KPMG

Directors Quarterly

Insights from the Board Leadership Center

April 2019

Envisioning the future

The more difficult it is to envision the future, the more important that exercise becomes.

Aside from Brexit uncertainty and the lingering trade war with China, the economic indicators this quarter paint a fairly clear picture. With interest rate hikes likely off the Fed's table for the rest of the year, a downward revision to the U.S. growth forecast (from 2.6 to 2.1 percent), the stimulus from the 2017 tax cuts receding, and continued slowdown in the global economy at large, companies can anticipate slower growth ahead.

Much harder to plan for, however, are the megatrends shaping the future—e.g., technology and digital innovation, labor automation, climate severity, social expectations and demographic shifts—and their impact on corporate strategy.

This quarter, we share insights from our in-depth interviews with seasoned directors on facilitating the board's engagement in strategy—including developing a vivid picture of the future. (We'll be exploring this issue at our 2019 KPMG Director Roundtables—*Envisioning the future and its impact on strategy*—a series of panel discussions around the country in May/June). We also share highlights from our recent KPMG Board Leadership Conference in Orlando and cover a range of board governance issues, including considerations for boards related to voting in proxy fights, as well as financial reporting and auditing developments that audit committees should have on their radar.

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

Dennis T. Whalen
Leader
KPMG Board Leadership Center

What's inside

Facilitating the board's engagement in strategy

Lead directors are uniquely positioned to create the "right" level of engagement and facilitate quality boardroom discussions on strategy, according to several directors interviewed for the KPMG Board Leadership Center Lead Director Initiative. Those conversations, conducted under the Chatham House Rule, surfaced practical techniques and approaches that all lead directors can apply.

At the end of the day, it's the company's strategy. But the long-held view that the board's role is limited to reviewing and concurring with the strategy is giving way to deeper engagement by the board. Increasingly complex and disruptive business conditions demand it, and investors and other stakeholders expect it. As the interviews made clear, the extent of the board's engagement in strategy—and the lead director's role—will vary by company and the lead director's style (from a light touch to more active leadership), as well as the CEO or chair's approach to leading the strategy effort.

Setting expectations with the CEO and directors for the board's engagement in strategy

How does the board want to engage in strategy? What does it need from management and from individual board members to be effectively engaged and adding value as the company's strategy evolves to address new risks, opportunities, and disruptions? As a starting point, the lead directors we spoke to emphasized the importance of setting clear expectations, including the following:

Evaluating management's proposed strategy is the real endgame for the board, and that requires thinking about the future and understanding the forces affecting the industry. "The board will need time to pause and reflect and to spend ample time with the assumptions and the environment. What other strategic options did management consider, and what was the reasoning behind the option management recommended? Good strategy discussions require the right board culture and unconstrained discussions, and that takes time, leadership and discipline to develop." Does the board have the right people around the table to evaluate the strategy beyond simply reviewing and concurring with management's recommendation?

The goal is for the board to reach consensus on the overall strategic direction, with the lead director playing a key role. "Each director has an obligation to share his or her view about the direction of the company's strategy. And if there's disagreement at the fifty-thousand-foot level about whether the company should go east or west, that needs to be aired and resolved up front. You can debate the details along the way."

Describe to management what the board wants in terms of the strategy process and the board's information needs. "Don't be led by management. Be explicit about what information the board wants from management and others, and when. Recognize that getting to the right process and the right information will require time and iterations. Don't expect to get it right on the first or second try."

Each director must become a student of the company and its strategy. While it is management's role to educate the board about the competitive environment and the implications for strategy, directors also need to be proactive about their own education—reading, visiting facilities, experiencing the business firsthand—to make sure that they understand the strategy and its risks.

Strategy done well is an ongoing process—a journey and not a destination. "It's not about 'getting the answer right' once a year. It's not a one and done." There should be a clear plan with specific milestones. Expecting adjustments or course corrections along the way is the sign of a healthy strategy process.

It is particularly important that management and the board understand the expectations of one another and that new directors understand the board's role in strategy.

