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Some Thoughts for Boards of Directors in 2021

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Many of the challenges that corporations and their boards have encountered in 2020 will continue to be front and center in 2021, including the COVID-19 pandemic, the movement to address racial injustice and broad-based socioeconomic inequality, an accelerating sense of urgency around climate change, technological innovation and an evolving political and regulatory climate. These trends have underscored the key themes of sustainability, resilience and corporate purpose, and are prompting new perspectives on the ways that corporations must operate to manage the multiple stakeholder interests that are critical to the health and long-term success of their businesses. And, in this environment, boards are seeking to optimize their functioning and leadership role to navigate these challenges as well as the evolving expectations of stakeholders.

Summarized below are highlights and practical suggestions for corporations and boards to consider in the new year.

Corporate Purpose and Strategy

- It is more important than ever to have a clear understanding of, and conviction about, the corporation's purpose. As BlackRock CEO Larry Fink has observed, "Companies and investors with a strong sense of purpose and a long-term approach will be better able to navigate this crisis and its aftermath." This view has been expressed by many major investors who, in the aggregate, manage shares representing voting control of almost all major public companies.

- Our broad formulation of corporate purpose focuses on conducting a lawful, ethical, profitable and sustainable business in order to ensure its success and grow its value over the long term. This should be tailored for any given corporation, including by articulating the particular objectives and values that animate the corporation's business strategy, and taking into consideration key corporate constituencies such as shareholders, employees, suppliers, customers and communities.

- Many boards have been seeking practical guidance as to how they should partner with management in both developing and communicating the corporation's purpose. In this regard, the Enacting Purpose Initiative recently released a report, entitled "Enacting Purpose within the Modern Corporation," which provides a framework for how corporations can translate corporate purpose into practice. The report provides guidance on how corporations can: (1) adopt a clear and simple statement of purpose, (2) connect the statement of purpose to the corporation's decision-making, (3) build support and organization-wide acceptance of the defined corporate purpose, (4) establish measures of performance that evaluate the corporation's success in delivering on its stated purpose and (5) ensure that leadership exemplifies and communicates the corporation's purpose through narrative strategies. While the current report is largely designed for European and UK corporations, a similar framework for U.S.-based corporations is expected to be issued in the spring of 2021.

- In addition, a recent McKinsey report identifies five specific actions that boards may take to embed a sense of purpose in their corporations: (1) build an authentic purpose narrative with management, engaging stakeholders proactively, (2) own purpose in board practices, including board composition and agenda, (3) assess purpose commitments to ensure goals are defined and clear, and that there is accountability at all levels of the corporation, (4) use purpose as a lens in making key board decisions, including those regarding strategy, risk, performance management and governance and (5) drive organizational accountability for purpose through management evaluations and reporting.

<u>Corporate Culture</u>

- Another focal point of investors has been the importance of corporate culture and the ways in which that is tied to the preservation and creation of value. State Street, for example, has urged companies to align corporate culture with long-term strategy, and cited a study which found that "intangible assets" (e.g., human capital and culture) comprise an average of 52% of a company's market value. Culture is a key ingredient in a corporation's ability to attract talent, improve business performance, and drive long-term value. And particularly in times of uncertainty, corporate culture can not only provide reputational capital and help mitigate compliance risks, but also enhance business resiliency.

- As we have long advised, the board should, in consultation with management, set the "tone at the top" and work to create a corporate culture that gives priority to ethical standards, professionalism, integrity and compliance in setting and implementing both operating and strategic goals. Corporate culture should also reflect, and serve as a foundation for, a corporation's purpose. This is particularly important as companies work to incorporate environmental sustainability, employee safety and well-being, diversity and inclusion, and other values into decision-making in a manner that will both mitigate risks and drive long-term value.

ESG and Stakeholder Governance

- ESG continues to be a major topic, not only with respect to "good governance," but also as an essential component of business strategy and value. A recent McKinsey study that examined the link between ESG and value creation found that strong ESG performance can help companies tap into new markets and expand in existing markets, reduce costs via sustainability strategies, reduce the risk of regulatory and legal interventions, and increase talent retention and employee productivity.

- This link between "value" and "values" has been spurring new business strategies, not only among companies, but also in the investment community, as illustrated by the recent capital inflows into ESG and sustainable investment funds. Recent research suggests that ESG-tilted portfolios generally outperformed their non-sustainable counterparts during the sharp market downturn earlier this year, and a Europe-focused survey by PricewaterhouseCoopers found that more than 75% of the 300 institutional investors surveyed indicated they would stop investing in traditional non-ESG compliant products within the next two years.

