Southeast Audit Committee Network

February 2019

SEACN

SUMMARY of THEMES

Disclosures and investor engagement, blockchain, and corporate conduct and culture

Southeast Audit Committee Network (SEACN) members met in Coral Gables on February 7, 2019, for discussions on investor engagement and innovations in corporate disclosures, blockchain and evolving applications, and corporate culture and conduct.

Members also discussed the US Securities and Exchange Commission's (SEC's) request for comment (RFC) regarding quarterly reporting, including the nature, content, and timing of earnings releases and quarterly reports.[1] We will hold similar conversations on the RFC with other networks and share the results separately.

Disclosure trends and investor engagement

Members and guests exchanged views on the recent trends in corporate disclosures and investor engagement with Ray Cameron, head of investment stewardship, Americas at BlackRock, and Jennifer Cooney, advisory director at Argyle Company.

BlackRock's priorities and engagement

Mr. Cameron shared insights into BlackRock's engagement practices and the key points contained in the annual letter to CEOs from Larry Fink, BlackRock's chairman & CEO:

- **Larry Fink letter.** "*Purpose and Profits*" is the theme of this year's letter, explained Mr. Cameron, who noted that there is an *"inextricable link"* between purpose -- a company's *"fundamental reason for being"* — and *"what it does every day to create value for its stakeholders."* Mr. Cameron said that good governance means that companies need to have a clear sense of corporate purpose in order to achieve long term sustainable growth. As Mr. Fink wrote in this year's letter, in an era of political dysfunction and economic volatility, corporate leadership is more important than ever. Additionally, Mr. Cameron explained that a company's ability to effectively manage material ESG factors can be a signal of operational excellence and management quality. As such, BlackRock's Investment Stewardship team expects companies to identify and report on business-specific ESG risks and opportunities and explain how these are managed. As part of its fiduciary responsibility to its clients, BlackRock is committed to integrating sustainability considerations into its investment process in order to better assess investment risks and opportunities.

- **Engagement.** Mr. Cameron said that BlackRock's stewardship group participated in over 2,000 meetings with companies in 2018 and governance was a top priority in many of those discussions. He further explained that BlackRock *"works on the premise that companies know more about their business and operations than we do"*. Therefore BlackRock's goal is not to be too prescriptive but to understand how the company is approaching issues important to BlackRock as an investor, and how its policies and practices position the company for long term growth. Mr. Cameron said, *"Direct interactions and disclosures are valued because they provide a window into how risk and opportunities are viewed, how the board holds management accountable, and whether the company is living up to its long-term strategy and plan."* In conversations about climate or cybersecurity, for instance, BlackRock solicits the company's thoughts about how it assesses salient risks and what steps it might take to mitigate them. They may seek additional engagement where they see signs that suggest the company's practices may be an outlier, e.g. if they have no women on their board, or are focused heavily on a specific risk area. Typically, that engagement happens with the company's management, but independent lead directors are becoming an increasingly important part of those conversations. Other directors may also be included on a case-specific basis. He also noted that while many companies have reacted positively to BlackRock's engagement and progress has been made around many governance issues, board diversity is one area where there is still work to do.

- **Disclosures.** Asked about what specific kinds of communications BlackRock values most, Mr. Cameron replied that BlackRock *"finds value in multiple forms of communication. Quarterly reports, for example, offer a scorecard of a company's self-assessment at a point in time and should be viewed in relation to its long-term objectives."* He emphasized that disclosures are one input, as are analyst reports, information from advisory firms, and other industry-specific reports.

- **Proxy advisory firms.** A member inquired whether BlackRock scans the filings and uses AI to do filters and screens. Mr. Cameron responded that BlackRock *"embraces technology as a way to enhance capacity and productivity."* This includes reviewing reports from advisory firms like ISS and Glass Lewis, which may be incorporated into its analysis of a company's governance. However, Mr. Cameron emphasized, *"We do not exclusively rely on their recommendations and we do not outsource our proxy voting responsibilities."* BlackRock gives consideration to proxy advisory firm reports for context*, "in some instances after we have concluded our engagement."*

- **Red flags.** Mr. Cameron said that a lack of disclosure may be a red flag that suggests the need for additional engagement. *"For example, when you know a company is operating in an industry with specific issues that are ignored or glossed over in their disclosures. Or, instances where companies concentrate their disclosures around one particular risk."* A member inquired whether Mr. Cameron would *"ever recommend that BlackRock sell [a company] as a result"* of something they perceived as problematic from an ESG perspective. Mr. Cameron noted that the majority of BlackRock's investments are in index funds, meaning they have to hold the stocks of companies included in those indexes. However, this does not mean that BlackRock will overlook those issues. *"We would share our concerns with the company, with the intention of giving them time to address them. However, if we find that the company is not sufficiently responsive to shareholder concerns despite repeated engagement, we may choose to exercise our right to vote against management."* Mr. Cameron remarked that BlackRock has an interest in ensuring those companies are focused on long-term sustainability, *"because we represent permanent capital".*

Companies improve content and communication

Ms. Cooney, Mr. Cameron, and members discussed improvements being made to corporate disclosures and the issues that are of most concern to investors.