Planning the setup and staging of board strategy discussions and providing the backdrop to drive the right focus and dynamics

Good strategy conversations require good preparation and quality information. The setup and staging—number of meetings, agenda, format, quality of meetings, and physical setting—are all key to avoiding meetings that are presentation heavy with little discussion.

In addition to each director's own learning, it is management's job to help educate the board about *the future* and its impact on strategy. The lead director should help the C-suite understand the board's expectations for the process, the timeline, and the board's information needs. "This education process will also shed light on how effective management is at thinking about the company's future."

Consider breaking down the strategy development process into backdrop sessions. For instance, hold a series of backdrop sessions dedicated to discussing (1) disruptive forces impacting the industry (not just forces inside the industry), (2) competitors, (3) alternatives to address strategic issues, and (4) how to tie it all together—discussion of management's recommendation. Other backdrop sessions might address information technology, talent development, regulation, or key industry issues.

Strategy discussions should be ongoing and woven into every board meeting and agenda. "A two-day retreat for the board to evaluate strategy is fine, but it should be just one element of an ongoing process and conversation." "We make a conscious effort to link every agenda item to the strategy."

Create the right environment for effective board discussions, including the physical setting and dynamics. "Reducing the theater is a good goal. Our board moved from a cavernous, formal boardroom requiring microphones to be heard, to a smaller, sunlit space with fewer staff and no microphones, and the whole dynamic changed for the better."

Building consensus about the proposed direction of the strategy—the fifty-thousand-foot view

It's important for the CEO and board to set the expectation that the board's goal is to reach consensus, at a high level, on the strategic *direction*. Questions or concerns about detailed elements of the strategy will naturally arise and should be followed up on and not left unresolved, but the details shouldn't prevent the board from reaching a consensus. "Nonconsensus on the direction of strategy—at the fifty-thousand-foot level—should not be acceptable. If there isn't consensus on the general direction, it suggests there are some very different views about the future, and you need to resolve that right away. Having one or more directors who disagree with the strategic direction can create a counterproductive environment in the boardroom."

Keep the initial strategy deliberations at a very high level. "Are we going east or west? The key is to get true alignment on the overall strategy—the 'bet the company' direction. If you go too narrow too quickly, you're likely to run into gridlock right out of the starting gate." At the same time, be mindful that board consensus out of the gate could be an indicator of groupthink.

Don't assume everyone is on the same page. "Unless the board engages and reconciles and reaches consensus, you can quickly go down the wrong path. Make sure every director voices their opinion about the proposed direction of strategy."

It's helpful for the lead director to understand each director's view on the proposed strategy in advance of board meetings. Where does each director stand on the issue? "The goal is not to steer the conversation, but to better manage the dynamics and work toward consensus by understanding where the starting point will be." Additionally, the lead director can help elicit the information individual directors may need to resolve concerns about strategy.

Know when to move from debate to decision. While it's essential that all directors participate in a robust dialogue, "the lead director needs to be strong enough to cut off debate at the right time and in the right way. That requires a good culture and trust in the people and the process."

Critical work and communication should be happening outside the boardroom. Whether it's regular email updates from the CEO, check-ins with management, follow-ups on open issues, or monitoring industry developments, "There should not be radio silence or zero activity between board meetings." Indeed, moving toward consensus often happens outside of the boardroom. "A good lead director will bring the hallway, coffee room, and dinner discussions back into the boardroom dialogue."

Find more insights at read.kpmg.us/LeadDirectorInitiative

Leading with agility and purpose

KPMG's annual Board Leadership Conference delved into the issues driving board agendas and provided directors with deep dives on committee-specific topics. Following are highlights.

Economic and geopolitical outlook

Constance Hunter, KPMG's chief economist, and Admiral James Stavridis (Ret.), former NATO Supreme Allied Commander, a corporate director, and an operating executive of The Carlyle Group, shared their views on the economic and geopolitical outlook shaping the business and risk landscape in the year ahead.

Admiral James Stavridis (Ret.)

