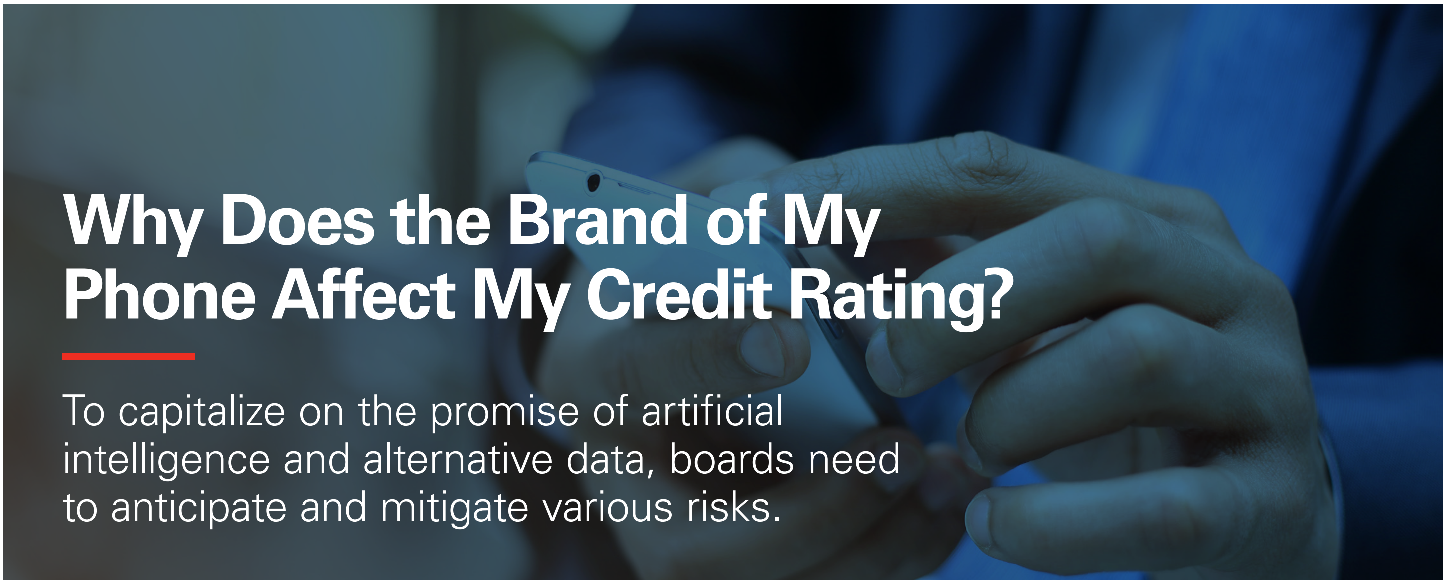
Skadden

The Informed Board

Winter 2021

The business world confronts a host of shifting challenges in 2021. To help boards navigate these, Skadden is launching *The Informed Board*, a package of concise articles that provide broad insights about key issues directors face. We aim to help flag potential challenges that may not be obvious, explain trends, share our observations and give directors practical tips without a lot of legal jargon. These are based not just on Skadden's deep knowledge of the law, but on our front-line experience inside boardrooms.

We look forward to our continuing discussions with you.



Why Does the Brand of My Phone Affect My Credit Rating?

To capitalize on the promise of artificial intelligence and alternative data, boards need to anticipate and mitigate various risks.

- Hidden biases need to be prevented.
- Neither regulators nor the public will be satisfied with "black box" decisions.
- Reputational risk must be weighed alongside legal requirements.

The Potential

Alternative data and artificial intelligence (AI) have generated tremendous excitement in the business world. The technology offers the potential for faster, more efficient and more reliable decisions. Banks and fintech platforms already use them to make credit decisions, and they show promise in other areas, from fraud prevention to hiring decisions.

But the surprising predictive success of AI-based decision models is precisely what makes them tricky legally. Often, the developers of such models cannot explain the relation between a variable and its predictive value. Anything from where you shop to the type of mobile phone you use or the first letter of your last name may prove to be a predictor of, say, the likelihood you will default on a loan or that you will perform well in a job you are applying for.

To the companies that use such models, this may seem like brilliant data mining — unearthing nonobvious predictors that outperform conventional ones. But to regulators and those harmed by AI-based decisions whose rationales cannot be fully explained, the process may seem capricious.

AI models are the subject of particularly lively debate in the lending sphere, both because lending is a heavily regulated activity and because the technology may turn out to be more reliable than traditional credit bureau factors (number of tradelines, average balance, debt-to-income, etc.). The latter have proven less effective in predicting defaults over the past year, particularly during the pandemic.

Alternative data may also benefit consumers who have not established the kind of borrowing track record typically relied on by credit bureaus. It could therefore expand the population qualifying for credit. Similar benefits and problems arise in recruiting and other areas where AI models based on alternative data are being explored.

Hidden Biases

The appeal of AI is that the technology can make predictions using offbeat data that humans cannot make or explain. But the fact that AI uncovers new and surprising predictors by poring through hundreds of types of data poses a basic problem: The most valuable variables may have no obvious relation to the thing being predicted, such as a borrower's ability to pay its debts.

In the worst cases, outcomes of these models may be both surprising and problematic. For example, one AI-based recruiting model for software developers relied on the success of previous hires. They were almost entirely male, however, and the model turned out to have a strong bias against women — so strong that it excluded any candidate from two women's colleges. That could violate employment nondiscrimination laws in jurisdictions where it's not necessary to show discriminatory intent.

