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FRIEND OR FOE: HOW SHOULD DIRECTORS FACE DISRUPTIVE RISK?

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FRIEND OR FOE: HOW SHOULD DIRECTORS FACE DISRUPTIVE RISK?

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RAPPORTEUR

Kayla Winarsky Green

PROGRAM DIRECTOR

Charles E. Ehrlich

PROGRAM MANAGER

Antonio Riolino

CONTRIBUTORS Stephanie Bertels, Robert H. Mundheim, and Melissa Obegi
with Stacy Baird, John Cannon III, and Michael Ling

EDITOR Louise Hallman

PHOTOS Ela Grieshaber

COVER IMAGE Pixabay/rawpixel

CONTENTS

5 Introduction

6 Thought Leadership

7 Understanding Emerging Disruptive Risks

7 Tackling Obstacles to Effective Risk Management

[Constraints on Effective Risk Management](#)

9 Managing Disruptive Risks

[Guiding Questions for Managing Disruptive Risks](#)

[Responses to Risk Indicators](#)

[Indicators of a Coming Scandal](#)

10 Heeding The Warning Signs

11 Assessing Risk and Evolving Corporate Priorities

13 Constructing a Modern Board

13 Refreshing Board Membership

13 Encouraging Diversity

[Skills or Characteristics to Consider for a Diverse Board](#)

14 Advising a Nominating and Governance Committee

15 Exploring the Shifting Role of the Corporation

15 New Shareholders and New Priorities

15 Examining The August 2019 Us Business Roundtable Statement

17 Concluding Thoughts and Next Steps

18 Salzburg Questions for Corporate Governance

18 Robert H. Mundheim: What is the Significance of the Business Roundtable Statement on the Purpose of a Corporation?

19 Stephanie Bertels: Why is it Increasingly Important for Boards to Clearly Signal Their Position on ESG Issues?

21 Michael Ling: How Can a Sustainability Committee Better Look at Potential Risks?

22 John Cannon & Stacy Baird: Is the Board Ready to Address Disruption?

25 Appendix

25 Participants

36 Advisory Committee

37 Staff

39 Rapporteur & Report Contributors

INTRODUCTION

In today's tumultuous world, corporations face conflicting and unsettling forces. Geopolitics collide with economics, new competitors disrupt industries, and the changing nature of shareholders challenges traditional concepts of corporate stewardship. Looking forward, directors need the right skills and tools to improve risk literacy and resilience of their companies.

Foresight and anticipatory leadership have never been more important for the running of complex multinational corporations. Directors must be able to support and advise management to help them recognize, prepare for, and react to risks. Some risks companies face may be truly unpredictable, whereas others are underestimated, under-appreciated, or simply ignored. Achieving maximum resilience – through proactive measures or nimble responses to circumstances that arise – will determine success.

Risk creates opportunities as well as challenges for companies that are well prepared. Corporations that can adapt to rapidly-changing competitive and political environments can emerge stronger. Conversely, those which lack proper strategies will likely get overtaken by events, competitors, or popular opinion.

In a time of political and economic turmoil, companies will need to better address exogenous risks. Sanctions, trade wars, and oil production swings highlight geopolitical volatility; conflicting or unfavorable regulatory reforms impact functionality and the bottom line; cyberattacks have become routine; new technologies disrupt industries; and concerns mount over the erosion of environmental and social systems.

Internally, disruptive trends in governance models call into question the fundamentals of how corporations are run and for whom. Board directors may face new challenges to the exercise of their legal and fiduciary duties because of changes in the very nature of shareholders – and their expectations. Decision-making in companies is now impacted by large-scale shifts in ownership, with different categories of shareholders having very different objectives. For example, institutional pension and sovereign wealth funds have increased their asset holdings, passive investments may soon overtake active market share, and capital continues to flow to activist investors who do not hesitate to exert their influence in the boardroom.

The **Salzburg Global Corporate Governance Forum** – through its fifth annual program, *Friend or Foe: How Should Directors Face Disruptive Risk?* – sought to address some of these challenges. Bringing perspectives and experience spanning 13 countries, an international and intergenerational cohort of 35 company directors, lawyers, policymakers, investors, academics, and representatives of key civil society interest groups explored how directors can identify both the challenges and opportunities of disruptive risk, achieve resilience, and navigate an increasingly complicated landscape.