With a base forecast of slower global economic growth in 2019 and into 2020, Hunter noted that domestic and global headwinds are increasing—and there is now more headwind than tailwind. Key risks to the economic outlook include climate volatility, China's economic challenges, trade tensions, Brexit, and emerging market debt. "We see some real clouds on the horizon," Hunter told directors. Given the tremendous uncertainty facing companies today, she emphasized the need for boards to frame their agendas to help ensure that the company is prepared for a potential economic downturn—and possible recession. But Hunter added that any recession will likely be very different than 2008.

On the geopolitical front, Stavridis predicted continuing turbulence, fueled by several factors, including the slowing global economy, Brexit, conflict in the Middle East, "Asia's cauldron" (Iran, Russia, and China), and climate change, that could increase geopolitical tensions. But Stavridis said cybersecurity—and in particular the vulnerability of the U.S. power grid—is what "keeps him up at night," and should be a top concern for boards. While there is turbulence ahead, Stavridis sees opportunities to improve chances for security. "We can listen better, and we can educate." And he emphasized that business and political leaders need to *read*.

Longer term, Stavridis expects India to become an enormous political partner for the U.S. in this century—and potentially, a more important nation than China because of demographics and India's growing population. This century will be remembered for the rise of China, the rise of India, the rise of women, and the rise of biology and how it impacts us. According to Stavridis, "there is reason to be cautiously optimistic."

CEO perspective

Matthew Rose, executive chairman of BNSF Railway, a director of AT&T and Fluor, and chairman of the Federal Reserve of Dallas, shared his views on the challenges facing CEOs today and the board's role in supporting the CEO in a fireside chat with Jeffrey Cunningham, professor of Global Leadership at Arizona State University's Thunderbird School of Global Management and editor-at-large of *Chief Executive* magazine.

In Rose's view, the demands on CEOs today are different today than 10 or 15 years ago. While CEOs have always been accountable for strategy development, execution, and delivering shareholder value, today they are also held accountable for a broad range of environmental, social, and governance issues, technology leadership, diversity, and, of course, total shareholder return (TSR). "It's a huge list." At the same time, CEOs operate in an environment of dramatically increased transparency and outside influences that make the job more difficult. And while some investors focus on long-term performance and value creation, analysts continue to focus on quarterly earnings.

Matthew Rose

"The board has three responsibilities: hire the CEO; monitor implementation of the strategic plan, and, if need be, fire the CEO," Rose said. The board should select a CEO "based on the culture the company has or wants." He also stressed the importance of board exposure to employees a level or two below the CEO and CFO as part of the succession planning process.

Rose closed by discussing the need to restore society's trust in business: "Our society no longer appreciates the value of American business." Among his suggestions to restore trust: Have leadership and a workforce that reflects the diversity of the society in which you operate, and continually remind business leaders and employees that "we can't afford to lose a shred of reputation."

Board engagement in strategy

Given the dynamic operating environment, oversight of strategy remains a critical challenge for boards. A panel of directors and governance professionals highlighted differing views on the appropriate level and nature of board engagement in strategy and emphasized the importance of the lead director or independent chair working with the CEO and board to determine the right level of engagement and dynamics.

While at the end of the day the CEO and management team own the company's strategy, panelists agreed that it's becoming increasingly common for boards to have deeper engagement on strategy. Increasingly complex and disruptive business conditions demand it, investors and other stakeholders expect it, and lead directors are uniquely positioned to create the right level of engagement and facilitate quality boardroom discussions on strategy. "The real endpoint is for the board to evaluate the strategy," noted one of the panel members. "That requires thinking about the future and understanding the forces impacting the business and the industry."

While the extent of board engagement and the lead director's role will vary by company, to help facilitate board engagement in the process—from strategy development and evaluation, to monitoring execution and recalibrating as necessary—panelists emphasized the importance of board involvement early-on with clear expectations for how the board will engage in strategy and how management will support board engagement. Among the questions directors might explore: What degree of confidence do we have in the strategy process? Are management's assumptions sound? How do we test them? What strategic options or alternatives were considered but not chosen, and why? Is the CEO comfortable with the board's level engagement in strategy? Although strategy is supposed to be long term by design, panelists noted that agility is important. As one director said, "You have to have clarity about your destination, but you also need the ability to adjust along the way." Another added, "focus on ruin, not just risk."