This sort of unforeseen bias is on the minds of bank regulators, because it could violate fair lending rules. This hiring example was cited by Federal Reserve Bank Governor Lael Brainard in a recent speech about AI in financial services. Regulators may demand proof that a similar nonobvious variable is not a proxy for another, forbidden factor such as the race or gender of the applicant.

The hiring example also underscores that companies cannot blindly accept AI-based recommendations as technical wizardry. The predictions based on novel data may be quite explainable if you dig deep enough.

Predictors That Aren't Understood

An AI model's "black box" quality itself poses a problem, apart from any biases. To illustrate this, assume one variable in a lender's underwriting model is whether the applicant uses an Apple or a Samsung mobile phone, because that (hypothetically) has been shown to be highly predictive of an applicant's risk of default.

If predictive value were the only factor, the brand variable might satisfy "safety and soundness" bank rules. But regulations often require more than predictive value. U.S. banking regulators require that financial models be "conceptually sound." And banking rules in the U.S., EU and Hong Kong all generally require lenders to be able to explain to an applicant why credit was denied.

Hence, "explainability" — the ability to articulate the relationship between a variable and the attribute being predicted — has become a buzzword in AI, and is particularly central to fintech regulation and the growth of AI in finance. In the U.S., regulators may also ask if a prospective borrower could anticipate that a lender would consider a certain factor in its decision, so the applicant can take action to avoid being denied credit. If the model uses, say, the first letter of an applicant's surname, the consumer would have few options. (And, of course, if the phone brand proved to be correlated with race, gender or some other factor lenders cannot consider, that would pose fair lending and other problems.)

Potential for Bad Publicity

Finally, reputational risk needs to be weighed. If it becomes public that an institution makes decisions based on complex "black box" models relying on puzzling alternative data, it could lead to bad publicity. Several years ago, a lender drew criticism for scoring applicants based in part on the chain stores where they shopped. As a result, the company stopped using that factor.

Explain Yourself

In many cases, the best approach will be the common sense one: Make sure your business can explain the relationship between each type of data used and the decisions that result. That will be necessary to satisfy regulators, customers and the public at large.

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A Checklist for Boards

Key steps companies can take to identify and mitigate the risks of using alternative data and artificial intelligence models:

- ☐ Make sure the company has reviewed each variable used in the model through a compliance lens. For model variables that are not intuitively associated with the decision at issue, management should challenge modelers to explain why the variable is predictive.
- ☐ Conduct statistical analyses of models to determine whether some variables serve as a proxy for prohibited biases (race, gender, ethnicity, etc.), and explore less discriminatory alternatives.
- ☐ Confirm the accuracy of alternative data points on a regular basis and validate that the model is operating as expected with respect to the data to avoid "model drift."
- ☐ Perform periodic risk assessments, with a focus on the impact of such data on outcomes for groups that are protected by law.
- ☐ Document the results of these analyses and any action plans that grow out of them.
- ☐ Make sure that the use of alternative data does not violate data privacy laws, contractual restrictions on its use (*e.g.*, nondisclosure agreements) or intellectual property rights. For instance, "scraping" data from public websites without permission may infringe intellectual property rights or violate terms of use.

A Practical Guide to the Role of Directors in Fighting Ransomware

Ransomware is such a major threat to businesses that directors need to take an active role overseeing cybersecurity programs.

- Boards need to take an active role overseeing cybersecurity measures.
- Directors may be held personally responsible for lapses that result in attacks.
- U.S. money laundering and sanctions rules may prohibit some ransom payments.

The biggest cyberthreat most companies face is not attacks backed by nation-states like the recent SolarWinds hacking episode. It is ransomware, a type of malware that encrypts its victims' data and holds it hostage until a ransom is paid in untraceable bitcoin.

These attacks have grown more frequent and sophisticated at the same time that more people are working remotely and are more reliant on corporate IT systems. According to BitDefender's analysis of the cyberthreats, there was a 715% increase in detected and blocked ransomware attacks in the first half of 2020 versus that period in 2019. Many of these are never publicly disclosed. In some recent attacks, sensitive data was stolen before it was encrypted, and the attackers threatened to leak it if the victims failed to pay.

Two legal developments bear directly on directors' roles in dealing with the problem:

Officers and directors may face personal liability in the event of a cyber attack. Lawsuits arising from other kinds of data breaches reflect an emerging expectation that directors must play an active role in cybersecurity planning and cannot delegate the issue entirely to management. Those cases suggest that directors may be held personally liable for (a) failing to ensure proper policies were in place to protect a company or (b) issuing misleading statements about their companies' preparedness. For example:

- A class action complaint against one company alleges that its board knew of an initial data breach whose scope only became clear two years later but "failed to act

The Growing Role of Boards in Cybersecurity Planning

25%

Share of financial services firms whose boards discussed cybersecurity more than once a year in 2017

95%

Share of those whose boards or committees discussed cybersecurity at least four times a year in 2020

48%

Share that involve their boards in cybersecurity exercises

Source: McKinsey

sufficiently upon the full extent of knowledge known internally by the company's information security team."

– In litigation over the theft of consumer credit information from Equifax, a federal judge found that the company "relied upon a single individual to manually implement its [software] patching across its entire network" and that person "had no way to know where vulnerable software in need of patching was being run on Equifax's systems." That "failed to meet the most basic industry standard," the court found, and therefore "it was false, or at least misleading, for Equifax to tout its advanced cybersecurity protections" in public filings.

The implication: Directors need to take this threat seriously and play an active oversight role in implementing protections.

U.S. anti-money-laundering and sanctions laws may bar some ransom payments. Boards need to be aware that the Treasury Department requires ransomware victims and their financial institutions to perform due diligence on those to whom they plan to pay ransom. Because several prolific ransomware groups are subject to U.S. sanctions, Treasury rules may prohibit some ransom payments. That leaves the victims with no choice but to rebuild their systems from scratch and suffer the consequences of having their data disclosed publicly.