- **Risk and risk oversight.** Ms. Cooney remarked that *"the number one issue and where we seem to be spending the most time this year is risk oversight. Historically disclosures have been limited to the requirements, essentially explaining how risk is delegated among board committees,"* she said, but noted that investors want to understand more about board oversight now. *"Instead of just saying 'the Audit Committee oversees operational risk,' say what's included in operational risk."* Argyle is also seeing *"more detail about the enterprise risk management (ERM) process, even though that is primarily at the management level. There is an effort to explain how top risks filter up to the board for oversight."* BlackRock's Ray Cameron agreed that risk disclosures matter, but he emphasized that companies need to discuss *"not just what could go wrong, but also how they think about opportunities."*

- **Human capital management.** Investor concerns about the potential for unexpected CEO or senior executive departures and a greater interest in how companies are preparing for the future of the workforce is driving a desire for more disclosure about the board's approach to succession planning and other human capital management issues. Investors are *"looking for how the board thinks about human capital and gets a handle on it,"* Ms. Cooney said. One member emphasized, *"Boards pay substantial attention to the supply chain of human capital below the CEO."* Another member recounted, for example, how after his company's *"extensive pay equity study,"* it was now *"ready to deal with the detailed findings, position by position, band of experience by band of experience."* Ms. Cooney said companies usually address disclosures on these issues in either the CEO or board letter or *"depending on how each company handles the subject, it may land in the risk oversight area, or as part of succession planning and oversight of organizational wellness."*

- **Other focus areas.** Other areas seeing increased disclosure attention are strategy broadly, corporate culture, including how the board thinks about and measures culture, and efforts to tie the story together around purpose, risk, culture, people, and performance. With governance practices having improved significantly during the last few years, investors have turned more attention to "E" environmental, and "S" societal, factors. Larry Fink's letter encouraged CEOs to be more vocal on these issues. *"Investors want to know the priorities you are focused on and how you are assessing them … how purpose is linked to long-term strategy and how the board is looking at ESG issues and their impact on financial performance,"* said BlackRock's Ray Cameron.

- **Effective narrative versus caution.** It can be difficult to find the right balance between due caution and telling the firm's story in a clear, concise, and engaging manner. While acknowledging this tension, members stressed the importance of sharing the company's narrative. One member said, *"We had a robust pay for performance system, but it was too complex to explain."* The company converted from *"a 10K/10Q proxy written by lawyers to a narrative that provided color and conveyed the company's purpose. The upshot was an investor 'yes' response of between 80 and 85% on say and pay."* Another member spoke about conducting a comprehensive assessment of a company's risk strategy. The attorneys' inclination was to cover everything that could go wrong, but, recognizing that the SEC has asked companies to write about their unique circumstances, the company regrouped and radically streamlined its disclosures to address the most pressing and material ones. The company and board *"de-lawyered"* their documents, to borrow Ms. Cooney's term, prioritizing clear, readable Qs and Ks, emphasizing sustainability and proxy reports over financials. Many companies are adopting a more visual approach to disclosures, adding color, graphs, and charts to improve the ability to easily glean important information.

Ms. Cooney added that, as shareholder engagement grows and "*proxy documents become packed, the need for streamlining grows."* Both Mr. Cameron and Ms. Cooney advised companies to focus their disclosures on information that's relevant to companies' unique circumstances and that would be most useful to investors.

Finally, members asked Mr. Cameron for his view on the state of governance in American companies today. He was optimistic: *"Governance is dramatically improved from 10 years ago … boards are increasingly rising to the occasion and dedicating their focus and energy to good governance practices."* He summed up with a charge to members: *"You are in a very privileged position as directors and owe it to not only your company, but to all your stakeholders to be the most effective director you can be. And that means being attentive to these important issues."*

Blockchain technology and applications

Penny Morgan, manager of global securities operations at Western Asset, and Eli Stern, principal, financial services organization, advisory services practice at EY, shared their views on blockchain technology. Few members reported their companies had adopted blockchain, even in the experimental or pilot stage, but all expressed great interest in its potential applications.

Guests and members discussed blockchain's disruptive impact in financial markets, real estate, shipping and insurance, supply chain, and identity protection. Conversation centered on the ways blockchain technology could lower transaction costs in many industries, its potential practical applications, and its future.