THOUGHT LEADERSHIP

The Salzburg Global Corporate Governance Forum was launched in 2015 to enable critical thinking on the changing roles and responsibilities of directors across jurisdictions and cultures.

The highly interactive program takes place in plenary and breakout sessions without any pre-designated speakers, panels, or formal presentations. Small group conversations allow for intense exploration of specific aspects of the general themes, returning to the plenary to refine conclusions. Adherence to the Chatham House Rule ensures an open and free exchange among peers.

This report aims to capture that exchange and share it beyond the candid yet closed discussions of Schloss Leopoldskron and the Salzburg Global Corporate Governance Forum. Authored by Kayla Winarsky Green, adviser in the Human Rights and Business department of the Danish Institute for Human Rights and with contributions from Melissa Obegi, Asia general counsel for Bain Capital, based in Hong Kong; Stephanie Bertels, director of the Centre for Corporate Governance and Sustainability at the Beedie School of Business of Simon Fraser University in Vancouver, Canada; and Robert H. Mundheim, of counsel to Shearman & Sterling LLP, the report includes recommendations, takeaways, and questions focused on three key areas:

1. Understanding Emerging Disruptive Risk
2. Constructing a Modern Board
3. Exploring the Shifting Role of the Corporation

Accompanying the report are a selection of articles written by Fellows of the Corporate Governance Forum for the monthly series *The Salzburg Questions for Corporate Governance*:

- **What is the Significance of the Business Roundtable Statement on the Purpose of a Corporation?**
By Robert H. Mundheim
- **Why Is It Increasingly Important for Boards to Clearly Signal Their Position on ESG Issues?**
By Stephanie Bertels
- **How Can a Sustainability Committee Better Look at Potential Risks?** By Michael Ling
- **Is The Board Ready to Address Disruption?**
By John Cannon III and Stacy Baird

The Salzburg Questions for Corporate Governance, began in 2018 in response to the 2017 program of the Salzburg Global Corporate Governance Forum, which explored



how “courageous directors” might emerge as global thought leaders. Several Fellows of the Forum have since taken up that mantle, volunteering to author a series of articles addressing questions that arose during discussions in Salzburg. Continuing throughout 2019 and now into 2020, a new question is addressed each month by different Fellows. Members of both the Forum and the Fellows’ wider networks are encouraged to join in the accompanying discussion online. To receive notifications of when each month’s article is published and to join in the online discussion, please follow Salzburg Global Seminar on LinkedIn and sign up to our dedicated mailing list: www.salzburgglobal.org/go/corpgov/newsletter.

CHATHAM HOUSE RULE

The Forum is held under the Chatham House Rule, whereby participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.

DISCLAIMER

This report reflects the authors’ views of the overall discussion during the program and should not be attributed to individual participants.

UNDERSTANDING EMERGING DISRUPTIVE RISKS

Today’s companies are faced with a wide array of risks, both familiar (economic) and emergent (geopolitical, climate-related, technological and societal). Trade frictions increasingly complicate corporate activity. The degradation of the environment demands attention. New technologies are transforming competition. Nationalism and populism are disrupting the status quo.

A number of these conditions were not widely considered as threats five years ago, highlighting the need for companies to refresh their assumptions and their tactics for addressing risk. The risks that stood out among the participants at the 2019 program of the Salzburg Global Corporate Governance Forum (hereafter referred to as Fellows) as most threatening included technological and economic

risks, followed by climate.

Over the course of the three-day program, the Fellows examined case studies on how companies faced these risks and considered whether their strategies were successful or not, and what tools could be deployed to prioritize corporate attention in order to achieve better outcomes.

TACKLING OBSTACLES TO EFFECTIVE RISK MANAGEMENT

Boards face many hurdles in improving their approach to risk management. Fellows in Salzburg identified some of the constraints and the greatest risks they felt were currently being underestimated by corporate boards.

CLIMATE CHANGE RISK

The first step in managing climate risk is ensuring the board understands the multi-faceted nature of climate risk and the company’s specific exposure to those risks. When considering climate-related risk, boards should be contemplating physical risk, transition risk, and liability risk.