Technology, digital disruption, data risk, and privacy

Technology is at an inflection point. As one panelist noted, "We'll see more augmentation than automation for a while, but as technologies begin to build more technologies, the acceleration curve will be significant."

Dennis Whalen, Dona Young, Jeffrey Cunningham, Peter Gleason

Seven questions every CEO should be able to answer

1 What are the key risk factors and mega trends (such as climate change) your business faces over the next three to seven years and how have these influenced corporate strategy?

2 How do you identify your financially material business issues and which frameworks do you use for reporting on these issues? How do these figure into your future strategy and capital allocation plans?

3 How do you describe your corporate purpose and how do you help your employees share your vision for the company's role in society? How does this shape your long-term strategy? How does your future strategy act upon this purpose?

4 How do you manage your future human capital requirements over the long-term and how do you communicate your future human capital management to your investors?

5 What is the corporation's framework/strategies for interacting with its shareholders and key stakeholders?

6 How will the composition of your board (today and in the future) help guide the company to its long-term strategic goals?

7 What is the role of the board in setting corporate strategy, setting incentives for and overseeing management? How does the corporation ensure a well-functioning and diverse board accountable to its key stakeholders?

Source: CECP's Strategic Investor Initiative 2018

Leading with agility and purpose *continued*

This massive disruption will translate into tremendous opportunities and significant risks, which will require boardroom conversations about technology disruption and data security and privacy to change.

Cybersecurity and technology transformation should be considered hand in hand. And boards need to ask broader questions about the new digital civilization that's emerging: What's possible and what's at risk?

The proliferation of sensors and the Internet of Things (IoT) is creating huge amounts of personal data and a vast number of new vulnerability points for hackers to exploit. The convenience and efficiency that new apps and devices offer consumers and businesses are compelling, particularly as 5G technology comes online—but they're moving organizations to a whole new level of data security risk.

Boards need to ask: How are the organizations that are collecting personal data using it? Is data being shared with third parties? What controls exist around its collection and use? As highlighted by a major casino that was hacked through a temperature sensor attached to a fish tank in its lobby, boards should ask whether the convenience of a particular data sensor is worth the risk. Finally, it's important to remember that all data are not equal. The highest security resources should be allocated to the company's most important data—the company's crown jewels.

As boards help their companies navigate the upside and downside of new technologies, leveraging cross-functional teams with a broad range of skills and experience is crucial. As one executive noted, "Technology is fabulous, but it can also be dangerous and it can be weaponized." By bringing a diverse group of people into the conversation, companies can draw on their respective areas of expertise to help the company make better decisions and use data in a more efficient manner.

Long-term performance

Communicating the company's long-term strategy to investors has become increasingly important as public company ownership has shifted to a broad swath of large institutional investors who are long-term holders, often with diverging views.

Bill McNabb

"We believe that companies should be able to state what their strategy is and what outcomes they expect," said Bill McNabb, former chairman of Vanguard and chair of CECP's Strategic Investor Initiative. "They should be able to tell you what the important factors and measures are that show performance and they should be able to explain their non-GAAP measures."

Shareholder primacy vs. stakeholder primacy

Observers, including Marty Lipton of the law firm Wachtell, Lipton & Katz, have noted a shift in the governance landscape in recent years from shareholder primacy (corporations should maximize profits for the benefit of shareholders) to stakeholder primacy (corporations should be managed in the public interest, considering employees, customers, suppliers, communities, the environment, the economy, and the public interest generally, as well as the shareholders).

In a January 2018 letter to public companies, Laurence Fink, chairman and CEO of BlackRock similarly wrote, "To prosper over time, every company must not only deliver financial performance but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."

This shift was the subject of a discussion moderated by Tom Kim, partner of Sidley Austin, with Charles Elson, a corporate director and director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, and Hillary Sale, law professor at Georgetown University and affiliated faculty at Georgetown University's McDonough School of Business.

