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2022 GOVERNANCE OUTLOOK

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The *2022 Governance Outlook* is designed to give corporate directors and senior executives a comprehensive overview of major business and governance issues that are likely to demand board focus over the coming year. The report begins with an introduction from NACD that highlights survey findings about leading board priorities for 2022 and follows with four partner contributions that provide distinct insights and projections on the following themes: proxy priorities, ESG oversight, M&A oversight and purpose, ransomware risk, assessing DE&I practices, and D&O threat landscape.

Each partner contribution provides (1) an overview of key trends in a particular area of governance, (2) an outlook for how those trends will play out in 2022, and (3) relevant implications and questions for boards to consider. The *2022 Governance Outlook* is designed as a collection of observations to help corporate boards to prioritize their focus in 2022 and increase their awareness of emerging issues through both detailed topical analysis and coverage of broader governance implications.

National Association of Corporate Directors

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Board Agendas Must Change to Meet 2022 Director Priorities

Barton Edgerton, NACD

INTRODUCTION

Although many had hoped that 2022 would see a return to normal, COVID-19 variants, supply chain disruptions, and inflationary pressures suggest that next year will continue to challenge corporate boards as they and their management teams continue to navigate a demanding business environment. Furthermore, larger social concerns about ESG and DE&I will make it difficult for many boards to return to the status quo when—or if—the pandemic recedes.

To gain better insight into which trends directors believe are most likely to impact their organizations in 2022, where directors allocate too much or too little time, and what priorities they have for making improvements, NACD surveyed nearly 250 members in November 2021 as part of its annual *Director Trends and Priorities* report.

Overall, directors report some significant changes in what will affect their firms. A greater emphasis on talent and digital transformation suggests that many forces are changing how work gets done in American companies. This should come as no surprise to the vast majority of board members who have embraced the potential of virtual meeting tools to transform the board's work.

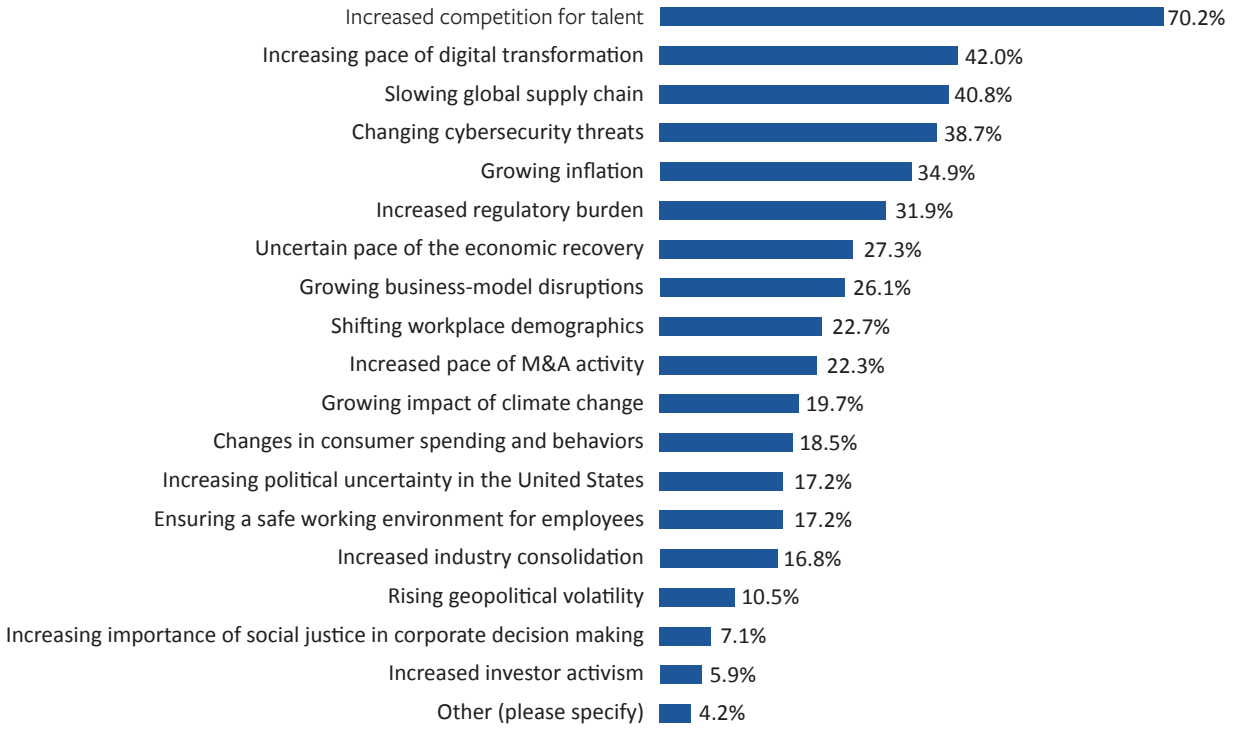
Competition for Talent is Overwhelming the Top Reported Trend

Since last year, increased competition for talent has bolted to the top of the list of trends that directors believe are most likely to impact their organizations over the next 12 months. Further, it was a top-five choice of 70 percent of survey respondents, an unprecedented finding since over the last several years the top trends have struggled to receive majority consensus. Further behind, directors saw the increasing

pace of digital transformation (42%) as the second-placed trend. More than two in three directors noted that their boards had discussed risk factors associated with the "Great Resignation." Taken together, this suggests that a variety of factors affecting the way that work (more remote, more virtual, and with more digital tools) gets done now are likely to impact not only how organizations operate but also the discussions that boards have. Other, more economic challenges, such as the slowing global supply chain (41%) and growing inflation follow (35%). Cybersecurity (39%) remains a perpetual concern and rounds out the top five.

Room in the top five was created by several significant drops in the rankings of several trends. The pace of business model disruptions dropped from third in 2021 to eighth this year. Change in customer behaviors dropped from 8 to 12. But the largest fall was in ensuring a safe working environment, which dropped from 2 to 14. While health and safety remain a top concern, most of the impact it has on the firm is already well managed, with 88% of directors reporting that they are confident their management teams can handle it.

What five trends do you foresee having the greatest effect on your company over the next 12 months?



2022 NACD Trends and Priorities Survey, n=238

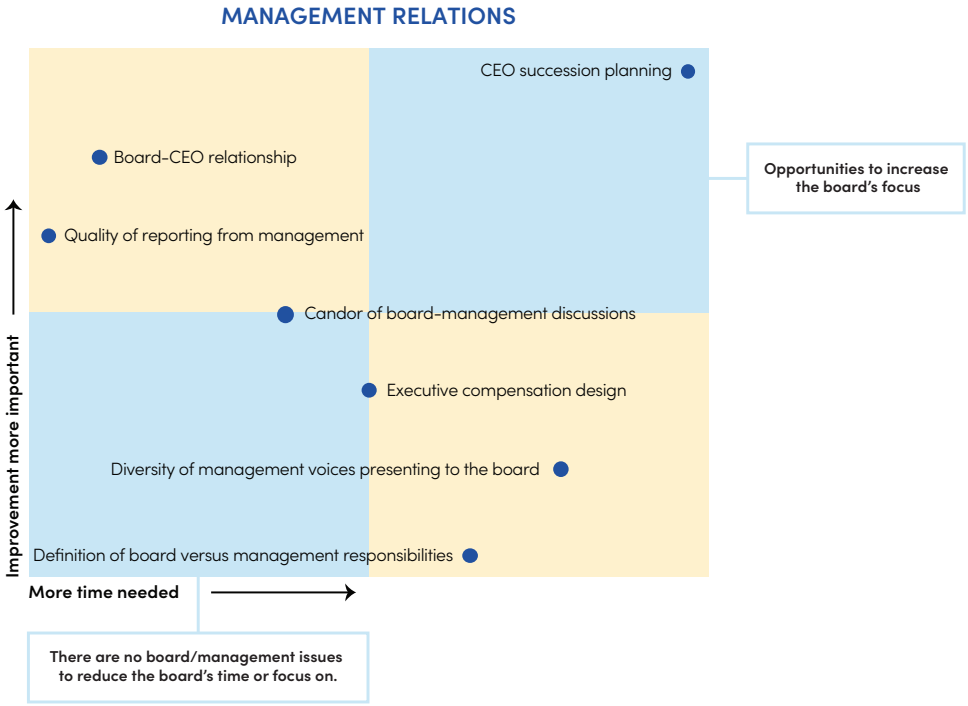
Given how organizations have changed over the last several years, it is not surprising that many boards are working to ensure that succession plans remain fit for purpose.

Priorities for improvement

To help gauge where board members might increase or reduce their focus next year, NACD asks members to evaluate whether or not they spend enough time on 30 boardroom activities across three categories: board and management relations, oversight, and board operations. We also ask the degree to which it is important to improve in each area. Results from these three areas are presented in the charts that follow.

BOARD MANAGEMENT RELATIONS

CEO succession remains important, and in aggregate, directors report that they want to spend more time on it and that it is important to improve their work. Given how organizations have changed over the last several years, it is not surprising that many boards are working to ensure that succession plans remain fit for purpose. Many report that the relationship between the board and the CEO has grown more important since last year, continuing a pattern seen since the start of the pandemic. A similar trend is seen in management reporting. Interestingly, the bottom-left box of the chart below is left empty, suggesting that there is no area where directors can reduce focus with their management teams.