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A Checklist for Managing Ransomware Risks

- ☐ **Boards should discuss cybersecurity regularly.** A recent McKinsey survey of financial services companies suggests best practices. Nearly 95% of the firms reported that one of their board committees discussed cybersecurity and technology risks four times or more per year. Almost half the companies involved the board in cybersecurity exercises, and nine in 10 provided regular updates on cybersecurity to the full board.

  Financial services firms furnish a good model because they have long been targets of attacks and have advanced cybersecurity programs. Their approach hints at what shareholders, regulators and others are likely to demand from boards in other industries.

- ☐ **Responsibilities need to be defined in advance.** The inevitable disruption of an attack can be compounded by uncertainty about who should handle different aspects of the response. For instance, CIOs/CTOs, general counsels and communications chiefs will each have roles, sometimes overlapping, so their responsibilities need to be spelled out in advance. The board should also consider pressure-testing management's plans and lay down procedures to ensure the board plays an appropriate oversight role during an incident.

- ☐ **Prepare a response playbook in advance.** Corporate networks are often disabled by ransomware. Since attackers typically demand payment within days, victims can find themselves scrambling to engage outside experts (*e.g.*, a digital forensics consultant, ransomware negotiator, outside counsel and public relations specialist) and make strategic decisions while the company's e-mail system is inoperable and vital records are inaccessible. It may be impossible, for example, to fulfill contractual obligations to notify customers about the incident because contact or contract information has been locked up by encryption.

  Procedures need to be in place to deal with such a situation. At a minimum, secure communication alternatives need to be in place, and records required to respond to a crisis must be accessible even if primary IT systems are down.

- ☐ **Cybersecurity needs to be assessed within a larger risk management framework.** Given the potentially catastrophic impact of an attack, cybersecurity risks need to be evaluated as part of a company's overall risk management. Budgets for risk mitigation need to factor in the damages an attack could cause, including its impact on customers and suppliers. Companies should find metrics to monitor their progress in mitigating cyberrisks. Objective metrics will also be needed to back up any claims the company makes about its cybersecurity practices, especially those aimed at investors.

- ☐ **Consider hiring outside vendors to test your systems and people.** A survey of directors last year by the University of California, Berkeley and Booz Allen Hamilton showed that many companies seek regular third-party advice to ensure that management is keeping up with the latest evolving threats. That may be essential for the board to fulfill its oversight role.

  Even for companies that follow established procedures, such as the National Institute of Standards and Technology's Cybersecurity Framework, third parties can help verify that those are being adhered to. For example, the American Institute of Certified Public Accountants has set standards for companywide audits of cyberrisk measures.

The Brexit Deal Leaves Some Mighty Big Holes

The Brexit agreement covered goods but not financial or other services, creating uncertainty for many businesses.

- Goods trade was provided for, at the cost of much new paperwork.
- Crucial rules for banking and other services were left unresolved.

The Christmas Eve agreement between the United Kingdom and the European Union to settle their relationship now that the U.K. has withdrawn from the union was hailed by both parties as a successful conclusion to their protracted, contentious talks.

The goods news. The Trade and Cooperation Agreement (TCA) allows goods trade without tariffs or quotas, something the EU has not agreed to so comprehensively with other nations. But goods will need to meet complex rules-of-origin requirements, and businesses will have to adapt to a new regime of customs paperwork that was unnecessary when the U.K. was part of the EU.

Financial services and other omissions. Other key areas of trade were not addressed by the agreement or rules were not finalized. That includes financial services, state aid and subsidies, data flows and mutual recognition of professional services. Since services make up the majority of the U.K.'s economic output, this leaves significant uncertainty surrounding the future trade relationship.

Take financial services, which account for nearly 7% of the U.K. economy. The parties committed to implement international standards, such as the Basel Committee's rules for the banking sector, to which both sides are already party. There is also a commitment to establish a structure for regulatory cooperation. But that is a long way from establishing concrete rules.

Significantly, the TCA does not cover "passporting rights," which have allowed U.K. financial firms to operate in the EU under their U.K.

licenses. Options such as "enhanced equivalence" or mutual recognition remain to be discussed, but the U.K. may conclude that the price of agreeing to an equivalence regime, which would allow firms to operate under their home state regulation for certain financial services, is too high. This could lead to significant regulatory divergence in coming years.

In the meantime, many facets of the future economic trade between the EU and U.K. remain up in the air.