Elson views the debate between shareholder and stakeholder primacy as somewhat a matter of semantics, since he believes the shareholder primacy model and its emphasis on total shareholder return must consider stakeholder interests to achieve TSR and long-term value creation. "What is in shareholders' long-term interest? Keep your customers and workforce happy, have a community that likes you. Otherwise, the company can't make a profit. The objective isn't to make everyone happy. The key is to make sure the company has the right strategy and is effectively run," Elson said.

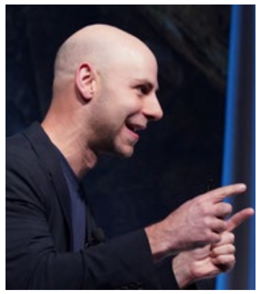
Sale noted that the shift is happening amid a number of high-profile governance failures. "Boards need to do a better job of challenging management effectively," she said. Boards should widen the scope of the interests they consider and "understand when stakeholder interests are critical to the long-term success and growth of the business," Sale said. "It's important not just to ask questions but to question the answers."

Elson and Sale both highlighted the importance of board diversity and leadership. Boards should include a diverse group of directors with diverse experiences and skills who understand the company's strategy and how stakeholder interests are linked to the success of that strategy. Directors need to ask questions, be independent of management, have a stake in the game, and have the courage to speak up if they see something wrong.

Talent, diversity, culture, and the workforce of the future

Talent, diversity, and culture permeated all facets of the conference discussions. Whether it's dealing with disruption, overseeing cybersecurity risk, or questioning whether changes in the business environment require a shift in strategy, speakers and panelists reiterated the importance of having a diverse set of experiences and skills in the boardroom and throughout the organization to drive better outcomes, and cultivating and reinforcing a culture that supports execution of the company's strategy.

As part of a discussion about talent and hiring, Wharton professor and author Adam Grant cautioned that the term "culture fit," frequently used as a way to assess whether a candidate is the right hire for a position, can become a "proxy for groupthink." Facebook Global Chief Diversity Officer Maxine Williams echoed a similar sentiment in a luncheon discussion about the challenges of addressing diversity.


Adam Grant

"'Fit' is an easy way to mask bias," Williams said. "Be clear about what adds value versus random preference."

Throughout the conference, Grant, Williams, and others underscored the importance of hiring for cognitive diversity—finding people who can add value by bringing something different to the conversation. Because the sensitivity around diversity-related issues can make those conversations personal, Williams acknowledged that a "fear of saying the wrong thing" can lead people to avoid discussing the issue. To encourage the conversation, Williams offered three tenets: presume good intent, be respectful in all communications, and be forgiving if someone makes a misstep.


Maxine Williams

She also encouraged leaders to consider both quantitative and qualitative data as part of their diversity metrics, and to "Be bold, be intentional, and make it everyone's issue."

Throughout the conference, attendees discussed ways to enhance board oversight of corporate culture and to gauge whether the culture supports the execution of the strategy. During a breakout discussion on culture, panel members stressed the need for the board to understand how the company defines its culture and to receive metrics on various cultural indicators, such as employee and customer surveys, hotline complaints, and lawsuits. But that doesn't mean boiling the ocean. "Pick the indicators that are most important to the company and follow them with the management team," one director said.

It's also important to supplement information provided by management with directors' firsthand observations of the company's culture in action. A number of directors say they make it a point to spend time engaging with employees outside of the C-suite. As one director put it, "You can't assess the mood in the middle or the buzz at the bottom if you are spending all of your time with the people at the top." If management pushes back or discourages directors from asking questions or speaking with workers, it should raise a red flag to dig deeper.

To read about hot topics and ongoing challenges for board committees, see **Leading with agility and purpose**.

Financial reporting and auditing update

Current quarter financial reporting matters

Public companies adopt the leases standard. The mandatory adoption date for the new leases standard is here. Calendar year-end public companies were required to adopt the standard in the first quarter of 2019. At this time, most public companies have assessed the effect the standard may have on their business operations, made their accounting policy and transition elections, and estimated the financial statement effect.