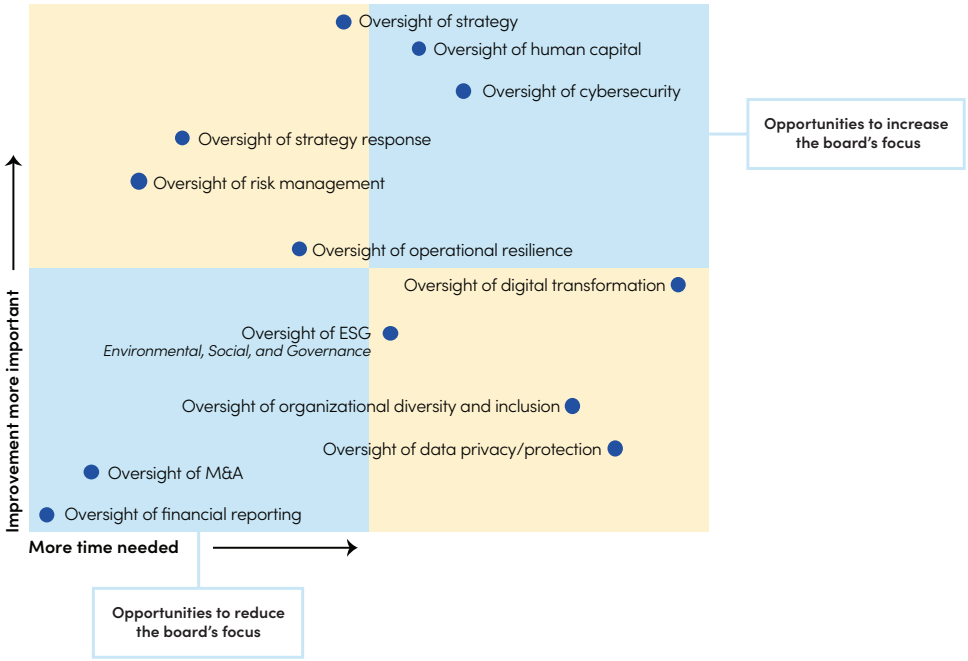
Directors view both human capital and cyber-risk oversight as areas to spend more time on and opportunities to improve board action.

BOARD OVERSIGHT

Consistent with what we saw in the trends above, directors view both human capital and cyber-risk oversight as areas to spend more time on and opportunities to improve board action. To gain time on the board agenda, boards may consider reducing their current emphasis on M&A and financial reporting oversight, both of which directors report spending enough time on and where the need for improvement is relatively low.

Continuing a trend seen in recent years, when it comes to strategy and risk oversight, directors seek improvements but not additional time. This suggests that "more of the same" is unlikely to be helpful. Rather, boards, and their management teams, may be in a position to rethink how they oversee strategy and risk without increasing the time they spend in these areas.

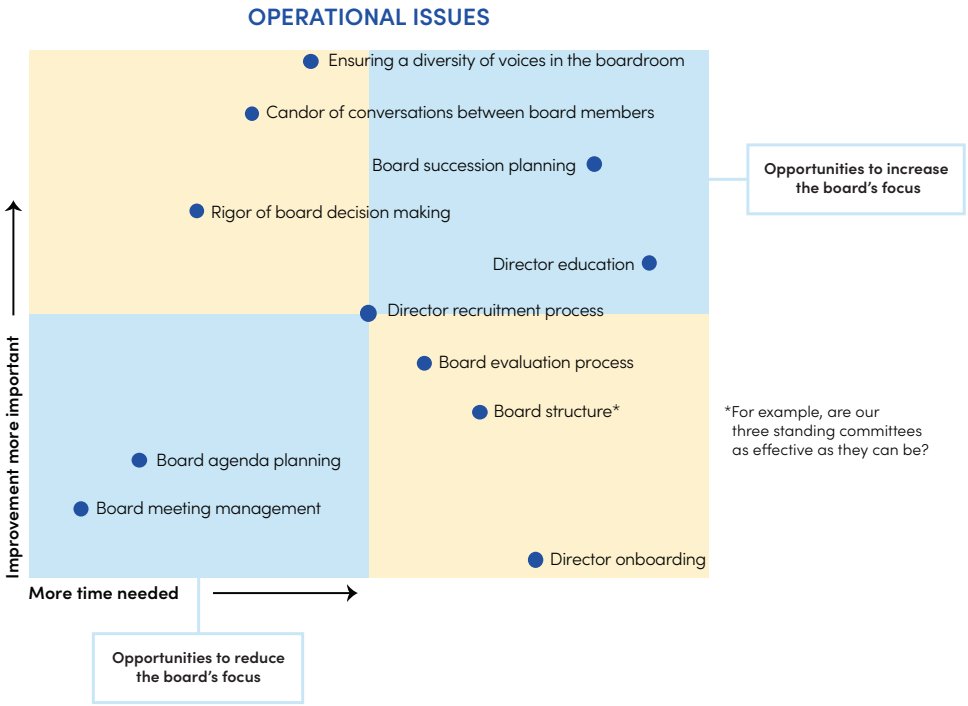
OVERSIGHT ISSUES



BOARD OPERATIONS

Given the emphasis on board diversity and the ever-increasing focus on board decisions, it is no surprise that board succession planning and board decision making are in the top-right box—areas where there are opportunities to increase both time and focus. However, in the last decade board agendas have continued to grow and expectations for boards continue to increase. The discussion above suggests that board agendas and board meetings need to change to accommodate new priorities. Add to these greater expectations for boards concerning ESG and DE&I, the evolving nature of

cyber risk, traditional issues such as M&A, and the associated liability risks that directors may face, and one would expect that directors would prioritize improving their meeting management and agenda planning. However, this is not only a low priority but one where little additional time is expected.



Change, as always, is on the horizon. Great boards will find ways to focus their effort on top priorities while minimizing their time on areas that are already well-managed and low risk. Armed with this information, they will seek ways to change the board agenda and how meetings are run, to continue to focus on what matters most.


Barton Edgerton

Barton Edgerton is NACD's associate director of Governance Analytics and Products, where he is responsible for generating insights to elevate board performance. Over the past 20 years, he has worked with a variety of boards, private equity firms, and Fortune 500 executives.

Embracing Greater Investor Interest in ESG Practices

By Dorothy J. Flynn and Chuck Callan, Broadridge

The 2021 proxy season was an ESG inflection point for US corporate boards, and many more directors are now preparing for heightened shareholder interest in corporate social responsibility.

Environmental activists this year won a series of victories against several of the world's biggest companies, passing shareholder resolutions to force companies to adopt more sustainable business practices and winning board seats. As climate-related proxy contests made headlines, activist shareholders also achieved success with initiatives aimed at companies' diversity, equity, and inclusion (DE&I) policies and the demographic makeup of corporate boards.

None of this should come as a surprise. In fact, many boards have been working proactively for years to integrate environmental, social, and governance criteria into their businesses and annual financial reports. Many companies are embracing greater investor interest in ESG policies and practices.

But for others, pressure for greater disclosure and change is coming from many sources. Internally, companies are hearing from employees demanding greater pay equity and more meaningful commitments to improving their communities. Externally, investors are demanding better reporting on climate risks and human capital management.

Investors' embrace of ESG reporting is on the rise. For example, institutional investors representing more than $100 trillion in assets have signed on to the United Nations-supported *Principles for Responsible Investment*. These asset owners are incorporating ESG criteria into their investment decisions and capital allocation. Research from consulting firm Coalition Greenwich shows that 72 percent of institutional

investors now include some form of "sustainability" in their investment processes. The firm projects that share to grow to 80 percent by 2026.[1]

Environmental activists were able to win proxy votes in 2021 with backing from mainstream global index-fund giants. Over the past two years, some of the largest asset managers have vowed to champion ESG causes. They voted in favor of many environmental and social shareholder resolutions, and they are holding board members accountable for progress in reporting ESG risks.

Many of the successful 2021 resolutions also had the support of proxy advisors, who are in the process of adopting much-more-detailed ESG policies. As one example, Institutional Shareholder Services (ISS) recently updated its list of "material failures of governance, stewardship or risk oversight" that would warrant negative recommendations against directors when there is "demonstrably poor risk oversight of environmental and social issues, including climate change."[2]

The activist trends described so far pertain mostly to institutional investors such as pension funds and hedge funds, which together with mutual funds as a group hold approximately 70 percent of the outstanding shares of US listed firms. While individual (aka retail) investors have generally voted more in line with board recommendations on shareholder proposals, it remains to be seen whether their interest is changing. In the same way that Reddit galvanized retail interest in GameStop and other meme stocks, there were instances where the social media platform became a forum for environmentally conscious individuals voting their proxies.

Over the past two years, some of the largest asset managers have vowed to champion ESG causes.

According to Forbes, the 2021 proxy season set new records, with at least 467 shareholder resolutions on ESG issues.[3] Some of these proposals received "eye-popping" levels of support, according to the "2021 Proxy Season Review" on the *Harvard Law School Forum on Corporate Governance*, which cites more than a dozen proposals on diversity, climate change, and political spending that scored over 80 percent, and 34 that received majority support—up from last year's record 21.[4]

Engine No. 1, the climate-change activist, continued to agitate for change and was successful in winning board seats where it launched a proxy challenge. Activists also scored with resolutions to force Chevron to lower emissions, and garnered high levels of support for proposals requiring oil producers to disclose the impacts of climate change and the move to a net-zero economy on their businesses. Meanwhile, the number of proposal submissions related to DE&I reporting and effectiveness tripled from 2020 to 2021, with three proposals receiving majority support.[5]

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[1] See Coalition Greenwich's press release, "Institutional Investors Directing Assets to Thematic Strategies Focused on Climate and Other Sustainability Goals," August 10, 2021.

[2] See Brian V. Breheny, Marc S. Gerber, Richard J. Grossman, Regina Olshan, Stephanie Birndorf, and Blake M. Grady, "ISS and Glass Lewis Release Updated Proxy Voting Guidelines," December 7, 2020, on skadden.com.

[3] Bhakti Mirchandani, "What You Need To Know About The 2021 Proxy Season," June 28, 2021, on forbes.com.

[4] Shirley Westcott, "2021 Proxy Season Review," the *Harvard Law School Forum on Corporate Governance* (blog), August 5, 2021.

[5] Ibid.

The number of ESG-related resolutions would have been even larger this year if companies hadn't altered policies in response to investor engagement apart from shareholder meetings. For example, numerous resolutions related to board diversity and "Rooney Rule" requirements for director candidate searches were withdrawn after companies adopted new business practices. Also in play were new proxy rules making it harder for smaller shareholders to get resolutions onto proxy ballots, as well as some successful exclusions granted under Rule 14a-8 "no action" rule. Had these resolutions not been abandoned, prevented, or excluded, they could have been put to a vote by public pension plans and asset managers through letter-writing campaigns and other engagements. November 2021 guidance from the SEC removed certain limits on the kinds of "social policy" proposals that management was required to put to a vote. Under the new guidance, shareholder proposals with a broad social policy interest not strictly connected to day-to-day operations may not per se be excludable by management from company proxies.

