Corporate Governance Monitor

Spring 2020

For the current edition of our Corporate Governance Monitor, Ferguson Partners selected research that focuses on the leadership attributes of Board members and C-Suite leaders. The moral character of corporate leaders, the diverse perspectives they bring to their organizations and their willingness to advocate for social causes have become just as important as their ability to be financial stewards.

The first selection, originally published in *Agenda*, focuses on Board leadership during the COVID-19 crisis and how Directors could enhance oversight during emergency situations. While Directors cannot predict the outbreak of pandemics, they can implement procedures to ameliorate the effects of public health crises on their businesses. Some of the article's recommendations include forming a risk committee, informing investors as to potential business risks and reassessing healthcare benefits for employees.

Boards Tackle 'Sea of Unknowns' on Coronavirus

By Lindsay Frost (with edits by Ferguson Partners)

Boards' risk agendas are piling up thanks to a deadly viral outbreak that has spread globally and impacted human capital, supply chains and numerous other areas of businesses, and caused a dent in financials for major U.S. companies.

The deadly strain of the coronavirus, COVID-19, was first identified as a public health emergency stemming from Wuhan, China, on Jan. 30. As more people get sick, businesses are working toward resiliency and solutions as supply chains get interrupted and employees become unable to work.

In their oversight duty, boards should be setting aside enough time to discuss risks from the outbreak as a full board or on a risk committee. Directors should also ask management about the impact on the supply chain, work with management to reassure the company's workforce, and hedge against financial losses, among other responsibilities.

Risk Oversight

The coronavirus outbreak is a good example of why it is beneficial for boards to have a risk committee. Cathy Allen, chairman and CEO of the Santa Fe Group, says risk committees should focus on business continuity planning, business resiliency planning and pandemic planning, which is a combination of continuity and resiliency. Some companies created risk committees during the Severe Acute Respiratory Syndrome (SARS) outbreak that impacted companies throughout the globe in 2003, Allen says.

Additionally, reputational risk should also be high on the list. The markets have already seen steep declines in stock prices due to investors' and the general public's perception of how businesses are handling the outbreak, and this should concern boards.

Human Capital Risks

For global companies, the coronavirus outbreak is impacting employees in many ways, and companies are wise to mitigate the risk of disease spread and business interruption by paying attention to human capital issues, sources say. As boards increasingly look at human capital management from a risk and governance perspective, this outbreak is an opportunity for boards to question management about areas such as work from home, travel and health care benefits. … Now is also a good time to take a look at medical coverage, Allen says. Some employees who have poor health coverage may risk spreading disease by going into work infected.

Financial Impacts

The spread of the coronavirus has already negatively impacted company finances. Some experts say loss of revenues in the first quarter will likely extend into the second, so companies should be open about this, sources say. Indeed, the SEC announced on Jan. 30 that it was monitoring disclosures on the coronavirus outbreak and would provide companies with assistance regarding disclosures. As of Feb. 11, 26 U.S. public companies disclosed coronavirus risks in 10-Ks, according to Audit Analytics, but the firm predicts to see more disclosures as 10-K filing deadlines get closer.

"We … remind all companies to provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus to the fullest extent practicable to keep investors and markets informed of material developments," SEC chair Jay Clayton said in a March press release. "How companies plan and respond to the events as they unfold can be material to an investment decision, and I urge companies to work with their audit committees and auditors to ensure that their financial reporting, auditing and review processes are as robust as practicable in light of the circumstances in meeting the applicable requirements.

In the next selection, Berkshire Hathaway CEO Warren Buffett considers the quandary that often arises when Boards appoint non-wealthy Directors, or NWDs. Buffett notes in his annual letter to shareholders that NWDs might pursue Board seats with the goal of enhancing their personal wealth, thereby skewing their judgment towards self-interest rather than the best interests of the company.

