- **Prepare for meaningful engagement.** BlackRock is increasing its capacity for engagement. Companies should do the same. Boards should ensure engagement staff are well-prepared and well-equipped to have an effective discussion. BlackRock broadcasts its priorities and concerns (e.g., website, public statements). The appropriate members of management must be prepared to discuss the key issues—and address the social purpose question.
- **Review the strategic framework** for long-term value creation. Ensure you have a clear, concise, and convincing strategy story and that management and the board can communicate it effectively. BlackRock specifically states that they want to know if the board has reviewed and affirmed the strategic framework. Part of that strategic framework should include an understanding (and mitigation and/or management) of broader societal impact on your business. For example, can the company address how broad, structural trends such as wage growth, automation, or climate change will affect its business?
- **Prepare for director-investor engagement.** Having an independent director meet with shareholders is no longer just a nice offer, it is expected. Boards and management should discuss how and when those interactions will take place.

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Mark your calendar

NACD Global Cyber Forum, Geneva, Switzerland
April 17–18, 2018

KPMG joins NACD and other partners for a two-day forum on cyber risk. Multinational directors, C-suite executives, cyber experts, global law enforcement, and others will examine board oversight practices and offer practical, actionable items that board members and C-suite executives can effectively implement to help defend their companies against global cyber risks.

To register visit *NACDOnline.org*.

KPMG 2018 Spring Director Roundtable Series, select U.S. cities
May–June 2018

Hosted by the KPMG Board Leadership Center at locations across the country, the Spring Director Roundtable series—Board oversight of corporate culture—will explore how the board can influence, monitor, and assess corporate culture. The discussions will also include an update on the financial reporting implications of Tax Cuts & Jobs Act.

For more information and to register, visit kpmg.com/blcroundtable.

WCD Global Institute, New York
May 8–10

Beginning with the Family Business Institute on May 8, the WomenCorporateDirectors Global Institute will include networking opportunities, breakout sessions, and panel discussions on topics such as governance, risk, technology, global trends, and corporate citizenship. The Visionary Awards Dinner will be held on May 9.

Learn more at *www.womencorporatedirectors.org*.

NACD Master Class, Austin, TX
June 14–15

This highly dynamic and interactive two-day program from NACD is developed exclusively by and for experienced directors, fostering thought leadership around the latest topics and emerging issues affecting the boardroom.

Request an invitation at *NACDOnline.org*.

Selected reading

Guardians of trust *KPMG International*

How to be a good board chair *Harvard Business Review*

Nonfinancial metrics, strategy, and culture *NACD*

Disruption is the new norm *KPMG*

The new playbook for advancing women in leadership *Korn Ferry*

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The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement of public- and private-company governance. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at *kpmg.com/blc*.

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