The adoption work does not end there, however. Companies also must turn their attention to developing quarterly disclosures, including new and expanded qualitative and quantitative disclosures for lessees. SEC registrants must provide the same disclosures for both interim and annual periods in the year of adoption. Companies should dedicate sufficient time and attention to their 2019 financial reporting to ensure their lease-related disclosures are complete and accurate.

Brexit. The political and economic uncertainty from Brexit is significant and its effects may be far reaching. The SEC staff is closely monitoring how companies—particularly those with operations in the UK or EU, or with operations that link to the UK—disclose the effect that Brexit may have on their business operations. In addition to risk factor disclosures in Form 10-K or Form 10-Q, companies should consider whether Brexit-related economic uncertainties and market volatility will significantly affect accounting judgments and estimates. Companies should monitor the status of Brexit for changes that may require them to revise risk factors in their 2019 quarterly reports.

LIBOR. Banks that currently report information used to set LIBOR are expected to stop doing so after 2021. Efforts to transition away from LIBOR as a benchmark reference for short-term interest rates have been ongoing and the SEC staff has been attentive to the related accounting considerations. Banks may face significant risks and uncertainties in managing the transition from LIBOR to a new rate such as the Secured Overnight Financing Rate (SOFR). At the 2018 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff commented that it expects to see disclosures addressing these risks and uncertainties, if material.

New standards and guidance

New credit impairment standard. The new standard will be effective in 2020 for certain public companies. Companies should be analyzing the implications of adoption and considering the adequacy of their transition disclosures. Although the nature and extent of preparations will vary, companies need to thoroughly evaluate the effect of the standard and determine what changes to their loss estimation processes are necessary. Companies may need to collect more data and significantly change their systems, processes and internal controls to comply with the standard.

PCAOB adopts new estimates standard and amendments related to using the work of specialists. In December 2018, the PCAOB adopted (1) a new standard to enhance the requirements when auditing accounting estimates, including fair value measurements, and (2) amendments to certain standards to strengthen the requirements when auditors use the work of specialists in an audit. If approved by the SEC, the new standard and the amendments will be effective for audits of financial statements conducted under PCAOB standards for fiscal years ending on or after December 15, 2020.

Reminder: Auditor communication of critical audit matters (CAMs). The external auditor's communication of CAMs is intended to provide information about audit areas that involved especially challenging, subjective, or complex auditor judgment and to explain how the auditors addressed these issues. For audits of large accelerated filers, the CAM requirements take effect for fiscal years ending on or after June 30, 2019. Early engagement between the auditor, management and the audit committee will be key to successfully implementing the CAM requirements. Management and the audit committee should talk with their auditor about potential CAMs, including how the specific matters and related descriptions compare with information already disclosed by the company. In March, the PCAOB published three staff guidance documents developed to support implementation of the CAM requirements. The staff guidance consists of: (1) a high-level overview of CAM requirements, (2) thematic observations that arose from the Office of the Chief Auditor's review of audit firms' CAM methodologies, and (3) a deeper dive on the determination of CAMs.

Governance Debates

Voting in proxy fights

You can't always get what you want

by Claudia H. Allen

The 2019 proxy season will, predictably, bring proxy contests. What is less predictable is the outcome of those contests and the impact of the often-overlooked proxy card. Boards and companies should make sure they understand how the technical rules governing proxy cards—and the candidates who may be listed on them—operate in practice. At the same time, renewed discussion of universal proxies—which list both sides' candidates—and early attempts to use them, has added another dimension to the debate, even in the absence of final action by the Securities and Exchange Commission (SEC).

Proxy fights, in which activist investors nominate their own candidates to a target company's board and actively solicit proxies, are often distracting, expensive, unpredictable, and bring negative media attention.[1] Most proxy fights settle before a vote—frequently with the activist getting one or more board seats. However, when a contest does go to a vote, SEC rules effectively prevent stockholders from voting for their favored combination of candidates from opposing slates. This can make proxy contests even more unpredictable and invites gamesmanship.

continued

Voting in proxy fights *continued*

Competing proxy cards

In a proxy contest, each side prepares its own proxy card listing its nominees, and the cards are different colors, making them easily distinguishable. Investors face a stark choice. They can vote either card, but they cannot mix and match candidates from the two slates. If an investor voted for part of a slate on one card, and then voted for the remaining seats on the other card, the second proxy would nullify the first since, under state law, the last voted card revokes the prior card. The only way to vote a mixed slate is to vote in-person at the annual meeting—an unattractive option for most investors, particularly institutional investors who may vote at hundreds, or even thousands, of meetings.