- As ESG is increasingly incorporated into strategic and operational decision-making, it will likely become more salient in the context of mergers and acquisitions. For example, companies seeking to enhance the sustainability of their business by switching to cleaner technologies or improving the safety of their products may find that acquisitions become a strategic imperative. And as accountability around ESG metrics continues to increase, those metrics may play an important role in due diligence and the assessment of the pro forma impact of a potential transaction.

- In addition, it is clear that companies are now expected to do and say more when it comes to tracking, reviewing and disclosing ESG data. Investors (including activists) and certain proxy advisors are actively monitoring board oversight and responsiveness to ESG factors and comparing the company's ESG performance to that of its peers—and laggards face a heightened risk of consequences, particularly during proxy seasons. For example, BlackRock reported in July that it had identified 244 companies during the 2020 proxy season that were not doing enough to prepare their businesses for, or inform investors about, risks related to climate change. BlackRock further indicated that it had voted against directors at 22% of those companies, and that the remaining 78% of companies are "on watch" the following year if they fail to make progress. In addition, Glass Lewis recently announced that, starting in 2021, it will flag as a concern S&P 500 companies that fail to make clear disclosures regarding board-level oversight with respect to environmental and social-related issues and risks, and starting in 2022, it will generally recommend voting against the governance committee chair of companies that fail to provide such disclosure.

- This accountability will accelerate as ESG metrics become more standardized. In that regard, there were several significant developments over the past year to drive toward a consensus approach. In September, the International Business Council of the World Economic Forum released, in collaboration with the Big 4 major accounting firms, its final recommendations for a universal disclosure framework. More recently, the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) announced they are merging to form a new organization called the Value Reporting Foundation, which will link IIRC's integrated reporting framework with SASB's disclosure standards. Many major institutional investors have also endorsed specific frameworks in an effort to drive convergence. Despite this progress, sorting through the numerous frameworks and metrics for ESG disclosures will continue to be a major company and board issue in the year ahead and beyond.

- As the expectations for "ESG competent" boards continue to evolve, directors should work with management to identify the material ESG risks and opportunities faced by the corporation, ensure that adequate reporting and monitoring processes are in place, and work to integrate these considerations into the corporation's strategic and operational decision-making. In some cases, it may be appropriate to adjust how this oversight function is structured and allocated at the board level by, for example, creating a new board committee or refining the mandate of an existing committee to more specifically address certain categories of material ESG risks, or by recruiting new directors with relevant ESG expertise.

- Also in conjunction with management, directors should engage with investors and other stakeholders to understand their perspectives and priorities with respect to ESG. The support of shareholders in particular will continue to be essential to corporations as they work to identify and operationalize their ESG goals.

<u>COVID-19 Pandemic</u>

- The COVID-19 crisis has upended multiple facets of business operations, society and the economy more broadly, and this uncertainty and disruption will continue in the months ahead as we navigate the latest wave of coronavirus cases and then vaccine approval and rollout. As we reflect back on the turbulence of this period, a few governance themes have emerged that seem likely to persist even as the exigencies of near-term crises subside.

- First, the importance of resiliency has precipitated an increased emphasis on general preparedness for future risks. This, in turn, has prompted companies to pressure test many of the baseline assumptions that have factored into their risk management calculations, and to think more holistically about the risks and opportunities facing their businesses—including systemic threats and the complex ways in which businesses are dependent on the well-being of other stakeholders. For example, for many companies, the pandemic has propelled new insights into their supply networks and revealed an unsettling lack of visibility and/or exposed critical weaknesses or concentrations.

- In addition, the pandemic has created an intensified societal focus on social and economic equity, as well as the role of corporations in addressing these issues through good business practices. In particular, employee health and safety has been a top priority with significant repercussions not only for business performance but also in terms of reputational capital, corporate culture and investor expectations. As we recently noted, this focus seems likely to persist.

- Another area that has changed significantly during the pandemic is corporate communications and disclosure practices. Many companies have spent considerable time and attention this past year in responding to calls for heightened transparency for employees, investors, regulators and other stakeholders. While it remains to be seen whether certain of the changes to "best practices" will persist—such as the suspension of issuing quarterly earnings guidance—it seems likely that stakeholders will continue to demand more transparency around ESG data.