To the Shareholders of Berkshire Hathaway Inc.:

Over the years, board "independence" has become a new area of emphasis. One key point relating to this topic, though, is almost invariably overlooked: Director compensation has now soared to a level that inevitably makes pay a subconscious factor affecting the behavior of many non-wealthy members. Think, for a moment, of the director earning $250,000-$300,000 for board meetings consuming a pleasant couple of days six or so times a year. Frequently, the possession of one such directorship bestows on its holder three to four times the annual median income of U.S. households. (I missed much of this gravy train: As a director of Portland Gas Light in the early 1960s, I received $100 annually for my service. To earn this princely sum, I commuted to Maine four times a year.)

> "Director compensation has now soared to a level that inevitably makes pay a subconscious factor."

And job security now? It's fabulous. Board members may get politely ignored, but they seldom get fired. Instead, generous age limits – usually 70 or higher – act as the standard method for the genteel ejection of directors.

Is it any wonder that a non-wealthy director ("NWD") now hopes – or even yearns – to be asked to join a second board, thereby vaulting into the $500,000-$600,000 class? To achieve this goal, the NWD will need help. The CEO of a company searching for board members will almost certainly check with the NWD's current CEO as to whether NWD is a "good" director. "Good," of course, is a code word. If the NWD has seriously challenged his/her present CEO's compensation or acquisition dreams, his or her candidacy will silently die. When seeking directors, CEOs don't look for pit bulls. It's the cocker spaniel that gets taken home.

Despite the illogic of it all, the director for whom fees are important – indeed, craved – is almost universally classified as "independent" while many directors possessing fortunes very substantially linked to the welfare of the corporation are deemed lacking in independence. Not long ago, I looked at the proxy material of a large American company and found that eight directors had never purchased a share of the company's stock using their own money. (They, of course, had received grants of stock as a supplement to their generous cash compensation.) This particular company had long been a laggard, but the directors were doing wonderfully.

Paid-with-my-own-money ownership, of course, does not create wisdom or ensure business smarts. Nevertheless, I feel better when directors of our portfolio companies have had the experience of purchasing shares with their savings, rather than simply having been the recipients of grants. ... At Berkshire, we will continue to look for business-savvy directors who are owner-oriented and arrive with a strong specific interest in our company. Thought and principles, not robot-like "process," will guide their actions. In representing your interests, they will, of course, seek managers whose goals include delighting their customers, cherishing their associates and acting as good citizens of both their communities and our country.

Those objectives are not new. They were the goals of able CEOs sixty years ago and remain so. Who would have it otherwise?

In the below op-ed from *The Financial Times*, the author argues that CEOs will remain ill-equipped to confront sustainability issues if chief executives do not embody the important qualities of empathy, compassion and humility.

Corporate leaders should show a little human kindness

They must put collective interests before their own to address sustainability challenges

By Alice Steenland

Misconduct recently passed financial underperformance as the top reason for forced chief executive departures at global companies. Some of them were implicated in #MeToo scandals around treatment of women. Many of these same CEOs are comfortable being paid thousands of times more than what they pay their employees.

Is this normal behavior? Perhaps not for regular people, but it is for people in positions of power. Research as far back as 2008 tells us that we are more likely to elect narcissists — people who are self-centered, exaggerate their talents and abilities, and lack empathy for others — as leaders. Another study of corporate professionals selected for management training programs observed that most of those who scored highly on tests for psychopathic traits "held high-ranking executive positions". And a study last year by consultancy TalentSmart found that chief executives had the lowest "emotional intelligence" scores in the workplace, far below middle managers.

> "… chief executives had the lowest 'emotional intelligence' scores in the workplace, far below middle managers."

While this has almost certainly been true for years, investors, voters and boards can no longer turn a blind eye to the lack of what Shakespeare called the "milk of human kindness" in corporate leadership ranks. That is because today's self-interested chief executive is fundamentally incompatible with addressing sustainability challenges. Fighting global inequality almost by definition requires leaders who are personally willing to accept less of the pie. The climate crisis demands dramatic changes to production and consumption models which will no doubt reduce short-term profits for many. To radically transform our economic model in time to halt irrevocable climate change, our leaders will not only need vision and foresight, but also the ability and willingness to put collective interests before their own.