There is no reason to think that the trends toward greater ESG activism has abated. New requirements for human capital disclosure and a recent request for comments on climate disclosure may bring to light information that will inspire new resolutions in companies that fall short of investor ideals. As a result of these trends, the increasing interest in ESG among investors is putting pressure on corporate boards, both in annual general meetings and behind closed doors. For example, the "2021 Proxy Season Review" notes that several of the world's largest asset managers have announced that, starting next year, they will vote against compensation committee chairs at S&P 500 firms that don't disclose a breakdown of workforce demographics. Their "against" votes would extend to nominating committee chairs of boards that fail to disclose, or that lack, racial and ethnic diversity—a protest that new board diversity disclosure rules will facilitate for investors in Nasdaq-listed companies by making it easier to identify such companies. As for climate, one prominent activist submitted proposals this year that would require companies to hold an annual shareholder advisory vote on their climate action plans. According to the "2021 Proxy Season Review," the fund plans to roll that initiative out to 100 S&P 500 firms by the end of 2022.

Proxy advisors have announced plans to further increase their scrutiny of corporate ESG policies.

Meanwhile, proxy advisors have announced plans to further increase their scrutiny of corporate ESG policies. Starting in 2022, ISS may oppose nominating committee chairs at companies with all-male boards and at companies without at least one racially or ethnically diverse director. Glass Lewis may start recommending against nominating committee chairs of boards that fall short on certain board diversity measures, and against governance committee chairs that fail to provide clear disclosure on board-level oversight of environmental and social issues.

Many factors point to a continuance of the ESG momentum in the 2022 proxy season in terms of proxy resolutions, direct engagement with investors, and the overall involvement of corporate boards. According to the "2021 Proxy Season Review," through June of 2021, 95 nominating/governance committee chairs had received negative votes of over 30 percent of the voted shares—up from just 55

chairs in the first half of 2020.[6] Those results suggest that investors will continue holding boards and individual directors accountable for real or perceived ESG shortcomings.

Companies viewed as lagging peers in progress on ESG should prepare for heightened scrutiny and, in some cases, activism. In general, board members should ask the following questions:

1. **Should the board add ESG expertise and establish a dedicated ESG committee?**
   Nominating directors with specific ESG expertise can increase the board's effectiveness in setting policies across a range of issues and can demonstrate a critical level of competence to both internal and external audiences. Creating an ESG committee (apart from required committees on audit, compensation, and nominating and governance) could be an important step in establishing effective board oversight for some firms. A dedicated ESG committee elevates the importance of ESG, works with management on investment priorities, and considers (with the compensation committee) how targets can be reinforced with appropriate incentives.
2. **To what extent should executive compensation be aligned with ESG performance?**
   Tying executive compensation to ESG metrics can be an effective way for corporate boards to communicate their commitment to elevating ESG standards and to achieving real improvements in corporate ESG performance. As NACD's Friso van der Oord has remarked in his op-ed on tying more CEO pay to climate progress, what gets measured gets managed.
3. **Does the board share a vision on the degree to which ESG drives company performance?**
   It's imperative that boards understand the importance of ESG to their businesses together with the risks to long-term value creation.

Tying executive compensation to ESG metrics can be an effective way for corporate boards to communicate their commitment to elevating ESG standards.

We expect many corporate boards will step up efforts with their management teams to address investors' expectations for greater information on ESG risks and progress on measurable ESG goals.

[6] Shirley Westcott, "2021 Proxy Season Review," the *Harvard Law School Forum on Corporate Governance* (blog), August 5, 2021.


Dorothy J. Flynn


Chuck Callan

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The Role of the Board in Overseeing ESG

By Kristen Sullivan, Maureen Bujno, and Jon Raphael, Deloitte

INTRODUCTION

In corporate boardrooms, few topics seem to be generating more conversation than environmental, social, and governance (ESG) matters. The Center for Audit Quality (CAQ) observed that 95 percent of companies published some type of ESG disclosure in 2020.[1] According to *Board Practices Quarterly*, diversity, equity, and inclusion; human capital management; and environmental and sustainability matters ranked among the top four board priorities this year.[2]

Despite this increasing focus, many companies are at the beginning of their ESG journey. As a company's ESG focus sharpens and as the landscape progresses, boards should be aware that the *G* raises several governance questions directors should consider.

KEY PROJECTIONS

There are several key projections that boards should be aware of as they enhance their ESG governance activities over the coming year:

- **Growing need for ESG and business alignment**. As ESG becomes increasingly prominent, more companies are likely to focus on aligning their ESG objectives and metrics with the overall strategic drivers of the business. A materiality determination can help drive this strategic alignment. Synchronizing key performance indicators (KPIs) for the overall business with ESG-specific KPIs can lead to overall enhancements in ESG programs.

[1] The Center for Audit Quality, "S&P 500 and ESG Reporting" (August 9, 2021).
[2] Board Practices Quarterly, "2021 Boardroom Agenda" (February 2021).

"If a company's current disclosures are made outside of its SEC filings, they often are not subject to the same governance and control frameworks as the company's SEC disclosures. The cost and time needed to develop and implement new processes, technology, and capabilities could be significant for some companies."

– Jon Raphael, national managing partner for Audit & Assurance, Deloitte & Touche LLP

- **ESG's rising stature on board agendas**. With surging interest from investors, consumers, and other stakeholders, ESG will likely increasingly become a standing board/audit committee meeting agenda item.
- **Compliance with SEC requirements**. The SEC will roll out new regulations governing the disclosure of specific ESG information. The board/audit committee should not only stay on top of these new regulations, but also understand how management is addressing SEC expectations. For example, this past September the SEC posted an open comment letter to provide an example format of the types of comments they have issued about a company's disclosures.[3]
- **Convergence of standards**. Many companies are looking to recognized ESG standards and frameworks to guide their activities. We expect this trend to increase as the move toward convergence of recognized standards and frameworks takes shape under the new International Sustainability Standards Board (ISSB), announced in November at the UN Climate Change Conference in Glasgow. This shift can result in greater clarity and certainty in meeting stakeholder expectations and make it easier for companies to apply broader ESG standards to measure performance against their ESG goals.
- **Heightened demand for alignment of ESG disclosures and financial statements**. As regulatory action is announced and an authoritative standard setting body progresses, there will be a heightened demand for companies to align their ESG disclosures and assumptions with their financial statements and disclosures regarding potential financial implications of the ESG initiatives and goals.
- **Increased focus on the essential role of assurance**. Assurance is a critical component of an effective governance process and is intended to enhance the confidence and trust in the ESG subject matter prepared, as well as to reflect performance against ESG risks and objectives. As the SEC's new ESG rules gain traction, we expect to see greater emphasis on assurance provided by the independent auditor to promote consistency with the audited financial statement's key assumptions and disclosures. Not surprisingly, some of the world's largest companies use public company auditors to provide assurance over specific parts of their ESG reporting, and we expect that trend to continue and expand.

BOARD IMPLICATIONS

To help boards prepare to address what is on the horizon for ESG and stay ahead of the rapidly changing environment, we've put forth leading practices for boards to consider. Each of these areas will likely become increasingly important as they embark on or expand their governance and oversight responsibilities in response to today's demands.

[3] US Securities and Exchange Commission, "Sample Letter to Companies Regarding Climate Change Disclosures" (September 2021).

To set a proper governance structure, board members should understand how sustainability is linked to strategy, opportunities, and risks.

1. **Define the board's governance infrastructure**

   Boards should define ESG oversight responsibilities across the board itself and its committees, and identify the steps needed to operationalize them. Board members should be deliberate about overseeing the overall ESG program as well as specific ESG objectives, risks, and opportunities.

   Deloitte's study of S&P 500 proxy statements in 2020 revealed substantial differences in how boards oversee ESG matters.[4] We also found significant variation in governance structures among industries. The largest percentage of boards delegated oversight responsibility to the nominating and governance committee (41%), while almost 30 percent had not disclosed whether the board had defined the structure, demonstrating that this remains an evolving area.

   To set a proper governance structure, board members should understand how sustainability is linked to strategy, opportunities, and risks. Considering the complexity of a typical sustainability integration, directors should also be familiar with the specifics, including measurement criteria, to monitor progress. The ESG lead committee or board should counsel and challenge the sustainability leader on a regular basis to understand how the program is maturing. Together, they should agree on whether the *E*, *S*, and *G* owners will report to the full board or to a subcommittee. Coordination among committees is critical, given the broad scope of ESG measures. At a minimum, the audit committee should be reviewing the company's sustainability report to understand key assumptions made and the controls supporting key metrics and goals that are disclosed.

   As the structure continues to be defined, the board should work with management to understand who will present on ESG topics, the type and level of information shared, and the cadence of ESG on the agenda(s).

2. **Understanding the ESG management structure**

   Where ESG resides within the company's management can have a significant impact and should be a focus of the board. To exert sufficient influence, drive accountability, and ensure alignment with the business strategy, the lead should be a senior executive. The CEO also plays a critical role in setting the tone at the top and underscoring the importance of the ESG program.

   Management teams should consider developing a formal ESG/sustainability management committee made up of cross-functional company leaders with assigned responsibility and accountability. The senior executive leading the sustainability efforts should also lead the committee, which should focus on a cross-section of ESG trends and activities.

[4] Deloitte Center for Board Effectiveness, *On the audit committee's agenda: Defining the role of the audit committee in overseeing ESG* (November 2020).

Audit committees should understand which ESG risks are deemed material and should be captured in sustainability disclosures.

3. ESG integrated into the company's strategic fabric

ESG success depends on a well-defined strategy that aligns with the company's purpose and strategic direction. Monitoring goals and metrics, such as stakeholder assessments and KPIs, are a telltale sign of whether any strategic ESG plan has the necessary rigor and accountability built in. When it comes to metrics, consistency is key. ESG disclosures, investor relations reports, MD&A, and financial statements should all be based on the same assumptions. The strategic information that management shares with the board may shift to align strategic objectives with ESG program pillars and stakeholder expectations. Directors can also ask how effectively ESG has been woven into the company's culture. Embedding ESG into company values and employee communications will not only help to ensure that it is part of the larger strategic direction, but also demonstrate to stakeholders that there is a strong, companywide commitment to ESG.