Bona fide nominees, short slates, and disenfranchising shareholders

Even if an insurgent wanted to include some management nominees on its card, it would typically be barred by the SEC's 1966 "bona fide nominee" rule[2] which requires a nominee to consent to be named on a proxy card. Such consent is rarely provided due to concern that it will result in the election of one or more activist candidates.

In most cases, activists do not nominate a full slate or a controlling slate. Instead, they typically present a limited number of nominees, or a "short slate," knowing that investors interested in change are more likely to support some "new blood" rather than an entirely new board since replacing a full board causes significant disruption. In that vein, the primary proxy advisory firms, Institutional Shareholder Services and Glass Lewis, often recommend in favor of one or more dissident candidates. The SEC's 1992 "short slate rule"[3] allows an insurgent to "round out" its slate with management nominees without running amok of the bona fide nominee rule. However, the candidates selected by the dissident to round out its slate may not be the same candidates the investor would have chosen. Investors voting on an insurgent card may therefore lose the ability to vote for management candidates they would have supported. If investors vote on the insurgent card for less than all open seats, they have effectively wasted some of their voting power, and some of the management candidates they oppose may nonetheless be elected. The other option is to vote on the management card but to "withhold" votes for certain candidates to register a protest. Either option disenfranchises investors to some degree. According to one study of proxy contests from 2001 to 2016, as many as 15% of proxy contests had outcomes that differed from what a plurality of stockholders would have preferred.[4]

Universal proxies

One potential solution would be amending the proxy rules to allow either side to use a "universal proxy" in a proxy contest without obtaining consent from the other side's nominees. A universal proxy would include all candidates from both sides, allowing investors to select their favored candidates. The concept is not new. The SEC considered mandating universal proxies in 1992. The Council of Institutional Investors (CII) filed a rulemaking petition with the SEC in 2014 to facilitate the use of universal proxies, and in 2016, the SEC proposed mandating universal proxies in contests. The rulemaking stalled, and many thought the issue was dead, particularly with a change in administrations. But a small number of contests in which the parties used (or agreed to use) universal proxies, recent discussion at the SEC's Investor Advisory Committee, and a November 2018 SEC roundtable on the mechanics of the Byzantine proxy process have focused renewed attention on universal proxies. In a letter to the SEC dated January 31, 2019, CII urged the SEC to adopt a final rule "largely consistent with 2016 proposal," stating: "allowing investors to split their tickets in proxy contests serves the principle that shareholders voting by proxy should have the same voting privileges as those voting in person."[5]

> Boards and companies should make sure they understand how the technical rules governing proxy cards—and the candidates who may be listed on them—operate in practice.

While companies were traditionally wary of universal proxies as a tool that could benefit activists, those views are moderating, particularly as the issue is analyzed more deeply. For example, in a situation where management believes one or more dissident candidates or a full or control slate are likely to be elected, it may be advantageous for the company to use a universal proxy. In that context, the universal proxy could allow investors to be more selective, resulting in fewer dissident nominees being elected than if the contest were run on opposing cards.[6] As noted by proxy soliciting firm MacKenzie Partners, "the universal proxy can be a powerful strategic tool for management teams, particularly those whose odds of defeating all of a dissident's nominees in a proxy contest for board control are uncertain."[7]

Yet, the universal proxy is not a panacea. According to one activist, it presents the risk of:

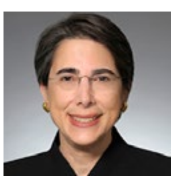
> freakish results. In a fight involving a short slate against a full one, there are enough possible outcomes for every single candidate to receive over 50 percent of the shares. The side running the slate—let's assume it's the company—could promote different candidates to different shareholders and split the vote, romping to victory.[8]

While this example favors the company, unpredictable outcomes could also go the other way.