Doing so requires empathy, compassion, honesty and humility, but these are rarely the attributes that boost you to the top of a large organization today. On the contrary, these traits appear to be diametrically opposed to the ones we are currently using to select our leaders.

So, what to do about this mismatch?

First, corporate boards must demand that the frameworks used in succession planning identify leaders not only for their ability to "execute" and "deliver" but also their record and ability to demonstrate honesty, humility, and compassion. We now know that each of us is hard-wired to believe that the most charismatic person in the room is also the best leader. To switch models, we will need to switch tools. We need to take ourselves out of the equation when possible and rely more on technology solutions, such as hiring software that uses nudges to counteract known cognitive biases. We can use algorithms and artificial intelligence to help objectively identify these 2020 leadership skills.

Second, regulators should consider certification requirements for CEOs that take honesty, humility and compassion into account. Doctors, engineers, lawyers, architects and others must prove they have certain skills before they are allowed to practice their professions. They submit to background checks to identify ethical or legal violations and sign a code of ethics, and violations can result in rescinding of the license to practice.

The idea is that people in these roles directly impact — and could potentially imperil — the lives of others in the course of their work and hence need to be held to a higher standard than other professions. Like doctors, CEOs should be licensed to practice. Lives are at stake.

Given the depth of the double climate and inequality crisis we face, and the breadth of the change that has to happen within this decade, redefining our leadership models might, in fact, be a prerequisite for our own survival.

This article from *The Wall Street Journal* details how company culture impacts women's ability to rise to the C-Suite. *The Journal's* investigation found that at the largest publicly traded firms, men hold most of the profit-and-loss jobs that prepare employees for the top leadership position. The article advocates for companies to cultivate corporate cultures that encourage women to assume P&L jobs and, ultimately, the role of CEO.

Where are all the Women CEOs?

By Vanessa Fuhrmans

Why, when women earn the majority of college degrees and make up roughly half the workforce, do so few occupy the chief executive job? For many, the barrier isn't only a glass ceiling at the very top, but also an invisible wall that sidelines them from the kinds of roles that have been traditional stepping stones to the CEO position.

A *Wall Street Journal* study of executives at the top companies, the biggest publicly traded firms by market value, shows that men on the way up overwhelmingly get the management jobs in which a company's profits and losses hang in the balance. So-called line roles with profit-and-loss, or P&L, responsibilities, such as heading a division, unit or brand, are what set executives on the CEO track. Women promoted into C-suites — the "chief" jobs in companies — on the other hand, often fill roles such as head of human resources, administration or legal, according to an analysis for the *Journal* by Equilar Inc., a research firm that collects data on executives and boards. Though important functions, the jobs don't have profit-generating responsibility, and are rarely a path to running a company.

Why the careers of ambitious men and women often take such different turns comes down to an alchemy of early professional trade-offs, work-life constraints and entrenched attitudes concerning women in power and the traits that make a leader, according to interviews with more than two dozen CEOs, senior female executives, board directors and talent recruiters. What's clear, many say, is that companies' initial moves to add more women to their senior ranks often have been haphazard — focused primarily on just getting at least one or two women onto leadership teams — and less a methodical effort to cultivate them for positions with the most power.

A recent Boston Consulting Group study of more than 200,000 employees at a range of companies suggests it is corporate cultures that make the difference for women and their ambition. In workplaces where men and women said their company had made good progress on diversifying their top ranks, 85% of midcareer women reported they sought a higher leadership position, nearly equal to the 87% of men who said so. At companies that scored poorly on gender diversity, only 66% of women did, compared with 83% of men.