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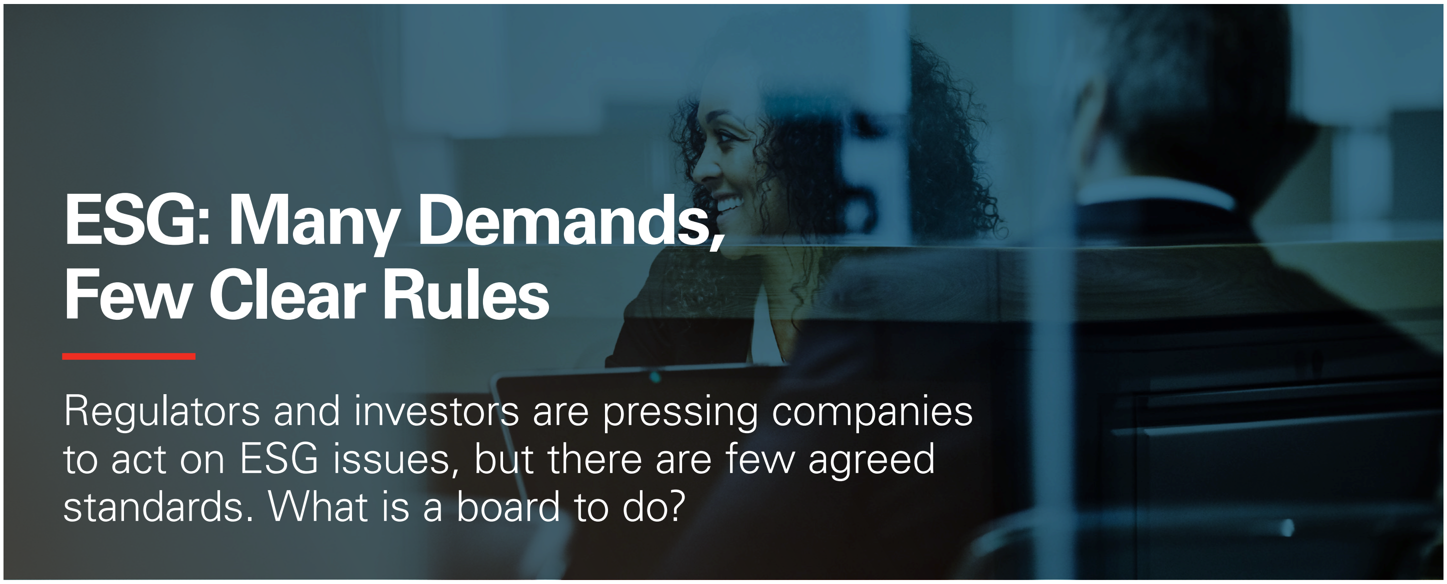

ESG: Many Demands, Few Clear Rules

Regulators and investors are pressing companies to act on ESG issues, but there are few agreed standards. What is a board to do?

- Boards can expect investors and regulators to demand increased disclosure of ESG metrics.
- With no uniform set of ESG standards, companies with global operations may face a hodgepodge of disclosure requirements.
- Investors will push for ESG to play a role in executive compensation.
- Directors need to be fluent in these topics when engaging with shareholders.

Environmental, social and governance issues (ESG) rose to the top of many agendas in 2020. Long-standing concerns about environmental issues continued to be important, but the "S" in ESG came to the fore as the world faced COVID-19 and the issues raised by the Black Lives Matters movement.

A focus on customers, employees, communities and other stakeholders will continue in 2021. We also expect environmental issues to remain a significant topic with the Biden administration's recommitment to the Paris Agreement and the upcoming U.N. Climate Change Conference of the Parties (COP26) in November.

For example, on January 26, asset manager BlackRock announced that it will ask "companies to disclose a plan for how their business model will be compatible with a net zero economy — that is, one where global warming is limited to well below 2°C," and to disclose how those plans are "incorporated into … long-term strategy and reviewed by your board of directors."

Growing demand for disclosure and a lack of uniform reporting standards. The continuing growth of ESG-focused investing, as well as the increased emphasis that asset managers and institutional investors are placing on ESG issues, is driving demand for ESG metrics. Nonprofit groups, governments and regulators have drafted or endorsed varying approaches. But the proposed disclosure regimes have varied by region and there is a lack of consensus as to which metrics are most relevant or useful. With asset managers such as BlackRock putting their weight behind a move toward common global standards, a core set of reporting standards is likely to emerge in the coming years.

The United States: Asset managers BlackRock, State Street and Vanguard, among others, have encouraged companies to follow reporting standards set by the Sustainability Accounting Standards Board and the framework established by the Task Force on Climate-related Financial Disclosures (TCFD), which was formed under the Basel, Switzerland-based Financial Stability Board.

> *"There is no company whose business model won't be profoundly affected by the transition to a net zero economy — one that emits no more carbon dioxide than it removes from the atmosphere by 2050 … As the transition accelerates, companies with a well-articulated long-term strategy, and a clear plan to address the transition to net zero, will distinguish themselves with their stakeholders — with customers, policymakers, employees and shareholders — by inspiring confidence that they can navigate this global transformation. But companies that are not quickly preparing themselves will see their businesses and valuations suffer … "*
>
> – **Larry Fink** / Chairman and CEO, BlackRock / 2021 Letter to CEOs, January 2021

Many expect the Securities and Exchange Commission under the Biden administration to consider rules requiring ESG disclosures, potentially addressing climate change, workforce diversity and corporate political contributions, but no new rules are imminent. (Listen to a short interview about possible ESG initiatives by the SEC.)

Meanwhile, Nasdaq has proposed amending its listing standards to require companies to enhance their disclosures regarding director diversity. In addition, companies eventually would be required to have at least one female director and at least one director from a racially or ethnically diverse background or the LGBTQ community, or explain why their board lacks them.

The United Kingdom and European Union: A proposal pending in the U.K. would force more than 650 public companies, including all of those in the FTSE 100, to make the environmental disclosures in line with the TCFD recommendations by the end of 2022. The rules would be extended to all large private companies in the U.K. by 2023.

In the EU, new rules will require fund managers to demonstrate how ESG factors are being integrated into investment decisions. The European Commission has also produced guidelines for companies on reporting climate change information.

A patchwork of standards will make compliance challenging. For companies operating in multiple jurisdictions, the hodgepodge of rules and guidelines may impose extensive but differing disclosures.

The upshot: Companies need to begin preparing to comply with different reporting requirements around the world.

Some investors want executive compensation tied to ESG performance. Many investors subscribe to the view that you get the results that you measure and reward, and we expect some investors to continue to argue for ESG to play a part in setting executive compensation. The U.K. Investment Association, representing 250 asset managers, Norway's $1.3 trillion national oil fund and the $400 billion Dutch civil pension fund ABP have said that companies should consider whether their remuneration systems promote sustainable business practices and progress on ESG issues. BlackRock has adopted proxy voting guidelines for EMEA companies stating that ESG-driven metrics for remuneration should be specific and linked to the achievement of strategic objectives.