- **Blockchain technology lowers transaction costs.** Blockchain is a digital distributed ledger that allows the recording of data and transactions. Mr. Stern noted that its value includes transparency, fast and accurate data management and preservation, and increased trust. As he explained, *"anyone [in the blockchain] can see the history of transactions, and it won't allow you to transact on the ledger without the consensus of everyone who has access to the ledger."* So, for instance *"underlying loan data moves from originator through the secondary market to rating. Wine [moves from] harvest to distributor, seller, and buyer … Blockchain manages and preserves the data [and] records the same version of the data, in real time."* Ms. Morgan explained that she had convinced her company to invest in and adopt blockchain because she and colleagues believe it will have a transformative effect on financial markets and well beyond, requiring companies to invest early if they are going to help *"write the rules,"* and ensure they have employees who understand how it works and its potential applications. She said: *"Blockchain ensures the security of data and lets the relevant people share information at the same time, and we no longer have to reconcile with each party [to whom] we send the data."*
- **Practical applications.** Asked what blockchain has improved and what it is replacing, Ms. Morgan gave examples of ways that it can streamline complex financial market infrastructure processes, reduce the number of intermediaries, and provide real-time information and reconciliation. Mr. Stern concurred, saying that in financial institutions, *"we're seeing intra-company settlements, settlements between entities within [a financial services company] – intra-day lending agreements."*

  Mr. Stern said EY was hired by Microsoft to create a blockchain application for royalty payments to XBOX designers. The application cut a process that took 45 days down to *"a matter of minutes."* Members shared other examples of blockchain's current and potential uses, ranging from insurance claims and warranty processing, to tracking the provenance of diamonds to ensure they were not blood diamonds, or verifying whether fish were wild or farmed. Ms. Morgan cautioned that *"finding the right use-case is key."* Mr. Stern concurred, saying, *"You need a problem that lends itself to the value added that blockchain offers."*

Corporate conduct and culture

Members discussed the board's oversight of corporate conduct and culture with Paul Saltzman, partner at White & Case. Mr. Saltzman defined culture as *"values, principles, standards, and processes that influence a company … It can be defined and articulated, measured, and monitored. It can be stated or unstated."* He emphasized that the board plays an important role in ensuring that the culture is aligned with strategy, and said that companies and boards need to demonstrate a concrete commitment to the values they articulate.

Boards need *"to be rigorous in [their] questions to management,"* according to Mr. Saltzman. Several members mentioned the importance of closely monitoring the whistleblower line, conducting culture audits, and engaging with mid-level managers in the organization to get a better sense of the culture. The external and internal auditors can also provide useful insights to the audit committee and board. Mr. Saltzman said there are generally warning signs or *"red flags"* that portend potential issues:

- **Incentive Structure.** One of the most important red flags to watch for is whether the organization's incentive structure is consistent with the values management has articulated. Mr. Saltzman referenced the root cause of failure at one financial institution, for instance, where the incentives created a culture that ultimately encouraged fraudulent behavior in the name of performance. He stressed that organizations also need to look beyond financial incentives, examining who gets promoted, for instance.
- **How tone at the top is translated and enforced.** Mr. Saltzman also encouraged boards to examine *"the 'tone at the top' and how that affects 'the middle.'"* He suggested that if management doesn't *"practice what they preach, if their behaviors don't reinforce the cultural values they claim to espouse, employees will know that and act accordingly."* While some members supported the need for an understanding of *"tone at the middle,"* others suggested the role of the board is to ensure the CEO and senior management are creating that culture, and the board should therefore ensure they get to know the CEO well enough to get a sense for what kind of messages are being delivered and reinforced.
- **Candor.** Is there a culture of openness and candor or is there a *"euphemistic atmosphere where bad actions are spun or colored?"* asked Mr. Saltzman. One member underscored the need for boards to have free and open access to all parts of the company, declaring that *"if the CEO won't let you go where you want, I wouldn't join the board."*
- **Complacency**. Mr. Saltzman cautioned: *"Don't become complacent … this is where the board's role is most critical. Are you reviewing why you won the mandate? Why profits are so high?"* Mr. Saltzman recalled a 1994 scandal when a trader at a financial institution exploited a flaw in the system to book fake profits. A week before this was discovered, the trader *"was awarded 'trader of the year' for all the money he was making … the firm took the money but didn't really look into it."*

Mr. Saltzman concluded by saying that *"Companies and boards have an opportunity to distinguish themselves"* in this area, and *"the journey is as important as the destination."*

Meeting participants

The following SEACN members attended all or part of the meeting:

- Eddie Adair, Rayonier Advanced Materials
- Maureen Breakiron-Evans, Cognizant
- John Davidson, Allergan and Legg Mason Inc.
- Denise Dickins, Watsco
- Juan Figuereo, PVH
- Jim Hunt, Brown & Brown
- Doug Johnson, Aflac
- Rich Macchia, Fleetcor
- Rick Mills, Commercial Metals Company
- Jason Papastavrou, United Rentals
- David Walker, Chico's FAS, CommVault Systems, and CoreLogic

EY was represented by the following:

- Jim Estes, Southeast Assurance Regional Managing Partner
- Bryan Yokley, Georgia/Alabama/Tennessee Market Segment Leader, Assurance Partner

Endnotes

[1] "The request for comment solicits public input on how the Commission can reduce burdens on reporting companies associated with quarterly reporting while maintaining … disclosure effectiveness and investor protections. In addition, the Commission is seeking comment on how the existing periodic reporting system, earnings releases, and earnings guidance … may foster an overly short-term focus by managers and other market participants." US Securities and Exchange Commission, "SEC Solicits Public Comments on Earnings Releases and Quarterly Reports," press release, Dec. 18, 2018.