“We’re not doing enough at companies to put action plans in place” to cultivate high-potential women, said Caroline Feeney, CEO of Prudential Financial Inc.’s Individual Solutions group, its consumer products and services business. “But it’s so important. I know, because I’ve lived it.”

Ms. Feeney, age 50, became in 2017 the first woman to lead Prudential’s life-insurance business, a precursor to her bigger role now. She had risen through the ranks in sales management, instead of as an actuary, the typical path to big P&L roles in insurance. But she had worked closely with the then-head of life, who saw her potential. When he stepped down, Ms. Feeney said, he championed her for a smaller P&L role, running the national sales organization while allowing her to work closely with his direct successor to become well-versed in the financials of the business.

The experience put her in place to take over the life business, and since 2018, her current role. Her successor in life insurance, also a woman who came up in sales, was trained in a similar fashion, and several other women also lead major businesses at Prudential. The effort hasn’t been about putting people in roles they aren’t ready for, she said, but about rethinking one-size-fits-all paths to leadership designed when it was mostly men in her field.

“There’s been a concerted effort to look at people with a different lens,” she said. “If you’d asked me five years ago, could I ever see myself in the role I’m in today or a CEO role at Prudential, I would have said no. But my thinking has evolved.”

The reporting in the next article, originally published in *Agenda*, indicates that many asset managers who support ESG in theory plan to demonstrate their commitment in practice this year. Firms including BlackRock Inc. and State Street Global Advisors declared that they would vote against Directors who do not comply with ESG reporting standards.

Investors' Bite to Match Bark on ESG

By Lindsay Frost

The 2020 proxy season marks the first year directors will risk losing votes from multiple major institutional investors if their companies fall behind on ESG disclosures and risk management.

For instance, State Street Global Advisors (SSGA) CEO Cyrus Taraporevala wrote in a letter to boards ahead of the 2020 proxy season that the asset manager will take voting action against board members at companies in major global indices that are laggards based on the firm's proprietary Responsibility (R)-Factor ESG scoring.

The letter corresponds to similar moves by BlackRock and Vanguard suggesting the asset managers will vote in line with ESG priorities during upcoming annual meetings.

"A number of commenters were wondering if the bite of these institutions matched the bark, but now there can't be any mistake — they are going to use their vote," says Jim DeLoach, managing director at global consulting firm Protiviti.

The SSGA letter follows a similar announcement from BlackRock last month threatening to use its vote against boards for companies that are not disclosing against the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD) frameworks.

Indeed, BlackRock indicates in its 2020 proxy voting guidelines that it will vote against directors if companies are not dealing with environmental and social issues "appropriately."

It may also support ESG-focused shareholder proposals "where there seems to be either a significant potential threat or realized harm to shareholders' interests caused by poor management of material E&S factors," BlackRock wrote in the guidelines, released last week.

In its 2020 voting guidelines, Vanguard does not specifically indicate it will vote against directors for failed ESG oversight or lack of disclosure. However, Vanguard says it will support ESG-related shareholder proposals that "[a] ddress a shortcoming in the company's current disclosure relative to market norms and key competitors' practices, reflect an industry-specific, materiality-driven approach, and are not overly prescriptive about time frame, cost, or other matters." This policy is unchanged from 2019.

Do companies with female executives achieve higher financial performance? A recent study conducted by Quantamental Research and published in *Agenda* found that having gender diversity in the C-Suite results in higher stock prices and profitability.

Stock Prices Soar With Women CEOs, CFOs: Study

By Stephanie Forshee

Man walks into a company. The company performs well.

Woman walks into a company. It does even better.

This is the narrative common in companies where the board adds a female executive to the role of CEO or CFO, according to new research from Quantamental Research, part of S&P Global Market Intelligence. Women don't get appointed to senior executive roles as often as men, but when they do, the financial results are positive, the research finds.