Expect increasing pressure on ESG issues. Boards can expect more demands for accountability on ESG matters in 2021, from investors and other stakeholders. For example, in 2020, major oil companies in the U.S. and Europe faced shareholder campaigns demanding reduced emissions, some spearheaded by new ESG-focused activist funds. (For a look at the new emphasis shareholder activists have placed on ESG issues, see "New Tactics and ESG Themes Take Shareholder Activism in New Directions.")

Diversity will likely feature prominently in 2021. Investors continue to advocate that new directors and executives better reflect the societies within which their companies operate. For example, the New York City Employees' Retirement System advocates policies to ensure that a diverse range of candidates are considered when directors and executives are named.

Proxy advisory services in the U.S. will continue to play a role on these issues. For example, starting in 2021, Institutional Shareholder Services will monitor the boards of companies in the Russell 3000 and S&P 1500 indices and flag those with no apparent racial or ethnic diversity. In 2022, ISS will recommend voting against nominating committee chairs of these companies where a board lacks diversity.

Already, Glass Lewis, another proxy advisor, generally votes against nominating committee chairs of all-male boards. Starting this year, it will point out boards with no more than one woman director, and in 2022 it will recommend against nominating committee chairs of boards with fewer than two female directors if the board has at least seven members.

Get ahead of ESG and communicate your progress. Boards and management teams need to understand the ESG changes that institutional investors, activists and regulators are seeking, and how the various disclosure mandates are shaping up so they can address shareholder concerns and respond to new disclosure guidelines and requirements.

Although disclosure may not be required, and guidelines vary across jurisdictions, waiting for mandatory or consistent disclosure regimes is not an option for most companies. Those that fail to tell their own ESG story will do so at their own peril. They are at risk of third parties painting a less flattering and less accurate picture.

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Audio Interview: How Far Can the SEC Go?

Opponents of mandatory disclosures about climate risk and diversity will argue that they exceed the agency's authority — a five-minute chat with ex-SEC general counsel Robert Stebbins.

– [Listen to the recording]

Opponents of mandatory disclosures about climate risk and diversity will argue that they exceed the agency's authority — a six-minute chat with Robert Stebbins, the SEC's general counsel until January.

Transcript

Ann Beth Stebbins: This is Ann Beth Stebbins. I'm a partner in Skadden's M&A Group, and I'm joined here this morning by Bob Stebbins. Bob was until January the general counsel of the Securities and Exchange Commission, and he also happens to be my husband. We're going to discuss what direction the SEC might take under Gary Gensler, President Biden's nominee for chairman. There's been a lot of speculation that a Democratic-controlled SEC may implement rules requiring corporate disclosures on ESG issues — everything from climate risks to diversity in the workplace. What I want to discuss today is the SEC's authority to require ESG disclosures across the board even when these disclosures are not necessarily material to an investor's understanding of a company's business.

Bob, to start off, many people expect more rulemaking generally from the commission once Gensler is in place. Is that what you foresee?

Bob Stebbins: I do. Then at that point there will be a 3-2 majority for the Democratic commissioners, Democratically appointed commissioners. And I do think you'll see rulemaking obviously and at the focus, he hasn't really foreshadowed what his theories of emphasis are going to be yet, but I think one could expect given what we've been reading about for a good while now that ESG and specific climate issues could be something, prescriptive requirements relating thereto could be something that they focus on.

Ann Beth Stebbins: Right now the SEC does require under its current rules companies to disclose information about climate. How are we going to see a shift from what's currently required to what we might expect to see required of companies?

Bob Stebbins: The big picture, the way we view disclosure is we think it's important to a company to disclose everything that's material about their business and take a look at, think about when they think about their business, what's material to them and make sure that's getting disclosed somewhere in their public filings. What they're talking about is something more prescriptive. So let's say climate wasn't a material risk to you under a materiality-based standard, then at that point there's nothing to disclose. But, if you're Exxon, obviously it is material, and so we would expect to see a fair amount of disclosure. What they're talking about is having prescriptive disclosures that would require everyone to make certain disclosures regardless of how material or immaterial the risks are to the company. Well, that's the tricky part, right? So when you do prescriptive requirements, you're inserting your judgment about what's important to investors, and the SEC doesn't really have expertise to do that. That's where it gets tricky, and that's always where it gets tricky on prescriptive requirements.

Ann Beth Stebbins: The other thing I've been thinking about is "how far can the SEC go in its rulemaking?" Clearly climate — and let's just take that for example, since we've been talking about it — is important to President Biden, and he will have legislative initiatives. He has already rejoined the Paris climate accord. So you can expect executive-level actions, which we've seen. You can expect bills to be introduced in the legislature. But, how does the SEC's rulemaking work alongside the legislative and executive actions that we may see in this area?

Bob Stebbins: Big picture of the SEC, we always expect when we're drafting rules that everything that we're going to do is going to be challenged in court. And there have been instances, of course, where rules are struck down. It doesn't happen a lot, but it happens. So when the SEC gets away from its mission — it is a tripartite mission, including investor protection and taking care of the markets, and capital formation is the third part — it's tricky. And then things are going to be judged certainly more closely by the courts. So the SEC always needs to be cognizant of making sure that what it's doing in rulemaking can be defended as something that the reasonable investor it's material to and something they're interested in. And if it's information that might be a very nice thing to do for a lot of reasons but it's unrelated to the SEC's mission, that gets much trickier for the SEC and the courts.