- **Physical risks** stem from weather-related events and longer-term shifts in climate patterns that can lead to the physical damage to assets and disruptions to operations or supply chains due to extreme temperatures; changes in water availability, sourcing, and quality; shifts in growing patterns; and droughts, flooding, and forest fires, among other issues.
- **Transition risk** includes the policy, legal, technology, reputational, and market risks and opportunities stemming from the inevitable transition to a lower-carbon economy; including greater demands for

CONSTRAINTS ON EFFECTIVE RISK MANAGEMENT

- **Lack of expertise.** The existing management or board may not have the expertise to understand emerging risks such as the impact of technological innovation on the business.
- **Lack of board refreshment** is a primary cause of the expertise gap.
- **Increased complexity.** The demands of board service have increased, and directors are finding it difficult to devote sufficient attention to more than four or five boards.
- **Insufficient information.**

Companies need a process for gathering information at all levels as relevant information and insights may reside throughout the organization, or in some cases may need to be sourced externally.

- **Insufficient board time.** Board agendas typically do not devote sufficient attention to strategy and risk.
- **Underestimation of the risks.** Companies often underestimate the likelihood of risks materializing. The use of specific scenarios could help to articulate more effectively the relevance of

emerging risks, including “black swan risks” (e.g. an unlikely event with potentially severe consequences).

- **Not addressing longer-term risks.** There is a tendency to focus on more immediate issues and defer or ignore more attenuated risks.
- **Unpredictability.** The outcomes of current geopolitical risks are hard to accurately forecast – e.g., the likelihood of Brexit in the UK or the resolution of the trade war between the US and China – making it harder to identify the impact to be mitigated.

disclosure, carbon pricing, technology substitution, changing customer demands, and/or societal acceptance of your transition strategy.

- **Liability risk** stems from a new round of climate-related litigation whereby companies and their directors are becoming the targets of claims from investors and other constituencies, either for failure to anticipate and guard against climate change-related conditions or to make timely and accurate disclosures regarding climate-related risk. In this regard, Fellows examined the possibility of climate-related liability resulting from what is now being described as a climate-related bankruptcy at PG&E in California.

Investor and corporate interest in the topic of climate change and sustainability has evolved, as acknowledged in Salzburg, so too has public sentiment (boosted by recent climate strikes). While there are clear national differences in the perception of the risk, Fellows acknowledged increasing public pressure to:

- **Assess and disclose corporate climate risk exposure** in alignment with the recommendations of Task Force on Climate-related Financial Disclosures (TCFD). The TCFD framework can help frame and quantify the potential financial impact of climate change, transition risk, and other difficult issues, and is expected by some to become an accepted standard to assess climate risk.
- **Set “science-based” emissions targets** that adhere to the targets in the Paris Climate Agreement to hold global temperature rise to well below 2°C above pre-industrial levels along with increasing pressure to align with a 1.5°C trajectory. Fellows also noted examples of companies that are setting 1.5°C as well as beginning to include climate targets in their procurement contracts.
- **Take a clear position on climate change.** Fellows considered the value of a board-level position statement on climate change, including examining the position taken by Mars Inc and how it might guide corporate action.

Climate change presents a range of risks, however, at the same time, the transition can create opportunities and

boards should be attentive to the potential for new sources of value as well as access to capital and markets from investors and consumers who increasingly expect companies to be more conscious of climate change and the environment.

Challenges abound. The investment community does not have a uniform or scientifically accurate understanding of climate risk. Fellows were also split on what to emphasize for investors and shareholders: whether the company’s role in combatting climate risk should be justified purely in terms of economic value, or whether there is merit in acknowledging that this is “what a good corporate citizen would do.” Attitudes towards climate risk and sustainability also vary greatly based on broader national priorities. For example, Fellows noted the difference between Germany, where climate change is an industrial policy priority (and renewables are omnipresent), and South Korea, where, while climate change is very important, it is not perceived as urgently as the risk of a nuclear threat from North Korea and the environmental impact of fine dust from China and Japan.

INCOME INEQUALITY AND WAGE DISPARITY: TOMORROW’S RISK?