4. Align risk and ESG oversight

Sustainability risks are business risks. A study by the Forum for Sustainable and Responsible Investment found that investors with $17.1 trillion in assets domiciled in the United States have adopted sustainable investing strategies, underscoring the link between ESG reporting, risks, and opportunities.[5] These are powerful arguments in favor of adding ESG to the board's risk infrastructure and fully integrating it into the company's enterprise risk management activities.

There are many factors to consider in adding ESG to the company's risk infrastructure. For many boards, the audit committee is the primary owner of risk oversight. However, it is increasingly common for the audit committee to retain oversight of the company's overall risk management efforts, as well as financial risk.

The audit committee should coordinate with the board/committee leading the oversight of ESG efforts to understand how ESG risks may already be included on the organization's risk map, who the risk owner is, and which committee is overseeing that risk. In addition, committees should understand which ESG risks are deemed material and should be captured in sustainability disclosures. Audit committees should also understand how ESG risks are being continuously identified.

5. Understand the company's ESG maturity

It is important for boards to understand where the company is on its ESG journey. This assessment can begin with specific questions related to ESG:

- Are the company's sustainability efforts embedded in strategic decision making?
- Has the company defined the key elements of its program and performed an ESG materiality assessment?
- Is the program aligned to recognized standards or frameworks?
- What disclosures are currently being made, and through what avenues?

[5] Forum for Sustainable and Responsible Investment, "Trends Report" (November 16, 2020).

- Has the company engaged internal audit or obtained assurance?

The company can use an ESG maturity model to assess the development of key elements, including the board/audit committee itself and risk and management controls, as well as ESG and climate reporting and disclosures.

6. Overseeing the adoption of an ESG framework

Given the clear market expectation for standardizing ESG performance measures, companies should consider whether adopting one or more existing standards or frameworks can help them to achieve their objectives. Going forward, the board should be engaged in any standards selection process and should be mindful of alignment that may be necessary based on the selection.

Currently, the leading global ESG standard frameworks include these:

- Sustainability Accounting Standards Board (SASB)
- Climate Disclosure Standards Board (CDSB)
- Task Force on Climate-related Financial Disclosures (TCFD)
- Greenhouse Gas (GHG) Protocol
- Global Reporting Initiative (GRI)

At the recent UN Climate Change Conference in Glasgow, the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB) to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs. The foundation expects to merge the CDSB and the Value Reporting Foundation (VRF, which houses the Integrated Reporting Framework and the SASB Standards) into the ISSB by June 2022. As part of this major standards initiative, other leading investor-focused sustainability disclosure organizations have agreed to consolidate their standards into the new board as well.

Investors have made their ESG expectations known and will likely continue to use their voting power to hold companies accountable for meaningful progress.

7. Assure, disclose, and communicate

Investors tell us that ESG information is not nearly as robust or accessible as they would like. Even for companies with more extensive disclosures, questions arise about the quality, credibility, and reliability of the information. Investors have made their ESG expectations known and will likely continue to use their voting power to hold companies accountable for meaningful progress. If not already being captured, going forward, management should discuss specific investor expectations and plans to address them with the board or committee at least annually.

The merits of an ESG disclosure strategy. Stakeholder needs are continuing to evolve and, as a result, companies need a disclosure strategy that integrates ESG performance into multiple avenues. A carefully conceived disclosure strategy can not only improve the quality of ESG performance information, but also enhance trust and drive business performance. Board members should understand the framework management is using to communicate the

company's sustainability story to specific stakeholders. This includes knowing how ESG metrics are communicated on the company's website, disclosed in a separate sustainability report, or integrated in an SEC filing.

The value of third-party assurance. As ESG gains prominence, there is also an increased focus by stakeholders on the integrity of a company's ESG disclosures. To instill confidence, companies should consider the value of getting third-party assurance on ESG disclosures. Overseeing the quality of both the ESG program and disclosures must be an objective process performed by an independent third party following quality control and professional standards. At the board level, this oversight resides with the audit committee. The CAQ observes that third-party assurance from a public company audit firm can improve the reliability of ESG information and the overall credibility of the disclosure.[6]

CONCLUSION

Given the growing consensus around ESG performance tied to company value, boards have a great deal to consider. With so much riding on the company's successful implementation and governance of ESG, boards will benefit greatly from continuing education as they carry out their oversight responsibilities.

ADDITIONAL QUESTIONS FOR BOARDS TO ASK

- Do we have a clear understanding of how management has assigned ownership of ESG overall as well as the individual components?
- Has management considered establishing a sustainability management committee to align company-wide sustainability goals?
- Has management aligned ESG execution with the enterprise risk management program?
- Have we considered how to coordinate the ESG oversight structure and continual monitoring? How will this process fit in with risk oversight responsibilities?
- Do we have a clear understanding of the company's ESG maturity and steps that the company plans to take to continue to evolve it?

[6] The Center for Audit Quality, "S&P 500 and ESG Reporting" (August 9, 2021).


Kristen Sullivan


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Kristen Sullivan is a partner and leads Deloitte & Touche LLP's Sustainability and ESG services, working with clients to help address their sustainability and non-financial disclosure strategy needs. Sullivan also serves as the Deloitte Touche Tohmatsu Limited's (DTTL) Americas Region Sustainability Services leader, the Global Audit & Assurance Climate Services leader, and the Integrated Reporting Community of Practice leader. Sullivan brings extensive experience in delivering sustainability risk assessment, governance, strategy alignment, measurement, reporting and assurance services.

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How Purpose Is Changing the Board M&A Oversight Role: What Directors Are Saying

By Nikki Beck and Annie Adams, Deloitte

INTRODUCTION

While the past two years have been defined and dominated by the global spread of COVID-19, the world has also witnessed a renewed reckoning with racial, economic, and environmental issues. Progress in the economy and success in business has taken place against a backdrop of protests in the streets, splintered politics, and an ever-more-worrying climate outlook.

These are powerful forces. Companies can feel the urgency, and the need to respond in constructive ways, as consumers and workers demand that businesses generate positive social impact. Society is asking how companies can produce solutions, not problems. Corporate boards, in their oversight role, have an opportunity to respond to this growing demand from diverse stakeholders seeking better outcomes.

Taken together, these concerns put a premium on corporate purpose—the ability of a company to align around a set of principles that define how it contributes to the greater good. Purpose can permeate the organization and extend into everything the company does, including mergers and acquisitions (M&A).

The organizations that will thrive today and in the future will be those that define their purpose broadly, addressing a broad range of stakeholders. They will be the companies that acknowledge, as the Business Roundtable articulated in its 2019 redefinition of corporate purpose, a responsibility to their customers, employees, and communities, while also generating long-term value to investors. Businesses have a moment right now where they can engage the stakeholders who they may have failed to fully recognize in the past.

Deloitte views purpose from the perspective of inclusive prosperity—defined as the effort to drive value through a focus on greater inclusion and shared prosperity.

Defining purpose

Purpose is bigger than the environmental, social, and governance (ESG) objectives that are a focus for a growing number of investors. It is broader than the diversity, equity, and inclusion goals that corporate managements have begun to address, and it goes beyond the environmental, health, and safety programs or corporate social responsibility initiatives companies may already have in place.

Deloitte views purpose from the perspective of inclusive prosperity—defined as the effort to drive value through a focus on greater inclusion and shared prosperity. This is about what companies can do to make the world more equitable, accessible, safe, and sustainable for all stakeholders. This is about value creation seen through the lens of what a business can do to improve the community or society in which it operates.

Executives and directors may have a range of definitions in mind as they discuss purpose. Some may be referring to a longstanding set of values the company brings to its decision making. Others may think of purpose as how the company responds to demands from customers, employees, or the community for better efforts on diversity or faster action on carbon emissions. Some leaders may see purpose mostly in terms of the company's brand, products, and reputation.

And yet, the purpose conversation, however it's defined, is reordering priorities for executives and directors. Bringing these new priorities to the table will be increasingly important as companies plan M&A strategy and pursue deals.

To assess how companies are using purpose as a lens for M&A strategy, target evaluation, and deal execution, we interviewed a select group of corporate directors across a variety of industries. We asked what role purpose plays in dealmaking today, where it comes into play, and how it affects decisions. We asked how they see this changing in coming years. This report is based on their responses, along with the experiences of Deloitte professionals who advise on thousands of transactions each year.

KEY PROJECTIONS

1. **Purpose doesn't set M&A strategy yet—but that may change.**
   Successful companies approach their M&A decisions with financial rigor, making sure that they know how a given deal will help to meet growth goals or fill competitive gaps. Revenue, margin, and earnings per share (EPS) are paramount. According to our interviewees, ESG considerations mostly don't yet reach the board level as M&A strategy is formed or potential deals weighed.

   ESG is interesting, but EPS is still more important, according to one interviewee who serves on the boards of several global companies. This may be changing, however, especially as the pandemic and other recent events have boosted debate on a range of issues. Purpose is demonstrated when a company acts in accordance with its values, and few boards are going to be willing to go out and acquire a company whose values are not in line with their own, this director argues.

   Indeed, as purpose permeates business strategy and planning, the impact on M&A strategy may become inevitable. A cosmetics maker building its brand around

environmentally responsible product packaging may want to acquire a packaging company that uses recycled materials innovatively. An apparel company that's committed to better treatment of workers might pursue a vertical supply chain integration to gain control over factory conditions.

David Meador, vice chair of DTE Energy, says a company such as his that pursues environmental leadership as part of its mission could well see purpose affect its M&A strategy. It might target a renewable energy technology company, for example. He adds that corporate purpose can also affect divestitures. In a recent spin-off, DTE Energy took steps to ensure that the carved out entity would have adequate resources to continue to pursue the environmental, social, and community objectives that the parent company established.

2. **Corporate purpose increasingly defines what acquisition targets are viable.**

That a company would seek to avoid headline risk in the acquisitions it pursues is hardly a new idea. Still, the increasing focus on corporate purpose raises the stakes around what might be considered an acceptable deal.

A potential buyer may want to avoid doing a transaction with a business that has a reputation for treating its employees unfairly. A growing focus on a company's purpose may reinforce such thinking.

For example, a buyer may not be interested in acquiring a company that has a history of racist policies or a track record as a polluter, according to Jim Hinrichs, a director at several life sciences companies. A potential buyer may want to avoid doing a transaction with a business that has a reputation for treating its employees unfairly. A growing focus on a company's purpose may reinforce such thinking.