Ann Beth Stebbins: Some of these areas we are talking about are a little gray. I mean investors obviously are very interested in climate from a big picture macro perspective. And you have the BlackRocks, Vanguard, State Street all putting out white papers on climate and the importance of climate. You have the big institutional investors taking a stand on board diversity. So it's clearly important to big institutional investors, but I guess what you're thinking is "is that material to an investment decision of Joe consumer, Mr. and Mrs. Main Street?" as Jay would've called them under the Clayton SEC.

Bob Stebbins: Well I would say that, I think that the rules you are talking about, at least in the examples you gave, have a better chance of surviving than some of the other rules. You can tie it to investors caring. To the extent that it's defensible and there is support that investors care about it, I think there's great chance these rules are going to survive, right?

Ann Beth Stebbins: Right. Thanks a lot.

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New Tactics and ESG Themes Take Shareholder Activism in New Directions

The dividing lines between activist and private equity firms are blurring, and new types of activists are emerging.

- Activism is likely to rebound as the business world recovers from COVID-19 disruptions.
- Some activists are raising permanent capital, giving them new leverage, and activist approaches have become more acceptable to many institutional investors.
- Even high-performing companies may face pressure on ESG issues.
- The best defense is a solid relationship with and understanding of your shareholders, coupled with a plan for dealing with activists if they emerge.

Shareholder activism levels decreased in 2020 amid the upheaval and uncertainty brought on by COVID-19. But activists did launch a number of high-profile campaigns and there was an uptick of activism in the second half of the year; and more than 80 CEOs were replaced during activist campaigns.

Today, even well-performing companies may find themselves targets of activist campaigns on environmental and social issues, as new funds have been formed to specialize in these areas. Moreover, established activists have established new types of investment vehicles that could strengthen their hands. Preparing for the possibility of an activist campaign should therefore be on the board agenda at most public companies.

Expect an uptick in activism in 2021. Historically, many activist campaigns have focused on M&A and returns of capital. The economic uncertainty and liquidity issues companies faced in 2020 reduced M&A activity and made it harder for activists to advocate transformative deals, such as the sale of a company, a breakup or major divestiture, or a large dividend payout. In addition, there were fewer announced deals for activists to challenge.

As the economy rebounds and business becomes more predictable, activists are likely to press companies to undertake transactions and advocate for changes to the deals companies propose.

COVID-19 problems may spur some campaigns. Underperformance is another traditional target of activists. As businesses struggle to cope with the challenges of the pandemic, or if a company's stock price does not return to pre-pandemic levels, some could find themselves vulnerable to activists pressing for operational or governance changes.

Even companies with solid financial performance may face activists. Environmental, social and governance (ESG) themes featured prominently in 2020 activist campaigns, and several factors are likely to accelerate that trend.

Many institutional investors, even managers of passive index funds, have called for the business world to address environmental and social issues such as diversity. (See "ESG: Many Demands, Few Clear Rules.") Major American and European oil companies, for instance, have been pressed to lower their emissions by activist groups that are backed by major pension funds and asset managers.

Some established activists have recently formed ESG-focused funds alongside their regular pools to target companies they contend have not met ESG standards, and some veteran activists, including ValueAct founder Jeff Ubben, have formed new ESG-only activist firms. Other new ESG funds have been formed by groups with few ties to established activist firms.

Boards need to prepare for this new set of players and their agendas, paying close attention to their companies' ESG profiles and ratings, and not just the financial vulnerabilities that traditionally attracted activists' attention.

The lines between activists and other investors are blurring. A number of major activist firms have begun acting more like private equity firms, pursuing outright acquisitions or negotiating for large stakes in companies for extended periods (private investments in public entities, or PIPEs). In 2020, three of the best-known names in activism, Pershing Square, Starboard Value and Third Point, formed SPACs (special purpose acquisition companies), shell companies that raised capital to buy businesses. One of the most influential established activist firms, Elliott Management, formed a buyout fund in 2019.

Meanwhile, some private equity firms have pursued more activist-like strategies, and in some cases, activists have teamed up with strategics or private equity firms on acquisitions. Since activists often zero in on management and operational shortcomings, a buyout is a logical next step.

These moves may alter the calculus for companies in some situations, because an activist investor with sufficient capital and a proven willingness to take a long-term position in a company or to take it private poses a more serious threat than one known only for saber-rattling and then trading out of the stock.

Traditional investors have become more open to activism. Over the last few years, as activism has become more accepted, some long-only asset managers, including money managers, have supported activist campaigns where they thought it would increase the value of their investments. Usually, this has been behind the scenes, but some traditional asset managers have now openly adopted activist tactics. For example, Wellington Management, the largest shareholder of Bristol-Myers Squibb, came out against the drugmaker's $74 billion deal to buy biotech Celgene in 2019.

This reflects a broader transition to a more shareholder-centric model of corporate governance. Potentially, any investor with a clear agenda, sufficient resources and the support of a wide shareholder base can utilize activist tactics.

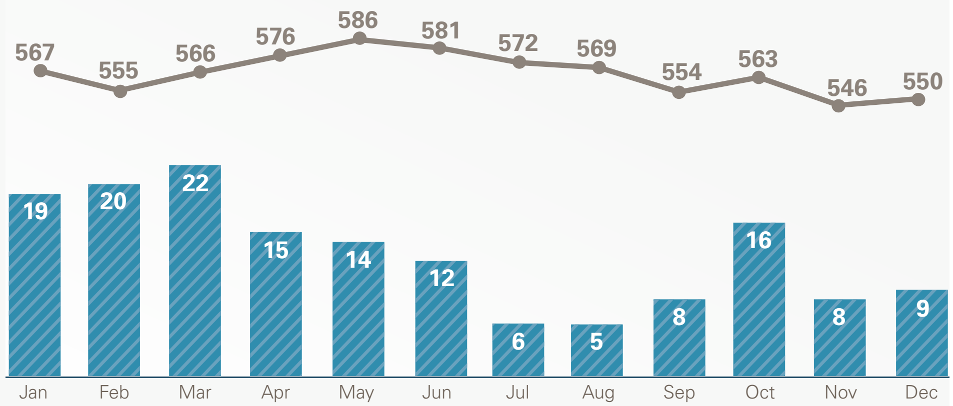
Framing a Strategy

Given the evolution of activism, it is vital for boards to ensure that their companies have strategies to address activist pressure.