Income inequality has become an increasing topic of concern in recent years and the question of whether people are being paid a living wage is being asked increasingly widely. Studies have shown that commute times, employee fatigue, lower productivity, stress and psychological safety all have a negative impact on employee performance. Fellows were divided on whether wage disparity represented a core corporate risk. This was attributed to differing levels of cultural tolerance for wage disparity and differing regulatory interests triggered by wage disparity. For example, the concern in the UK has centered on wage transparency rather than pay gap. In South Korea, wage disparity is viewed through an unfair labor practice lens, rather than one tied to human rights or ESG (environmental, social and governance) concerns. In the US, there has been more limited corporate action on the issue of wage disparity, but this may change with more political voices calling attention to the issue.



MANAGING DISRUPTIVE RISKS

Using a range of real-world and hypothetical case studies, breakout groups in Salzburg explored how boards can manage risk more effectively, focusing on four threats:

CLIMATE CHANGE

A hypothetical regarding a telecommunications multinational that explored the salience of climate risk and asked whether the board should be undertaking a more thorough risk analysis in light of potential business disruption and reputational risks.

CYBERSECURITY

A case study on Dun & Bradstreet, an enterprise data company whose customer credit card information ended up on the Dark Web after a data breach in 2015 and was subsequently penalized by authorities in California and New York.

DISRUPTIVE TECHNOLOGY

An exercise regarding the opportunities and threats that disruptive technology, in the form of electronic payment systems, poses to the financial service industry.

GEOPOLITICS

Two case studies faced by “national champions”: Chinese telecommunications company ZTE, whose sales to Iran repeatedly breached US sanctions, the penalties for which threatened its entire business; and Apple, which faces the prospect that US tariffs on electronics imported from China will impact a significant amount of its sales, as most of its products are made or assembled in China.

Though the conversations differed contextually, a set of guiding considerations emerged.

GUIDING QUESTIONS FOR MANAGING DISRUPTIVE RISKS

Does the board have the requisite expertise or training to understand the risk?

- What expertise is required to evaluate the current risks facing the company?
- Is the board diverse or homogeneous and what insights or experience may be lacking?
- Can an outside perspective bring better insights, especially where risks are complex or outcomes are less predictable?

Does the board have the requisite information to provide sufficient oversight?

- How accurate is the information used to assess the risk?
- Does the board understand the drivers behind the risk (to evaluate longevity of the risk)?
- Does the board have a process to ensure sufficient transparency from management?

- Does the company have a culture that encourages employees to speak up?

How should the risk be presented to the board?

- Was the risk discussed in advance of the meeting with specific directors to lay the foundation and avoid the element of surprise?
- Was the risk unpacked in a manner that the risk committee could clearly understand?
- Can risk committees and structured agendas be used to prioritize discussions on risk so that both imminent and emergent risks are addressed?

Can the risk function as an opportunity?

- Can the risk prompt positive changes in scenarios where the company must “adjust or die”?
- Can the company achieve a competitive advantage over rivals?

Can the risk be ignored, insured or accepted as a cost of doing business?

- Is non-compliance an option? Does the board have sufficient information to evaluate the trade-offs, including the impact on a company’s reputation and the financial impact of penalties for non-compliance vs. the profits from business as usual?
- Does the national identity of the company affect how it might be impacted by the risk?
- What kind of leverage does the company have to mitigate the impact and are there viable strategies to mitigate or change the regulation (e.g. waivers, lobbying, PR, litigation, insurance)?

HEEDING THE WARNING SIGNS

Examining recent real-world corporate governance failures, breakout groups also explored risk preparation in depth:

BOEING

Two fatal plane crashes within five months involving the 737 Max killed 346 people in 2018 and 2019, which drew scrutiny from aviation regulators across the globe, triggered lawsuits by the victims' families, caused the loss of billions in shareholder value, and led many to question the performance of its board of directors.

NORTHSTAR AEROSPACE

The 2004 case saw the Ontario Ministry of the Environment discover severe contamination of groundwater beneath the facility and nearby residential areas, for which the directors faced personal liability.

PG&E

After the 2018 California wildfires, in which 14,500 homes were destroyed and 86 people were killed, the utility filed for bankruptcy in response to its financial challenges.

NISSAN

Carlos Ghosn, Nissan Japan CEO was arrested by the Tokyo District Public Prosecutor's Office on November 19, 2018 on charges of violation of the Japanese Financial Instruments and Exchange Act on suspicion of systematically underreporting his compensation in Nissan's Annual Securities Reports.