Consider a life sciences company that discovers a business it intends to buy has significant unaddressed quality-control issues. This might be something that can be fixed, or it might be a reason to walk away. Insofar as the purpose of a life sciences company is to bring effective and safe products to patients, Hinrichs suggests, such decisions have tight links with corporate purpose.

There are businesses forming around ESG concepts. To cite one example, an investment trust saw potential value in ecologically sound resorts. They began by developing a product and service concept, and then they used this to identify acquisition targets. Their wish list for a potential purchase included: an ecologically viable water source, access to clean energy, a population that could benefit from a new source of employment, and a government that treats local populations fairly. Eventually, M&A diligence will include many of these points to identify value and incremental investment.

New concerns relevant to M&A activity may emerge as companies more carefully define their purpose, weighing how their actions affect a broader group of stakeholders. Even away from the bigger issues that might have raised red flags in the past, diligence is changing and may come to include an ESG scorecard right alongside assessments of financial control systems, HR competencies, or technology infrastructure.

When a company might be able to improve the diversity efforts of an acquisition target, or put better environmental policies in place, there may be much to gain from the deal, not just for the acquirer, but for society as a whole.

3. **Purpose is playing a bigger role in integration planning and execution.**
   If corporate purpose has growing importance for the financial success of every company and an expanding influence on its M&A activities, it follows that purpose will also be relevant to the integration planning and execution that comes with every deal.

   Companies are beginning to ask how completion of a merger is going to impact various ESG efforts. Will the combined workforce be more or less diverse? Will planned workforce reductions adversely impact a particular community? Will the combined company have a better or worse carbon emissions profile? These issues are being pushed to the fore, and they come into play during divestitures too. When the right questions are on the table, the integration planning process can be adjusted to mitigate impacts and improve outcomes.

   To be sure, value can be created in the process of addressing problems or shortcomings during an M&A transaction. When a company might be able to improve the diversity efforts of an acquisition target, or put better environmental policies in place, there may be much to gain from the deal, not just for the acquirer, but for society as a whole.

4. **Purpose-driven investment funds are driving purpose in M&A.**
   In a trend that has been building for many years—and one that accelerated during the pandemic—investors have come to believe more strongly that their money can be put to work in ways that produce prosperity in a more inclusive manner. This can be seen playing out in the explosion of retail stock investment funds with ESG parameters and in the recent growth of private equity and venture capital funds with specific themes, such as renewable energy or Black entrepreneurship.

   In some respects, a greater attention to and broader definition of corporate purpose can actually come full circle. If investors want companies to address the impact that they have on a broader set of stakeholders, then the purpose-driven company that is mindful of broad stakeholder impacts will in fact be paying heed to what investors and shareholders want. This is going to play out in the context of M&A and in other activities.

BOARD IMPLICATIONS

1. **Board members should be actively engaged in the purpose discussion.**
   Board oversight responsibilities should extend to what management is doing to shape and pursue the company's purpose. This requires formal inclusion of defined topics on the board agenda. Reports to the board on progress toward diversity goals might be appropriate, for example, or regular presentations on community economic development efforts. Some of these will undoubtedly become part of a company's regulatory reporting, if they haven't already.

When reporting around purpose-related objectives is on equal footing with other topics such as growth goals or financial milestones, and when it begins to inform M&A strategy and decisions, it indicates that management and the board are giving proper weight to corporate purpose. At DTE Energy, senior executives some years ago created a force-for-good committee that reports to the board on a regular cadence. Meador explains, "That was a tipping point."

It also matters that the discussion around purpose is honest—that it's not just for appearances. It must be focused on real, important societal concerns that the company and its people feel compelled to address, Meador says. When that's the case, it will pay dividends in areas such as employee and community engagement and ultimately will improve financial performance.

2. **Boards need a clear definition of purpose—and a way to measure progress.**

Directors, working with management, should be able to articulate a company's purpose and clearly define the objectives that support it. They need metrics that make it possible to track progress toward these goals. Increasingly, such metrics will be necessary whenever an M&A transaction is contemplated.

Directors, working with management, should be able to articulate a company's purpose and clearly define the objectives that support it.

In the Deloitte M&A Trends survey, conducted in October, corporate and private equity executives reported that ESG considerations now play a prominent role in their dealmaking. More than three-quarters of respondents (77%) said they incorporate ESG metrics in setting valuations and assessing risks, and 75 percent said they have reevaluated their business portfolio for acquisitions or divestitures using an ESG lens.

Kelsey Lynn Skinner, a technology venture capital investor at IP Group in London, who serves on public and private company boards, says that in a recent deal she was involved with, a large European company wanted metrics on diversity and carbon emissions for a business it was acquiring. These metrics were part of the discussion process, even if the financial numbers were still going to define the transaction.

There are few standards so far that address what ESG issues a company should track or how metrics should be reported, though European companies have reporting requirements related to climate change and some other issues.

Companies are just beginning to grapple with this challenge. "Across my experience as a director, I see how management is still having difficulty with purpose and ESG in determining what they should measure, how they should measure it, and how they can be consistent in their approach," Skinner says.

Indeed, some 72 percent of respondents in the M&A Trends research said ESG is a challenge for their organization. And yet, these issues also cannot be ignored: in the survey 72 percent of respondents said the environmental or social behaviors of acquisitions or portfolio companies had caused significant unrest among stakeholders and investors.

"Sometimes it's better to start with something instead of nothing—rather than waiting for the perfect approach—and be willing to have it evolve as you go," Skinner suggested. For precisely these reasons, board oversight and involvement in this effort may be particularly relevant right now.

3. **Boards should consider how M&A can be an engine to achieve a company's purpose.**

   Boards today are looking for all the possible touchpoints where they can exert influence or find leverage to support the greater purpose of the company. M&A activity is one of those touchpoints. This may not be the first place where purpose or ESG concerns garner attention, but because M&A presents important opportunities to shape a company's future, it will also be an engine for shaping its purpose.

   A company's purpose may be more or less directly related to its business mission. Elisha Finney, who serves on boards of companies in the technology and health-care industries, says that when an organization is in the business of making medical products, for example, that may clearly define its greater purpose. However, a company that sells entertainment or markets clothes or appliances also has a larger purpose as well. In either case, the setting of M&A strategy or the pursuit of specific deals will present significant opportunities to drive or change the organization's purpose—and boards should be alert to such opportunities.

BOARD OVERSIGHT QUESTIONS

- Has purpose been defined and clearly built into our corporate strategy?
- Has the M&A strategy or the screening process for potential deals been reviewed to assess how well it supports our company's purpose?
- Is the board examining M&A activity as an opportunity to help reshape or reinforce the company's purpose?
- Are defined topics related to the company's purpose being reported to the board on a regular basis?
- Does the board know what ESG metrics are being included in regulatory reports, or which metrics and topics related to purpose might need to be added to such reporting?
- In integration or divestiture execution planning, does our company examine how different racial or ethnic groups in our workforce may be disproportionately affected?
- Does the organization, in its M&A diligence, specifically examine a target company's ESG goals (including metrics around diversity, environmental compliance, and so on) and assess how they complement or conflict with the company's purpose?


Nikki Beck


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Board Responsibilities in Mitigating Ransomware Risk in 2022

By Donald Saelinger, Flashpoint

Oversight of cybersecurity matters has become an essential area of focus for corporate directors in recent years. The complexity of this task increased substantially in 2020 and 2021 with the rapid propagation of ransomware attacks. In 2022, ransomware will remain a prolific and costly cybersecurity threat to enterprises of all sizes, and it is expected that the disruption, cost, and liability created by ransomware will increase considerably.

Accordingly, corporate boards that advise their management teams to invest in education, preparation, and defense relating to ransomware will best position their companies to mitigate the risk and impact of ransomware attacks. This article is designed to provide directors and key board stakeholders with an overview of these topics:

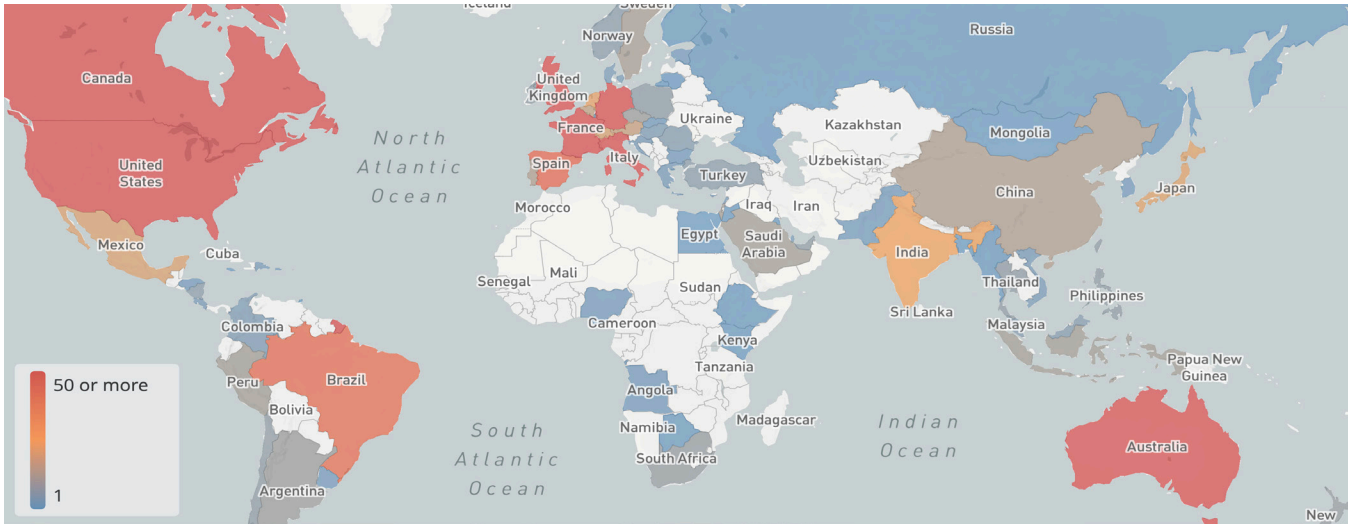
- The increasingly aggressive tactics that ransomware actors are adopting, expanding the risk landscape for companies in 2022
- Key trends that may lead to increased financial and reputational exposure for companies and directors, including: (i) reduced insurance coverage for ransomware attacks, (ii) regulatory changes which may delay or limit system recovery following a ransomware attack, (iii) proposed and passed changes to SEC and other regulations that will require expanded disclosure of an attack, and (iv) potential heightened fiduciary duties for directors associated with an attack
- Best practices that directors should take to verify that that their companies are prepared to defend against, and respond to, ransomware attacks