Shareholder engagement is the best defense. Ongoing dialogue with shareholders is the best preventive strategy. Know your most significant shareholders and understand their investment theses. Engagement with shareholders more broadly allows management to build relationships, articulate the company's strategy and establish the credibility that management and the board will need in the event an activist surfaces.

Executives usually take the lead in communications with shareholders, but direct engagement by independent directors is becoming more common, particularly regarding subjects under the board's purview, such as executive compensation, capital allocation and succession planning, and when a company is facing

Activist Campaigns Jan-Dec 2020



Open Campaigns at Month-End

New Campaigns at Month-End

Source: ActivistMonitor/Merger Market

major challenges. A company needs to weigh the pros and cons of using a director in this role, and give careful thought to the choice of directors and prepare them thoroughly.

Assess vulnerabilities and prepare responses. Proactively review your company's vulnerabilities ahead of any activist approach, looking at the business from the activist's perspective. Consider whether alternative financial and business strategies (say, a divestiture, spinoff or enhanced return of capital) could boost shareholder value. An open-minded review can go a long way toward reducing the risk of an activist intervention.

Develop a defensive plan. Implement a stock surveillance warning system to monitor new shareholdings, have a shareholder rights plan ready to implement if an activist acquires a substantial stake, assemble a team of advisers and prepare a playbook in case an activist emerges. Another tool being used more frequently is a "table-top" simulation of different activist scenarios to test and refine a company's reactions.

Early board involvement is critical. If an activist surfaces, it is crucial that management alerts the board immediately so directors are educated and are actively involved in the response. To avoid missteps, the board and management must be aligned in their approach and coordinate both internal and external communications.

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Get Used to the New Normal in US-China Trade Relations

Restrictions are unlikely to loosen under the new administration because there is bipartisan support now for taking a hard line with China.

- Tariffs and other restrictions on trade with China are unlikely to change significantly under the Biden administration, so companies will have to adapt their operations and supply chains accordingly.
- A bipartisan consensus has developed supporting many of the Trump administration's policies toward China.
- Trade disputes are closely linked to other strategic tensions between the U.S. and China.

The restrictions the United States and China placed on trade with each other during the Trump administration are unlikely to change significantly under the Biden administration. Over the past four years, bipartisan support developed for a more aggressive policy toward China on trade, and the countries' trade disputes are now intertwined with strategic and human rights issues, making them more difficult to resolve.

Companies therefore need to prepare for this new normal: an extended period of tariffs, export controls and other barriers to trade and investment, particularly in high tech. The Chinese and American economies are too deeply linked to fully decouple, but some relationships will likely be unwound and new ones will be slower to form.

Our Predictions

Given the new bipartisan consensus, President Biden will be under pressure to be "tough on China." As a result, we expect that the Biden administration will retain virtually all of the measures taken by the Trump administration against China. Here is what to expect more specifically:

Tariffs are likely to remain in place. Approximately $370 billion of Chinese imports into the U.S. are subject to the tariffs imposed since 2018. The Biden administration is unlikely to remove or reduce these without receiving something in return. It will be difficult for China to make concessions with respect to the primary sticking points: industrial subsidies, cyber intrusions, and state direction and control over Chinese companies.

Export control measures will continue to tighten. It is unlikely that the Biden administration will remove Chinese firms from the so-called "Entity List" of companies that are severely restricted in their purchases of U.S. goods, software and technology. Moreover, recently tightened "military end use" rules impose similar controls in many cases. The new administration will also continue to identify and control "emerging and foundational technologies" that will further restrict Chinese companies' ability to access U.S. technology. For its part, China may retaliate by using its own version of the Entity List — the "Unreliable Entities List" — against U.S. companies to block them from trading with or investing in China.

The U.S. likely will allow SMIC to buy some semiconductor technology. China's leading semiconductor company, SMIC, was added to the Entity List in December. We do not expect the Biden administration to remove it, but, given SMIC's importance as a supplier to many U.S. companies, we expect the government will grant export licenses for less sensitive technology that SMIC wants.

The Biden administration will emphasize human rights. In 2019 and 2020, the U.S. imposed sanctions and export restrictions on an array of entities and individuals in China, based on their activities in Xinjiang province, Hong Kong and the South China Sea, reflecting human rights and security concerns.

The new administration may take stronger action with respect to forced labor and other perceived human rights abuses. For example:

- It may take a broader approach and target companies outside of Xinjiang that allegedly use forced labor provided by "vocational centers" in Xinjiang that the U.S. claims target the province's ethnic minorities, including Uyghurs, or have other indirect ties to the alleged use of forced labor in Xinjiang.
- Most products sourced in whole or in part from Xinjiang will likely be banned. There was strong bipartisan support for the Uyghur Forced Labor Prevention Act (UFLPA) in 2020, and similar legislation has been introduced in the new session of Congress. This legislation would create a presumption that all goods sourced from Xinjiang are made with forced labor and thus are barred from importation into the United States.
- Apart from the UFLPA, we expect U.S. Customs and Border Protection to continue and, in fact, intensify its efforts to investigate the supply chains for imports from Xinjiang and bar products that are made through forced labor.
- The impact of these measures would extend well beyond the apparel industry, which relies on cotton from Xinjiang. For example, a significant portion of the global supply of the polysilicon used in solar panels comes from Xinjiang.
- President Biden may impose sanctions on parties perceived to be undermining democratic processes and institutions in Hong Kong.