Still, even as the business case for diversity continues to build, some anecdotal evidence shows that board members and some investors are becoming fatigued by research and questions raised about diversity. At the same time, the facts in favor of diversity are becoming more clear-cut. According to Quantamental's findings, Russell 3000 companies with a female CEO at the helm between 2002 and 2018 led their companies to a 20% spike in stock price momentum over a 24-month period. Meanwhile, companies with female CFOs showed a 6% increase in profitability and 8% larger stock returns compared to those with male CFOs.

> "...companies with a female CEO at the helm...led their companies to a 20% spike in stock price."

Historically, though, women haven't been appointed to senior roles with the same frequency as men. Among Russell 3000 companies, there were 19 male CEOs for every one female CEO, as of the end of 2018, and there were 6.5 male CFOs for every single woman in the same role.

"In other words, if C-Suite appointments have historically been made on the basis of merit with a proviso on male gender, we posit that removing that proviso and allowing the system to equilibrate will show that male and female executives are equally equipped to drive their firms' success," the study states.

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So what are female executives doing differently from their male colleagues? The report poses this question, which the authors say “presents an unexpected answer: nothing discernible.” In fact, the study looked at “stereotypical” gender characteristics — such as, “women try to avoid losses and are more cautious” — in the actions of female executives.

“Our analysis supports that firms with higher earnings quality and lower leverage are firms with a culture conducive to make a female appointment, rather than the premise that stereotypical differences in the actions of the female executives, after their appointment, drive these differences,” the study states.

Julie Gorte, SVP for sustainable investing at Impax Asset Management and Pax World Funds, says research like this that looks at hundreds or thousands of companies over a significant period of time is helpful for investors to see. It’s easy for naysayers, for instance, to pick apart the performance of someone like Elizabeth Holmes, whose blood testing company Theranos went bust after she and the company were accused of fraud, or even Geisha Williams, who was ousted from PG&E amid a scandal that found the company liable for causing multiple wildfires in California.

There are always extreme cases of failure, regardless of an executive’s gender, Gorte says, adding, “anecdotes can take you anywhere you want.”

Companies fired more CEOs for unethical behavior in 2018 than for poor financial performance, signifying that companies have placed an increased emphasis on the moral conduct of their leaders. The below article from *Market Intelligence* provides statistics from the study, conducted by PricewaterhouseCoopers.

Ethical lapses were top reason for CEO ousters in 2018, study finds

By Emmanuel Louis Bacani

Turnover among CEOs of major firms rose to 17.5% in 2018 from 14.5% in 2017 as more chief executives were dismissed over allegations of ethical lapses rather than financial performance or disputes with their boards, according to a PricewaterhouseCoopers study published May 15, 2019.

The study showed that 39% of ousted CEOs at the top 2,500 publicly traded companies globally were forced out due to scandals or misconduct, up from 26% in 2017.

PwC said this was the first time in the study's history that ethical lapses, which include fraud, bribery, insider trading and sexual indiscretions, were the top reason for CEO ousters.

"The rise in these kinds of dismissals reflects several societal and governance trends, including more aggressive intervention by regulatory and law enforcement authorities, new pressures for accountability about sexual harassment and sexual assault brought about by the rise of the 'Me Too' movement, and the increasing propensity of boards of directors to adopt a zero-tolerance stance toward executive misconduct," the PwC study said.

The growing influence of activist investors may have also contributed to the increase in CEO turnover, the study found.

In 2018, the communication services sector recorded the highest CEO turnover rate at 24.5%, followed by materials at 22.3% and energy at 19.7%. The lowest rate was in healthcare at 11.6%.

According to the study, the share of incoming female CEOs fell to 4.9% from a record 6.0% in 2017. No women took the reins at large industrial or IT firms in 2018.

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Diversity + Inclusion Practice

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- Diversity + Inclusion
- Total Rewards
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- Restaurants
- Sports + Recreation
- Amusement Parks + Attractions

Innovation + Technology

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- Venture Capital + Portfolio Companies
- The Digital + the Built Environment
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  - Early-Stage - Late-Stage
  - Buy-Outs/Recapitalization
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