INDICATORS OF A COMING SCANDAL

- **Repeated incidences of troubling behavior:** In many of the scandals, the major crisis was preceded by smaller breaches, which were ignored, tolerated or even condoned.
- **Compliance with the letter, but not the spirit of the law,** leading to a "false sense of comfort."
- **A backward-looking approach to compliance,** e.g. one that focuses on rectifying past instances of noncompliance rather than anticipating future areas of regulation.
- **An inexperienced or biased regulator.**
- **A lack of adequate board oversight** of management conduct.

Though the conversations differed contextually, a set of indicators emerged, which were viewed as contributing to the scandals.

Having identified the warning signs, Fellows suggested several action items to respond to risk indicators.

RESPONSES TO RISK INDICATORS

- **Adopt a committee structure.** Beyond the process benefits, the adoption of a committee structure is a hallmark of good governance that could help insulate boards from liability.
- **Establish risk or audit committees** to give structure, discipline and air time to consider risks beyond the immediate and most obvious.
- **Consider an ESG** or corporate responsibility committee.
- **Expect more teeth** to enforcement on social issues.
- Ensure directors **understand their directors' and officers' (D&O) exclusions** and industry liability issues.
- Ensure directors get to **know the Chief Risk Officer.**
- **Do not overlook the public affairs function.**
- **Conduct root cause analysis.** RCA can help ensure that if an issue presents, the drivers are understood and can be addressed before there is a second occurrence.
- **Do not presume** that lack of regulatory action or interest is a safe harbor.
- **Adopt a forward-looking approach to compliance,** with rear-view awareness, which can help anticipate upcoming regulations;
- **Set the right tone at the top** with high-level commitments to compliance and strong corporate governance reinforces corporate culture throughout the company.

ASSESSING RISK AND EVOLVING CORPORATE PRIORITIES

Anticipatory leadership is undeniably essential to effective risk management. Tools such as risk assessments and risk matrices can help to identify, catalogue and prioritize risk, and create a systematic way to tackle the pertinent issues in an anticipatory manner.

Fellows discussed techniques to improve the risk assessment and mitigation process:

- Management, rather than the board, having primary responsibility for conducting risk assessments;
- The board, or board committees, providing informed oversight, encouraging attention to longer-term and a broader range of risks, and helping ensure follow-through;
- Recognizing the importance of fresh and unaffiliated perspective, such as from outside counsel;
- Refreshing the board and committees annually to avoid becoming dated or creating a false sense of confidence that everything is being covered;
- Refreshing the format for the risk assessment to improve attention to the content, which might otherwise appear repetitive or stale;
- Being aware of “zombie” risks – those that remain and are never adequately addressed;
- Considering risks of third parties on the enterprise, such as supply chain and distributors;
- Establishing and implementing escalation procedures to ensure decision-maker attention to key risks;
- Adopting business protocols to mitigate identified risks (e.g. procurement); and
- Incorporating risk management measures into key performance indicators for employees or the organization to help improve accountability and align incentives across the enterprise.





CONSTRUCTING A MODERN BOARD

Board composition can have a profound impact on a company's ability to navigate risk. Board diversity is increasingly seen as a necessity as a homogenous board is “hobbled” and unable to make the overall best decisions. Board refreshment, while contentious, ensures fresh perspectives are introduced and directors' independence is ensured.

REFRESHING BOARD MEMBERSHIP

Board refreshment is one of the more controversial topics in corporate governance. The concept of imposing mandatory term limits for board members on one hand facilitates board turnover and increases the likelihood of promoting diversity but also mandates changes often to the detriment of board members who would prefer to maintain their position. Fellows in Salzburg were largely in favor of imposing mandatory term limits to facilitate board refreshment. Those who supported the policy cited benefits such as increasing age diversity and with it digital literacy.

A retirement policy that was based on limiting the amount of years on the board (rather than the age of board members) could promote board refreshment in a collegial manner as it avoided awkward conversations such as asking someone to leave. In support of this, a Fellow pointed out the Indian model in which a director may serve as an independent director for an initial term of five years, with a maximum of two such consecutive terms, after which they would be able to continue as a board member, but not in an independent capacity.

ENCOURAGING DIVERSITY

Legal mandates to increase gender diversity are becoming more and more prevalent around the world, such as the French quota law of 2011 imposed to increase women's representation at the highest corporate level in the country's largest firms. The impacts of such protections are not strictly limited to gender and have greater implications on the makeup of the board as a whole. One participant noted that the French mandate had the catalyst effect of opening up boards to newcomers whereas it was previously limited to the “old boys network” in which power was extremely concentrated amongst a select few.