Other Restrictions Affecting Chinese Companies

The Biden administration's policy decisions will take place against the background of other recent measures limiting Chinese operations and capital-raising in the U.S.

In August, President Trump signed executive orders barring the sale of two popular apps for Chinese internet firms, TikTok and WeChat, out of concern that the Chinese government could collect personal data of American citizens using the platforms. (Both orders were later enjoined by federal courts.)

In November, President Trump issued an executive order barring Americans from investing in the securities of companies with ties to the Chinese military. The New York Stock Exchange indicated that it would delist three Chinese telecoms companies identified by the government in order to comply. In addition, the Holding Foreign Companies Accountable Act was signed into law in December. It prohibits a foreign company's securities from being listed or traded on U.S. exchanges if the company's financial statements are not subject to inspection by the U.S. Public Company Accounting Oversight Board for three consecutive years beginning in 2021 — inspections that China thus far has not allowed.

In early January, President Trump issued an executive order banning transactions with eight additional Chinese apps, including Alipay.

The Future for US and Chinese Companies

Supply chains will be altered indefinitely. Since U.S. tariffs are likely to remain in effect for some time, American companies that have not already altered their sources of supply will need to consider changes. In many cases, that will entail finding new suppliers in countries such as Vietnam, Thailand and Mexico, either on an exclusive basis or as parallel "China-plus-one" alternatives. Measures such as the UFLPA, export controls and sanctions may also necessitate changes to American companies' supply chains.

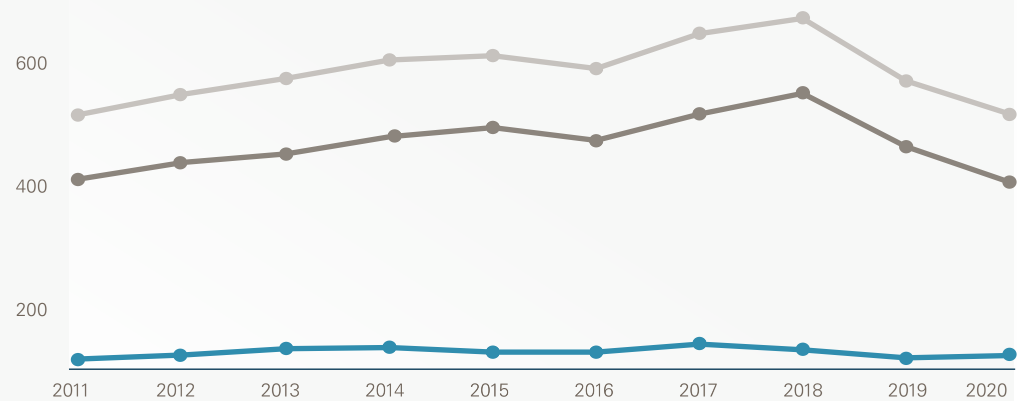
US Trade in Goods With China 2011-2020

Two-Way Trade Total

Imports

Exports

Source: U.S. Census Bureau
(data in USD billions)

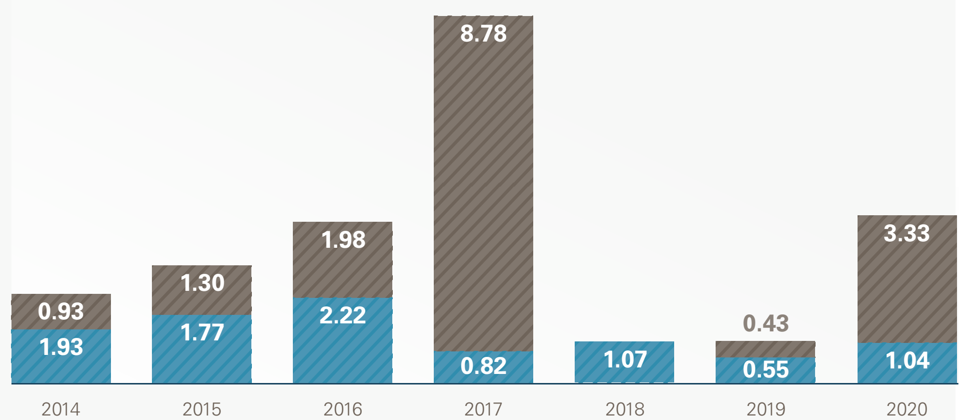


Chinese FDI Into the United States 2014-2020

Minority Stakes

Greenfields

Source: Rhodium (data in USD billions)



For their part, Chinese companies will continue to explore ways to become less reliant on U.S. technology, given the tightening of U.S. export controls.

Chinese investment in the United States will remain at relatively low levels. Since the onset of the trade war, Chinese investment in the U.S. has plunged, and it is likely to remain at relatively low levels for some time. In part, the drop reflects an expansion since 2018 of the authority of the Committee on Foreign Investment in the United States (CFIUS), which reviews foreign investments on national security grounds. CFIUS has recommended blocking or unwinding several Chinese investments in recent years, which has had a chilling effect.

We expect that Chinese investors will primarily invest in the U.S. market through passive minority stakes in investment funds, certain forms of venture capital and greenfield operations, which are not subject to CFIUS reviews. Lower levels of Chinese investment may create opportunities for investors from other countries.

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