Diversity and Racial Justice

- The disproportionate impact of the COVID-19 pandemic on Black communities, along with the "Black Lives Matter" movement, have brought salutary new focus on systemic racism. Many major corporations have announced commitments to racial equality, financial and otherwise, including Apple, PayPal, LEGO, HP, Verizon, Uber, Bank of America, Visa and many others. Groups like the World Economic Forum have encouraged corporate leaders to seize the opportunity to ensure that equality, inclusion and justice are better integrated into the "new normal" going forward.

- We also expect to see a continued focus on racial diversity from institutional investors. For example, this summer, State Street sent a letter to the boards of its portfolio companies asking them to articulate their risks, goals and strategies related to racial and ethnic diversity. In addition, the New York City comptroller (who oversees the city's pension funds) recently called upon the S&P 100 corporations that issued statements supporting racial equality to publicly disclose the composition of their workforce by race, ethnicity and gender (and 34 of those corporations have committed to do so).

- The increased focus on racial diversity will also extend to the composition of boards. There is a trend, evidenced both by pledges signed by major corporations and by legislation recently adopted in California, for increased racial and ethnic diversity requirements for boards. Beginning with the 2021 proxy season, ISS will highlight in its research reports any companies in the Russell 3000 or S&P 1500 whose boards have "no apparent racial and/or ethnic diversity," and beginning with the 2022 proxy season, ISS will apply a new policy of generally recommending against the chair of the nominating committee (or other relevant directors on a case-by-case basis) where the board has no apparent racial and/or ethnic diversity. NASDAQ also recently proposed new listing rules, which would require companies to disclose consistent diversity statistics for boards, as well as setting a standard for companies to have at least two diverse board members, including one woman and one minority director.

- As corporations grapple with how to follow through on these commitments and maintain momentum in the pursuit of equality, boards will need to work with management to drive meaningful change. Boards should partner with management to ensure that the corporation's goals, culture and actions are consistent with the principles of inclusion and racial justice, and to consider ways in which the corporation can foster a more just and inclusive culture. In this regard, ESG metrics can provide useful tools for directors to analyze and monitor progress. Each of the leading ESG disclosure frameworks contemplates certain annual disclosures regarding percentages of management and other employees by gender and, where relevant, racial, ethnic and other minority status, as well as information related to gender-based pay disparity.

- Another tool available to help spur progress on diversity and other ESG issues is incentivizing employees to achieve quantifiable ESG goals. According to a report from Willis Towers Watson, over half of the S&P 500 corporations use ESG metrics in their incentive plans, although ESG is still treated as a largely subjective matter. Especially in areas such as diversity and inclusion, which have historically been evaluated using qualitative criteria, boards seeking to operationalize their diversity goals should review the data and seek to set criteria that match their corporate objectives.

Socioeconomic Inequality

- Economic inequality in the United States is at a fifty-year high. The wealth gap between the richest and poorest families in the country more than doubled between 1989 and 2016, and the middle class, which once comprised the clear majority of Americans, is shrinking. Not surprisingly, 70% of Americans say our economic system unfairly favors the rich and blame corporations for aggravating disparities in income and wealth.

- These disparities have been exacerbated by the COVID-19 crisis, as the most economically vulnerable populations have been hit hardest by the pandemic. For example, McKinsey estimates that 86% of the near-term economic impact of the pandemic was borne by workers paid less than $40,000 a year. Some companies have responded by, for example, enhancing job security, providing additional paid sick leave or covering employees' medical costs.

- While socioeconomic inequality is a daunting, complex and systemic challenge, corporations are essential components of any solution—by serving as engines of broad-based employment opportunities and prosperity, by recognizing the importance of employee well-being to the success and sustainability of their businesses and by fostering symbiotic relationships with the local communities in which they operate.

Climate Change and Environmental Sustainability

- As Doug McMillon, Chairman of the Business Roundtable and CEO of Walmart, stated earlier this year, "Climate change is one of the greatest challenges facing the planet today, and we believe businesses are an essential part of the solution." Accordingly, in September, the BRT called for "new principles and policies to address climate change, including the use of a market-based strategy that includes a price on carbon where feasible and effective," which "would incentivize the development and deployment of breakthrough technologies needed to reduce greenhouse gas (GHG) emissions." And, recognizing the growing urgency around climate change, some of the world's largest corporations have made sustainability pledges to net-zero carbon targets.

- A recent HSBC study found that 78% of surveyed corporations had set environmental targets for themselves, a 10% increase compared to last year. In addition, 86% of respondents stated that they expect sustainability will increase their profits in the coming year, reflecting the increasingly prevalent theme that environmental sustainability should be a driver of, rather than an offset against, profitability.