1. RANSOMWARE GROUPS WILL BECOME MORE BRAZEN AND SOPHISTICATED IN 2022.

In 2021, ransomware groups adopted significantly more organized, brazen, and sophisticated methods. This is supported by data obtained from ransomware sites and by regulators through the course of investigations, which show an astronomical expansion of the quantity and diversity of companies successfully breached by threat actor groups. In 2021 alone, more than 4,000 companies were named by ransomware sites as having been successfully breached. And the total number of breaches last year was likely much higher than this reported figure, because victim companies that submit to ransomers' demands oftentimes do not have their breach or their negotiations made known to the public. Targeted companies are primarily located in the United States, Canada, and Europe (see Figure 1), and represented among targets are all types of industries, including critical infrastructure, health care, and government (see Figure 2 on page 28).[1]

From a monetary perspective, the Financial Crimes Enforcement Network (FinCEN, a bureau of the US Department of Treasury) tied $5.2 billion of Bitcoin transactions to just the top 10 ransomware variants in the past three years—suggesting that companies are paying ransomware groups many billions of dollars per year in response to ransomware demands.[2]

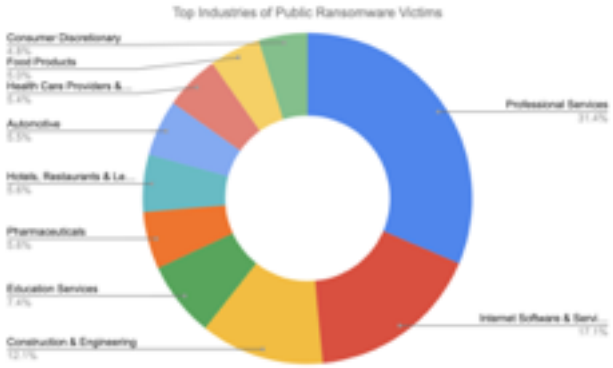
Figure 1: Number of Ransomware Victims by Country, 2021



Source: Flashpoint data collected from ransomware sites, 1/1/21 to 12/7/21. Used with permission.

[1] Data derived from Flashpoint analysis of ransomware group "leak sites" and similar threat actor forums.
[2] Financial Crimes Enforcement Network, *Financial Trend Analysis: Ransomware Trends in Bank Secrecy Act Data Between January 2021 and June 2021.*

Figure 2: Proportion of Ransomware Victims by Industry, 2021



Source: Flashpoint data collected from ransomware sites, 1/1/21 to 11/9/21.

While the volume and breadth of ransomware activity warrant board attention on its own, perhaps the more alarming data point is the increase in severity of attacks.

While the volume and breadth of ransomware activity warrant board attention on its own, perhaps the more alarming data point is the increase in severity of attacks, as ransomware actors resort to an evolving arsenal of destructive tools designed to extract payment or compliance from their targets. Traditionally, cybercriminals relied on permanent encryption of a company's data as the primary method to extract payment from their victims.

In 2022, we expect to see threat actors increasingly pursue multipronged ransomware attacks that add contingency extortion methods should the "traditional" threat of data encryption and downtime fail to appropriately intimidate the intended target. Specifically, as we move into 2022, we are seeing ransomware actors adopting the following tactics, which create a higher risk of liability, data exposure, and operational interruption for a company and its directors:

- **Tying ransomware attacks to major corporate events such as an IPO and M&A activity**. In order to maximize their leverage against their targets, ransomware actors are using confidential, stolen data to time their attacks to significant corporate events. This includes nonpublic acquisition announcements, capital market activity, and similar events that require direct board attention.[3]
- **Publishing victim names and confidential business information on victim shaming sites.** Once a novelty, ransomware websites that "doxx" (i.e., publicly shame and expose sensitive data of) new, nonpaying victims are now the norm. Starting with a simple post of the organization's name, accompanied by publishing a small amount of sample data that proves the breach is legitimate, these groups gradually release more and more information until a victim pays up.

[3] FBI Private Industry Notification, dated Nov. 1, 2021. In this notification, "During the initial reconnaissance phase, cyber criminals identify non-publicly available information, which they threaten to release or use as leverage during the extortion to entice victims to comply with ransom demands. Impending events that could affect a victim's stock value, such as announcements, mergers, and acquisitions, encourage ransomware actors to target a network or adjust their timeline for extortion where access is established," the agency added.

- **Data sell-off auctions.** Rather than negotiating with only the victim attempting to reclaim lost data, ransomware groups open bidding to all interested buyers by holding public, online auctions to sell off various portions of the data to highest bidders. With sell-off auctions, organizations lose business-critical information and are at higher risk of more sophisticated and strategic attacks since their data remains semiprivate, exclusively for the cybercriminal purchasers to use at their sole discretion.
- **Media amplification and cold calling.** If initial ransomware attacks aren't enough to coax victim organizations into paying out their ransoms, ransomware groups may take to cold calling high-profile journalists and media outlets who would jump at the scoop. Cybercriminals may also reach out to other concerned stakeholders, such as the victim's board of directors, customers, third-party vendors, suppliers, and strategic business partners—all of whom may be affected and may question why they're hearing the news first from ransomware groups instead of their internal staff or trust cybersecurity partner.

These tactics will increase in frequency and impact in 2022 and are much more likely to increase the potential of material, board-level risk for companies.

As ransomware attackers continue to expand their operations, regulators, insurers, and stockholders are struggling to keep up.

2. REGULATORY, INSURANCE, AND LITIGATION RISK WILL CONTINUE TO INCREASE IN 2022.

As ransomware attackers continue to expand their operations, regulators, insurers, and stockholders are struggling to keep up. As a result, trends that were initially seen in 2021 are likely to continue in 2022 and present significant liability risks to companies and their boards.

- **Cyber insurance may not provide the expected safety net.** Ransomware has become the primary cause of claims against corporate cyber insurance policies, accounting for 75 percent of all cyber insurance claims in 2022 (up from 55% in 2016).[4] As a result, premiums are going up by over 25 percent annually,[5] and loss ratios are increasing by 50 percent year over year.[6]

  The volume, pace, and cost of ransomware claims is an unsustainable set of trends for insurers, and we should expect to see insurers less likely to pay for claims arising from ransomware attacks[7] and to see them revise their cyber insurance policies to exclude reimbursement for ransomware payment, as AXA did in 2021.[8]

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[4] AM Best Market Segment Report: "Best's Market Segment Report: Ransomware and Aggregation Issues Call for New Approaches to Cyber Risk."

[5] The Council of Insurance Agents and Brokers' (CIAB) 2Q21 P/C Market Survey - https://www.ciab.com/download/31507/.

[6] AM Best Market Segment Report: "Best's Market Segment Report: Ransomware and Aggregation Issues Call for New Approaches to Cyber Risk."

[7] For example, in 2020, cyber insurers sought to withhold payment for a state-sponsored ransomware attack under the "war exclusion." See Jon Bateman, "War, Terrorism, and Catastrophe in Cyber Insurance: Understanding and Reforming Exclusions," October 5, 2020, on carnegieendowment.org.

[8] Tim Starks, "Experts suggest French insurer AXA's plan to shun ransomware payouts will set a precedent," May 10, 2021, on cyberscoop.com.

These changes may significantly increase the unreimbursed liability to victim companies and should be factored in as boards consider their companies' insurance positioning and cyber defense expenditures.

- **Sanctions compliance law is evolving quickly, and may limit a company's ability to pay a ransom.** In 2021, the Office of Foreign Assets Control (OFAC) has focused sharply on ransomware payments, with an objective of slowing the growth of the criminal digital finance infrastructure. Specifically, OFAC "strongly discourages all private companies and citizens from paying ransom or extortion demands, and recommends focusing on strengthening defensive and resilience measures to prevent and protect against ransomware attacks."[9]

  In connection with OFAC's more aggressive posture, ransomware payments are under significantly increased scrutiny, and it is essential that any company making a ransomware payment run a robust OFAC and sanctions compliance check in order to ensure that a payment is permissible by law. For directors, this means that payments (and the related system recovery) may take a longer time than anticipated, and in some cases where a ransomware actor is affiliated with a sanctioned person, making a payment to restart operations may not be legally permissible. Directors might consider asking their compliance leaders and organizations to review OFAC guidance strenuously as part of the company's cyber-risk preparedness plan.

It is essential that any company making a ransomware payment run a robust OFAC and sanctions compliance check in order to ensure that a payment is permissible by law.

- **Public disclosure requirements following a ransomware attack are likely to expand in 2022.** Currently, the SEC does not explicitly require public disclosure of a ransomware attack, unless the attack otherwise meets the materiality threshold for disclosure.[10] However, the SEC appears to be paying close attention to disclosures made by victim companies, and holding them to a high standard if material ransomware or other cybersecurity events go undisclosed.[11] Moreover, federal regulators and individual states are considering a number of laws which would require public disclosure of ransomware events.[12]

  Public disclosure of a ransomware attack or a ransomware payment can have significant, negative impacts on customer confidence, third-party relationships, and stock price. Accordingly, while we are doubtful that there will be support for a sweeping federal-led obligation to make public disclosures, directors and legal teams should carefully monitor current and evolving efforts to oblige disclosure of incidents.

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[9] Updated Advisory on Potential Sanctions Risks for Facilitating Ransomware Payments, U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC), dated September 21, 2021.

[10] Securities Exchange Commission Statement and Guidance on Public Company Cybersecurity Disclosures, February 26, 2018.

[11] In 2021, the SEC fined Pearson PLC and First American Financial Corp. relating to cybersecurity disclosure control failures. See SEC press release 2021-154 and SEC press release 2021-102.

[12] In October 2021, Democrats in Congress introduced the Ransom Disclosure Act, which would mandate disclosure of a ransomware event, which disclosures would be made public at least annually.