However, other forms of diversity are also important for a board to consider. In their conversations on the live case study and on the risk hypotheticals, participants discussed the aspects and credentials of board directors that could help optimize corporate decision-making. Board matrices (which plot skills of existing board members against the various needs of the company) were identified as a tool to help boards identify gaps to be filled when recruiting new members.

SKILLS OR CHARACTERISTICS TO CONSIDER FOR A DIVERSE BOARD

- Age;
- Attitude towards risk and compliance;
- Attitude towards fiduciary duties (which may vary by country, noting that breach of fiduciary duty can bring criminal liability in certain jurisdictions);
- Cultural or ethnic background;
- Experience with auditing or accounting;
- Experience with technology;
- Investment or industry experience;
- National origin/geographic location (should diminish the national-centricity of boards whose companies have significant interests overseas);
- Experience relevant to the current phase of corporate life (start-up, consolidation, distressed).

ADVISING A NOMINATING AND GOVERNANCE COMMITTEE

Fellows considered the subject of board construction through engaging in an exercise in which they acted as advisers to a company's Nominating and Governance Committee. The company discussed had a significant technology component and operated in a rapidly changing environment. Its stock price had dropped sharply from its IPO price a few years ago.

One question discussed related to whether the board had sufficiently up-to-date experience in the relevant technology areas. It was pointed out that the board was not devoid of technology expertise and much more sophisticated expertise existed in management. Some Fellows questioned whether the board needed additional expertise to properly oversee management. A response was that the board could retain consulting help if it believed its knowledge deficient for the oversight task.

Another hotly debated issue related to the fact that the board was relatively old. Indeed, a number of the board members were in their 70s or above. A number of Fellows urged the company to have mandatory retirement at a certain age. They felt that the board or the Nominating Committee would be unwilling not to re-elect a board member even though they no longer performed adequately. Other participants believed a vigorous director evaluation process led by an outside facilitator could adequately deal with this issue. There was also a concern that mandatory

retirement could deprive the board of relevant expertise (e.g., institutional knowledge of the industry).

A slightly different approach suggested was to have term limits on director service. In part, this approach was based on the belief that long service on a board eroded independence because of the social bonds created. The push back was that there was no need for general rules if the evaluation process was vigorous. There was some skepticism about the effectiveness of the evaluation process because of the social cost to the board members involved in not re-nominating a particular director.

A reason for focusing on an age limit or term limits was to force the board to bring on new, younger, and gender, geographically and ethnically diverse members. One Fellow observed that, in the particular company being examined, one-third of the board had been elected within the last four years. The new directors were younger than those of the existing directors and brought a modest amount of gender and ethnic diversity. The Fellow commented that much turns on the specific individuals on the board and how they interact with each other. However, there was general agreement that a diverse (in the broadest sense of the word) board, where all members feel sufficiently comfortable to interact frankly and independently with each other and management, was desirable.



EXPLORING THE SHIFTING ROLE OF THE CORPORATION

Blackrock Chairman Larry Fink’s 2019 Letter to CEOs, entitled “Purpose and Profit,” points to the failure of governments to address pressing social and economic issues and makes the case that businesses should step up and play a leadership role. He highlights wage stagnation, the impact of technology on job security, and public expectations to protect the environment. In the past, these risks (particularly societal and environmental risks) were seen as squarely within the province of governments and outside of a corporation’s scope of responsibility – a clear shift in the role of the corporation in modern society.

NEW SHAREHOLDERS AND NEW PRIORITIES

Similarly, for the past twenty years, the US Business Roundtable statements have endorsed the principle that corporations are run for the benefit of shareholders. However, its August 2019 statement, signed by 181 CEOs, departs from that position, stating that the purpose of

a corporation should be to benefit of all *stakeholders* – customers, suppliers, employees, communities and shareholders.

Fellows considered the significance of the new statement and how it should be interpreted.

EXAMINING THE AUGUST 2019 US BUSINESS ROUNDTABLE STATEMENT

WHAT IS GOOD CORPORATE CITIZENSHIP?