Looking ahead

For the time being, without a final rule from the SEC, the action is in the private ordering realm. Thus, a company facing a potential contest should work with its lawyers, proxy solicitors, and other advisors to game out the situation and determine if there is a potential upside to suggesting a universal proxy—which may be more likely if the activist is running a control or full slate of candidates—and if the activist might be interested in this mechanism. Notably, in one case during the 2018 proxy season, a company was unilaterally able to use a universal proxy because the activist inadvertently provided consent that satisfied the bona fide nominee rule.

If a universal proxy is possible, it is important for the company to carefully consider the layout—for example, which slate is shown first—since that can affect how stockholders vote[9] and whether they vote for too many candidates, thus voiding their proxies. The SEC's 2016 proposal included requirements addressing some of these mechanical, yet potentially outcome determinative issues, and emphasized the importance of providing shareholders with clear instructions. Since the rule was never adopted, companies and dissidents may choose to experiment with different approaches.



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1 This article does not address proxy access, under which large, long-term stockholders nominate candidates who are included in management's proxy statement and on its proxy card. Those stockholders do not produce their own proxy materials.

2 Rule 14a-4(d)(1) under the Securities Exchange Act of 1934 (Exchange Act).

3 Proviso to Rule 14a-4(d) under the Exchange Act.

4 Scott Hirst, *Universal Proxies*, Yale Journal on Regulation, 35, 2018, p. 437, available at http://yalejreg.com/articlepdfs/35-JREG-437.pdf. The plurality standard is relevant since in most proxy contests, the candidates with the most votes, up to the number of open seats, are elected. Thus, candidates need not achieve a majority vote to win.

5 CII letter to SEC on proxy mechanics, January 31, 2019, available at https://www.sec.gov/comments/4-725/4725-4864575-177347.pdf.

6 Activist Insight, *Activism This Week*, October 26, 2018.

7 MacKenzie Partners, Inc., *The Universal Proxy Gains Traction: Lessons from the 2018 Proxy Season*, 2018.

8 Activist Insight, *Activism This Week*, October 26, 2018, citing a presentation by Jeff Smith, the CEO of Starboard Value, a well-known hedge fund.

9 The SEC's proposed universal proxy rule specified how candidates would be listed and in what order.

Mark your calendar

KPMG Director Roundtable Series, Select U.S. cities
May–June

Hosted by the KPMG Board Leadership Center at locations across the country, the Director Roundtable series—*Envisioning the future and its impact on strategy*—will explore the forces shaping the future business and risk landscape, how boards can help the company envision the future, and how they can engage with management in quality strategy discussions.

For information and registration, visit *www.kpmg.com/us/blcroundtable*.

WCD Global Institute, Palo Alto, CA
May 19–22

This annual event will include WCD's Family Business Institute, keynote addresses, breakout sessions, panel discussions, and networking opportunities.

For information and registration, visit *www.womencorporatedirectors.org*.

Lead Director Webinar
June 6

Join NACD and KPMG's Board Leadership Center for a one-hour webinar focused on the lead director's role in facilitating boardroom discussions on strategy, from setting expectations and planning the setup to building boardroom consensus and helping the company envision the future.

For information and registration, visit *www.kpmg.com/us/blc*.

NACD Master Class, *June 20–21*

This foundation course for experienced lead directors, board and committee chairs features peer-to-peer discussion, fireside chats, and interactive simulations.

For information and registration, visit *www.NACDonline.org*.

Selected reading

Revamping investigations: Future of ethics of ethics & compliance *KPMG*

2019 Trends in governance *Broadridge*

Identifying and responding to a dysfunctional culture *WomenCorporateDirectors*

2019 Technology innovation hubs *KPMG*

Navigating a world of disruption *McKinsey Global Institute*

To receive articles like these from Board Leadership Weekly, register at *kpmg.com/us/blcregister*.

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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/us/blc*.

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