- For their part, investors have continued to make environmental sustainability an engagement priority. For example, at the beginning of this year, Larry Fink's 2020 letter to CEOs called out climate change as a "defining factor in companies' long-term prospects" and predicted that "we are on the edge of a fundamental reshaping of finance" as investors seek "to understand both the physical risks associated with climate change as well as the ways that climate policy will impact prices, costs, and demand across the entire economy."

- Climate change also poses litigation risk for corporations, as the class action plaintiffs' bar appears to be commencing a broad litigation campaign. Dozens of climate change suits against major corporations are already pending, many brought by municipalities (represented by class action attorneys) seeking billions of dollars to pay for structural responses to climate change. The suits invoke broad and flexible public nuisance theories that create liability risk across a range of industries.

- Given the current landscape, as well as President-elect Biden's plan to prioritize action on climate change, corporations that fail to adapt to the climate challenge face potential liability, reputational harm and operational setbacks. Boards should oversee the evaluation and management of climate-related risks and sustainability initiatives, the implementation of appropriate monitoring procedures and, particularly given the litigation risk, the recording of these efforts in board minutes and corporate records.

<u>Political and Regulatory Climate</u>

- In the current political climate, and absent effective voluntary actions by companies, boards, investors and asset managers, the likelihood of legislation and regulation targeted at corporations has continued to increase. While it remains to be seen how the agenda of President-elect Biden's administration will unfold, it is clear that there is broad-based populist mistrust of corporations at both ends of the political spectrum.

- Many lawmakers continue to press for a progressive social agenda through legislation, such as the recent racial and gender diversity mandates for California public company boards and the proposed "Green New Deal" reforms in the Democrat-controlled House of Representatives. On December 3, 2020, Senator Mark Warner released the first part of a proposal for legislation, "Toward a Resilient 21st Century American Capitalism: Investing in Workers and Promoting Inclusive Growth." And in a September 2020 white paper containing draft legislation and regulations, B Lab and The Shareholder Commons proposed substantial amendments to federal law that would establish new obligations and requirements to alter the fiduciary duties of corporations and institutional investors.

- The private ordering recommendations that we have made in The New Paradigm could obviate the need, and reduce the special interest pressure, for many legislative and regulatory changes. Corporations, boards, institutional investors and asset managers—through voluntary and collaborative action—are uniquely positioned to recalibrate existing governance and decision-making frameworks in a manner that will drive long-term value creation for the benefit of all stakeholders. There is a high risk that failure to do so will ultimately result in legislation that corporations, investors and asset managers will regret.

Technology, Artificial Intelligence and Cyber-Currency

- Artificial intelligence, cybersecurity and other technological developments continue to create game-changing opportunities and challenges for businesses. Accordingly, a company's risk management structure should include an ongoing effort to assess and analyze how technological developments may impact the corporation's profitability and prospects for sustainable, long-term value creation. In many cases, significant investments in research and development, capital assets and employee training may create headwinds for short-term profitability but be essential for long-term competitiveness and growth.

- Relatedly, investors are making clear that board oversight of cybersecurity risks should be a priority. As Vanguard stressed in its investment stewardship report this year, investors are seeing "increasing evidence that nontraditional but material risks" related to ESG topics, including cybersecurity, "can damage a company's long-term value." The World Economic Forum, in its Global Risks Report for 2020, also flagged cyberattacks as the second most concerning risk for doing business globally in the coming decade. Companies should implement and maintain comprehensive cybersecurity risk mitigation programs, data and system testing procedures, and cyber incident response plans.

- In addition, a growing number of public companies are evaluating the specific opportunities and risks associated with so-called digital assets or "cryptoassets," which are attracting attention from international regulators and auditor oversight authorities. Consistent with the SEC's December 2019 guidance, corporations should engage proactively with auditors regarding applicable emerging technologies that may affect a company's financial statements or internal control environment. Prior to engaging in cryptoasset transactions, boards and management should ensure that they have the appropriate expertise, third-party support and risk-assessment procedures in place, and have considered potential reputational and other risks associated with cryptoasset transactions.

While the topics highlighted above will be top-of-mind for many boards in the coming year, the perennial themes of effective board functioning will be as important as ever—including with respect to board leadership, structure and composition, activism and defense preparedness, risk management, crisis management, succession planning and executive compensation, as summarized in our December 1, 2020 memo, Spotlight on Boards.