- **Directors' fiduciary duties associated with ransomware events may grow in scope.** In addition to regulatory change, Delaware courts continue to expand directors' obligations relating to ransomware and cybersecurity attacks generally. In October 2021, in response to a claim associated with a large data breach at Marriott, the Delaware Chancery Court affirmed that directors do have a duty of oversight in cybersecurity. Noting that, "Cybersecurity has increasingly become a central compliance risk deserving of board level monitoring at companies across sectors,"[13] boards at companies in all industries must monitor cyber risks carefully, engage outside advisors to support awareness and compliance, and act diligently to mitigate cyber risk.

3. THESE TRENDS PROVIDE BOARDS WITH A CLEAR SET OF CONSIDERATIONS TO ADDRESS TO PROVIDE EFFECTIVE OVERSIGHT OVER RANSOMWARE RISK.

Directors' oversight duties in 2022 are increasingly clear. Boards will need to take an active role overseeing cybersecurity measures, including (i) ensuring that their companies are prepared to defend themselves from cyberattacks effectively, (ii) being primed to act quickly and effectively in the event of an attack, and (iii) following an attack, validating that the response is conducted carefully, legally, and according to a predetermined plan.

Cybersecurity expenditures are not just defensive actions, but instead should also be seen by directors as an investment in a company's operational continuity.

- **Defend:** At risk of repeating the message that has been presented to boards for years, the best way to prevent a ransomware attack is to invest in a robust cyber-security infrastructure. Cybersecurity expenditures are not just defensive actions, but instead should also be seen by directors as an investment in a company's operational continuity. At the board level, this means
  - including cybersecurity as part of a company's full risk management framework;
  - supporting and empowering the chief information security officer (CISO) and his or her peers and teams with the responsibility, autonomy, and budget to meet or exceed best practices; and
  - adopting standard metrics to monitor the occurrence and mitigation of cyber risks.

More granularly, board members should ask their executives if they are engaging in the following defense best practices: maintenance of backups; employing best practices for remote access (including multifactor authentication); conducting regular vulnerability scanning; patching software in a timely manner; implementing security awareness trainings; and enabling strong spam and phishing filters, among others.[14] The board might also consider asking the company's CISO if the organization's budget fits the demands of these practices.

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[13] See Firemen's Ret. Sys. of St. Louis v. Sorenson (October 5, 2021), Del. Ct. Chancery.
[14] Based on Cybersecurity & Infrastructure Security Agency (CISA) best practices.

Boards must take steps to prepare *before* an attack occurs, which means ensuring that the company is ready to respond quickly and effectively to an attack.

- **Prepare:** Boards must take steps to prepare *before* an attack occurs, which means ensuring that the company is ready to respond quickly and effectively to an attack. For a director, the first step in training to respond from the board level to an attack is knowing the data—specifically which data is most valuable to their companies' operations and the monetary value of its loss and recovery.

  Additionally, adequate preparation includes having and regularly reviewing an incident response plan that

  - clearly allocates roles and responsibilities, both internally (including security, information technology, communications, and legal experts) and externally (including law firms, breach coaches, incident responders, threat actor engagement experts, and insurance providers, among others);
  - delineates the board's role and level of involvement following an attack, in order to maximize the positive impact that a board can have in a moment of crisis;
  - encourages the use of threat intelligence tools to actively monitor threat actor communities for breaches, data leakage, and vulnerabilities; and
  - requires periodic tabletop exercises to validate the effectiveness of the incident response plan.

- **Respond:** Finally, in the event of a material ransomware attack, directors will likely be engaged by the CEO, general counsel, and CISO to provide oversight—and sometimes with great urgency, depending on what the company's incident response plan has laid out. In connection with a post-attack response, board oversight includes ensuring the following:
  - clinical and emotion-free execution of the incident response plan;
  - use of a third-party negotiator to ensure consistent and experienced communications and negotiations with the ransomware actor;
  - maintenance of attorney-client privilege, to ensure that all key communication associated with the response are kept private and not discoverable in potential legal claims;
  - compliance with critical legal requirements, including OFAC and sanctions law; and
  - execution of a communications plan that balances the needs and obligations of stockholders, customers, partners, employees, data subjects, and regulators.

In conclusion, the increased frequency and severity of ransomware attacks requires the close attention and oversight of corporate boards. In 2022, this trend is certain to continue, and boards that track the key risks associated with ransomware and ensure that their teams prepare and respond according to best practices will be the most successful in minimizing risk and preserving their companies' critical data and operations.

Donald Saelinger

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The Role of Boards in Assessing DE&I Practices with Advanced Data Analytics

By Alok Khare, FTI

INTRODUCTION

Racial and social gaps, paired with shifting social expectations in the United States, have increased the pressure on boards to act on diversity, equity, and inclusion (DE&I). While underlying social norms have been gradually shifting toward inclusiveness for some time, the #MeToo movement and the SEC's recent approval of Nasdaq's Board Diversity Rule[1] has catapulted the debate front and center. For boards, it's time to take immediate steps to review the DE&I practices at their companies. This involves evaluating the company's workforce composition, hiring practices, performance evaluations, and more. Increasingly, companies are instituting robust data and analytics infrastructures to unlock data-driven insights that better inform DE&I strategies. Before implementing solutions, however, boards must understand the changing DE&I landscape.

The scope, tenor, and norms governing DE&I conversations around the boardroom table have shifted dramatically—to one that now demands more transparency and accountability combined with better tracking capabilities, especially with respect to characteristics such as gender, race, religion, age, and nationality.

[1] See Nasdaq Rule 5605(f), Diverse Board Representation.

Companies should have a transparent feedback loop so that the outcomes of the claims are communicated and people know the situation was handled properly.

Boards also need to focus on diversifying their overall composition. For instance, the Nasdaq Board Diversity Rule is the latest in a string of laws started in 2019 when California became the first state to require diversity on corporate boards, starting with women and followed by "underrepresented populations."[2] The rule now requires listed companies to have at least two diverse board members. The Nasdaq Board Diversity Rule is not a mandate; instead, it requires listed companies that do not have at least one director who self-identifies as female (regardless of their designated sex at birth) and at least one director who self-identifies as an underrepresented racial or ethnic minority or as LGBTQ+ to provide a written explanation for their failure to meet these diversity goals.[3]

Moving forward, boards should be aware of four emerging DE&I trends that will impact how they can help organizations to cope with changing laws and increasing societal expectations around diversity:

KEY PROJECTIONS

1. **Greater use of proactive DE&I assessments is likely:**
   What used to be a reactive tactic is now becoming a proactive solution. For example, companies are beginning to proactively do regular DE&I assessments at specific intervals, such as during annual promotion periods and at end-of-year evaluations, instead of waiting for issues to be raised. Bigger organizations are also starting to use rolling assessments to proactively monitor real-time data related to DE&I through data collection and advanced analytics, which can reveal crucial insights and better outcomes across the employment life cycle. Additionally, companies are also using anonymous surveys, tip lines, and other forms of communication to ensure that workers feel comfortable stepping forward and reporting incidents.
2. **How investigations are conducted are as important as their outcomes:**
   When things do go wrong, boards are held responsible for the outcomes of DE&I practices and for how company leaders handle investigations. Once an issue is raised, outside parties should be brought in to handle the investigation and ensure neutrality. Finally, companies should have a transparent feedback loop so that the outcomes of the claims are communicated and people know the situation was handled properly. Throughout the process, boards must ensure that conflict resolution and investigations do no further harm to marginalized individuals.
3. **Employee data needs to be collected:**
   The foundation of tracking DE&I results is having the right data. Companies need to have the predictive characteristics of their employees to be able to analyze DE&I efforts in the company. As more organizations embrace data and analytics to

[2] See June D. Bell, "Corporate Board Diversity: Moving Beyond Lip Service," posted on shrm.org on January 16, 2021.
[3] See William S. Anderson, Troy L. Harder, Jason M. Jean, Kathy Witty Medford, and Caroline E. Ellis, "SEC Approves Nasdaq Board Diversity Requirements," on natlawreview.com.

proactively monitor their DE&I programs, company leaders and boards will need to devise plans to collect the appropriate employee data. Many companies are asking employees directly to self-identify, communicating clearly that the intended use of the data is for DE&I efforts. Companies could also use alternative methods, such as the Consumer Financial Protection Bureau (CFPB) Bayesian Improved Surname Geocoding (BISG) proxy method to predict race and ethnicity.[4] While the BISG method has its issues, it is a method that regulators often rely upon in their investigations.

4. **Shareholders will continue to demand more diversity:** The Nasdaq Board Diversity Rule strongly suggests that investors are going to continue to look to boards to diversify, especially given the focus on governance as a critical part of overall environmental, social, and governance (ESG) criteria. This is important given the increasingly diverse US population. There has been some recent progress in this area. Since 2020, about 72 percent of new directors are from under-represented groups.[5] Boards can make a commitment to continue these diversity trends by creating a committee to study diversity within the company, as well as by creating plans to help identify new diverse board members.

Disparate treatment occurs when a policy or practice intentionally discriminates against a group of people.

BOARD IMPLICATIONS

In light of these trends, boards must make DE&I efforts a priority in 2022 and beyond. This can be done by examining disparate impact and then identifying ways to address the issues, if any, that these examinations might reveal.

Understanding disparate impact

Most company leaders are familiar with the concepts of disparate treatment. Disparate treatment occurs when a policy or practice intentionally discriminates against a group of people.[6] In contrast, disparate impact occurs when a policy or practice is neutral, and yet that policy/practice results in a disproportionate impact on a protected group.[7]

As part of the DE&I process, it's critical for employers to proactively assess "disparate impact" by identifying assessment areas, such as hiring level, compensation, and promotions. The assessment can start with a simple examination of averages (e.g., promotion rates, salaries) across protected and non-protected groups. However, averages need to be adjusted for employee-specific characteristics (e.g., different levels of experience while reviewing promotion rates) for conclusions to be meaningful, and it is often done through sophisticated statistical tests (e.g., multiple regression,

[4] Consumer Financial Protection Bureau, *Using publicly available information to proxy for unidentified race and ethnicity: A methodology and assessment* (Summer 2014), p. 3.

[5] Spencer Stuart, "2021 S&P 500 Board Diversity Snapshot," on spencerstuart.com, noting, "Nearly half — 47% of new directors are Black/African American, Asian, Hispanic/Latino/a, American Indian/Alaska native or multiracial and 43% are women. Together, directors from historically underrepresented groups account for 72% of all new directors."

[6] Society for Human Resource Management, HR Q&As, "What are disparate impact and disparate treatment?" on shrm.org.

[7] Ibid.

logistic regression, etc.).[8] The statistical results could be supplemented with confidential interviews, anonymous surveys, and confidential focus groups with a cross-section of employees.

Relatedly, board members should also consider employee training to overcome unconscious bias, which, if left unaddressed, can lead to disparate impact.

How to increase diversity

The established legal protocols for employers are clear, and businesses must be proactive in optimizing existing policies, programs, and processes to prevent discrimination in the workplace. But there are ways to go beyond legal obligations to foster a more diverse and inclusive workforce:

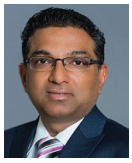
- **Conduct anti-discrimination and anti-harassment risk assessments** intended to identify, prioritize, and assign accountability for managing specific areas where these risks may arise.
- **Assess the design of the organization's anti-harassment and anti-discrimination compliance programs**, inclusive of organizational culture, governance structure, board reporting processes, policies and procedures, training, auditing, and monitoring.
- **Evaluate the degree to which the organization's anti-discrimination and anti-harassment compliance programs** are linked to broader, strategic initiatives related to diversity and inclusion.
- **Review organizational processes** that relate to the end-to-end employment life cycle to ensure compliance, from recruiting and hiring to separation.
- **Engage with the community and employees** to ensure that all stakeholders are aware of your DE&I efforts.
- **Make DE&I part of the company's growth strategy**, including looking at how new hires and more diverse boards could strengthen company performance.

There are ways to go beyond legal obligations to foster a more diverse and inclusive workforce.

CONCLUSION

Once employers have a good grasp of the DE&I challenges that they face and ways to leverage data to improve outcomes, boards will be in a stronger position to initiate long-lasting structural change. It is important to understand that liability and reputational risks around DE&I will not subside. The scale and speed at which this change is taking place, combined with diverse stakeholder expectations, including your company's employees and customers, will continue to intensify. Yet, with the right analytics in place, organizations will be much better positioned to benchmark progress and apply data-driven actions to mitigate areas of vulnerability and strengthen overall DE&I corporate practices.

[8] See, for example, Alok Khare, Maurice Crescenzi, and Matt Duffy, "Leveraging Data Analytics to Assess Corporate Diversity," posted on law360.com on September 14, 2020.



Alok Khare

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Directors and Officers Liability Threat and Insurance 2022 Outlook

By Priya Cherian Huskins, Woodruff Sawyer

The current liability threat landscape for directors, officers, and the companies they serve includes litigation from a growing variety of sources—all of which put a lot of pressure on the Directors & Officers (D&O) liability insurance purchase decision. Making this decision even more fraught includes year-over-year increases in insurance prices, particularly for new public companies.

Here are the nine key issues directors should consider as they think about the D&O threat landscape and their 2022 D&O insurance renewal.

1. SECURITIES CLASS ACTION SUITS ARE DOWN AND PARALLEL FILINGS DISSIPATING

Woodruff & Sawyer conducts an annual survey to fuel its outlook for D&O insurance by connecting with industry-leading underwriters to get their view on what's substantive and what needs focus in the upcoming year. Per this year's *Underwriters Weigh-In* survey, the good news is that the overall rate of securities class action suits is down, and parallel filings are dissipating. According to the D&O Databox, Woodruff Sawyer's proprietary dataset of D&O-related litigation, securities class action suits are down 21 percent when comparing the same year-over-year time period. Only 146 cases were filed through Oct 2021, compared to 184 cases filed during the same time period in 2020.

Parallel cases, the phenomenon of one issuer being sued in both state and federal court for the same alleged violation of Section 11 of the Securities Act of 1933, has

been a problem for some time now. In a piece of startlingly good news, the rate of parallel suits filed against IPO companies is down drastically (52% of 29 cases in 2020 compared to 25% of 24 cases from January through October of 2021).

Parallel suit filings are down because of the success companies have had in including federal choice of forum provisions in their certificates of incorporation. These provisions have allowed state courts to find that federal courts have exclusive jurisdiction over Section 11 cases. While it is hard to predict what will happen when it comes to the general rate of securities class action suit filings, we should expect the rate of parallel filings to stay low.

2. BREACH OF FIDUCIARY DUTY SUITS ARE STILL A CONCERN.

Unlike securities class action suits, breach of fiduciary duty litigation brought derivatively typically cannot be settled using corporate funds. For example, this is the case for companies incorporated under the laws of Delaware. Directors will want to keep an eye on these suits given a recent uptick in large settlements including Tesla ($60 million), McKesson ($175 million), Wells Fargo ($240 million), and American Realty ($286.5 million). No doubt these large settlements embolden plaintiffs to pursue more of these types of suits, which will put more pressure on the company's D&O insurance program.

Good corporate hygiene is critical when it comes to avoiding large dollar settlements. Boards will want to be sure to set up controls to ensure that appropriate information bubbles up to the board, thus allowing the board to exercise its oversight role in an informed manner. Excellent board meeting minutes will be crucial should a board have to mount a defense. Finally, confirm that your board has adopted state choice of forum provisions should any breach of fiduciary duty suit litigation arise. This way, any suits will be limited to just the state in which the company is incorporated; duplicative suits will not also be brought in other states as well as federal court.

Before accepting a board assignment, independent directors considering joining a SPAC board will want to understand how much of the SPAC's working capital will be allocated to the cost of D&O insurance.

3. SPACS

This source of financing has grown dramatically recently. Perhaps inevitably, more SPACs have led to more litigation, making D&O insurance carriers wary of this class of business. The consequence has been the doubling of the cost of D&O insurance for SPAC IPOs between Q4 of last year and this year. In 2022, expect carriers to continue to be wary of this class of business. Before accepting a board assignment, independent directors considering joining a SPAC board will want to understand how much of the SPAC's working capital will be allocated to the cost of D&O insurance. If the amount is too low, coverage will be anemic at best—not a good situation should a regulator or shareholders bring suit.

4. DE-SPAC TRANSACTIONS

As much as D&O insurance carriers have been concerned about providing D&O insurance for companies going public by way of a traditional IPO because of the high rate of litigation against IPO companies, carriers are even more concerned about rising litigation against companies going public through de-SPAC transactions. Consider:

- There were two post-combination securities class action suits in 2019 against companies going public through de-SPAC transactions.
- That number increased to five suits in 2020.
- Through Q3 of 2021, there were 24 suits.

De-SPAC transactions will be an obvious area of focus for plaintiff's bar and the Securities & Exchange Commission (SEC) in 2022.

5. INCREASED FOCUS ON REGULATORY ENFORCEMENT

Expect regulatory enforcement to increase in 2022. The Foreign Corrupt Practices Act is always a favorite for enforcement. In addition, the current administration is focused on False Claims Act actions, specifically as a result of COVID-19 payments. There is no doubt that a major area of focus is the Paycheck Protection Program (PPP) of the Coronavirus Aid, Relief, and Economic Security Act (CARES). In fact, on January 12, 2021, the government announced its first FCA settlement involving PPP loans. More will follow.

Continued focus on your company's environmental impact is important into 2022.

6. COVID-19 FALLOUT

As much as the US economy has opened up, Covid-19 infection rates continue to persist. D&O litigation related to COVID-19 continues, and existing claims likely can take years to resolve. Back-to-work efforts will bring their own challenges, including with respect to employment liability issues. Directors and officers must navigate these rocky shoals carefully. This includes reviewing your company's Employment Practices Liability policy to understand where there may be coverage should you find yourself in litigation.

7. CLIMATE CHANGE

Continued focus on your company's environmental impact is important into 2022. Consider how three climate activists managed to be elected to ExxonMobil's board based on their environmental aspirations and the support of institutional shareholders. Expect more actions like these in 2022.

Climate-related disclosures cannot be done in a careless way, particularly given that the SEC has set up a task force to examine climate disclosures. There is no question that the SEC will bring enforcement actions against instances of improper disclosure to ensure that everyone understands that these disclosures must be accurate and not merely aspirational.

8. DIVERSITY ON THE BOARD

2020 saw a spate of diversity lawsuits brought against boards of directors. Most of these have not moved forward in a meaningful way. Nevertheless, political, and social issues are still being pushed into the boardroom. Directors and officials should expect to continue to need to address these sensitive issues in 2022.

9. CYBER RISK

While boards are getting better at overseeing cyber risk, the ramifications of ransomware and other cyber events continue to escalate. This means cyber liability insurance rates have risen, and some insurance carriers are also pulling back on coverage. In addition, carriers are imposing higher underwriting standards than in the past. Directors and officers will want to get ahead of the curve when it comes to exploring what coverage will be available at what price in 2022.

PREPARING FOR YOUR 2022 D&O INSURANCE RENEWAL

Understanding the threat landscape—and how your company is positioned within this landscape—is a critical first step. Ask your broker for data to help you understand both the likelihood of being sued and the costs associated with various types of suits.

Next, be realistic about what is happening in the D&O insurance market. While there is good news in the form of new entrants coming into the D&O insurance market, prices will not fall back to 2015 levels (or better) quickly. As insurance capital supply starts to loosen, you want your D&O insurance broker to optimize the search for insurance carriers that are interested in putting their capital behind your company. This is a match-making process that is enhanced by getting an early start to your renewal process and having a clear idea of the risks you particularly want to be sure to cover, and at what level.

Priya Cherian Huskins

Priya Cherian Huskins is a recognized expert and frequent speaker and guest lecturer on D&O liability risk and its mitigation. In addition to consulting on D&O insurance, she counsels clients on corporate governance matters, including ways to reduce their exposure to shareholder lawsuits and regulatory investigations. Cherian Huskins has an impressive list of publications, speaking engagements, and awards for her influence and expertise in the industry. She has appeared on CNBC, has been quoted in periodicals such as the *Financial Times* and the *Wall Street Journal*, and she is the author and editor of the *D&O Notebook* blog. In addition to serving as a board member at Woodruff Sawyer, Cherian Huskins serves on the board of an S&P 500 public company, a mid-market public company, and a SPAC. She also serves on the advisory board of the Stanford Rock Center for Corporate Governance.

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