To some this means that companies should go “beyond compliance” by ensuring that they take actions beyond what is strictly necessary and make socially-minded decisions even when not required by a regulator. To others, it means a focus on sustainability, where there is alignment with long-term returns, or other investment-related metrics, or when a failure to consider ESG brings reputational risks. There was baseline consensus in Salzburg that stakeholders wanted more ESG disclosures, and the standard imposed on companies was to “comply or appear noncompliant.”

DO COMPANIES HAVE A ROLE IN SOCIO-POLITICAL ISSUES?

The ease and speed with which negative information can mobilize public opinion has created greater reputational risks for companies, triggering an impetus to respond to events or issues of social concern. The question was debated as to whether corporate boards should be making judgments based on their views of societal needs rather than purely based on shareholder interest. Some Fellows expressed concern; it is risky for companies to wade into these issues and corporate leaders lack the expertise or a mandate to act on socio-political issues. To others it was a natural for boards to take into account the implications of its decisions on a wider set of constituencies. In some situations, companies occupy a prominent position in an affected community and

can respond more quickly than governments, as was the case with local companies playing a role in disaster relief in New Orleans in the wake of Hurricane Katrina in 2005 and in the British Virgin Islands following Hurricane Irma in 2017. Whether these are isolated examples of self-help or indicia of more conscious corporate behavior remains to be seen.

WHAT ARE THE ROLE AND PERSPECTIVES OF INSTITUTIONAL INVESTORS?

Decision-making in companies is affected by large-scale shifts in ownership, with different categories of shareholders having very different objectives, including managed funds, passive indexed funds, institutional pension and sovereign wealth funds, and activist investors who do not hesitate to exert their influence in the boardroom. Larger institutional investors, in particular sovereign pension funds, have played a leading role in driving adoption of standards. For example:

- Not supporting board slates without, at a minimum, a commitment to diversity; and
- Incorporating climate-related impacts into investment analysis, including the potential impact on society, reputation, and profitability.

Fellows also agreed upon the importance of investor relations and noted:

- Investor relations should be more of a focal point for boards;

- More seasoned individuals should be charged with that responsibility;
- Directors should be prepared to be able to interact with investors; and
- Prospective board members should be put in front of investors.

Institutional investor engagement, however, may be more important in countries with more forward-leaning institutional investors, such as in the US, Canada or Europe, where pension funds have led the promotion of governance policies. In countries like South Korea, institutional investors may lack the capacity or the resources to drive corporate change in the same way. In some other countries, governments are the primary drivers of governance initiatives, such as the French gender quota mandate, or the Japan's new Corporate Governance Code.

Disruptive trends in governance models call into question the fundamentals of how corporations are run and for whom. Participants noted a move away from “short-termism” and greater willingness to consider longer term risks, driven in part by pension funds and sovereign wealth funds that can have longer investment horizons than other types of investors.

ARE THE NEW INSTITUTIONAL ASSET MANAGERS CURRENTLY ACTING AS EFFECTIVE STEWARDS?

Participants began by discussing the need for stewardship

and the current stewardship gap. It was acknowledged that institutional asset managers have tended not to vote their proxies and when they did so, tended to vote with management.

It was noted however, that some institutional asset managers are more engaged in active stewardship and investing resources in building out their capacity to engage in stewardship activities. This includes hiring subject matter experts in ESG that can support the proxy voting teams, engage with companies, and participate in the development of industry level initiatives. Fellows also pointed to the need for better corporate disclosure, especially when it came to ESG issues to facilitate more active stewardship. Two initiatives were viewed as helping to bridge this gap: the SASB (Sustainability Accounting Standards Board) and the TCFD (Taskforce for Climate-related Financial Disclosures).

The discussion turned to the topic of proxy voting and proxy voting policies, with Fellows noting that proxy voting policies can be a tool for decision-making and be used as a tool for signaling and issue advocacy, but that they can be a blunt instrument. To be true stewards, institutional investors should have a knowledgeable proxy team.

Participants also discussed the development of new stewardship codes in several jurisdictions and the role these codes would play in shaping future practice, including making it easier for shareholders to exercise their rights.



CONCLUDING THOUGHTS AND NEXT STEPS

To navigate the divergent risks facing companies today, directors require discipline, agility, and conscientiousness. Increasingly, companies are expected to respond to issues that affect the well-being of a wider set of stakeholders, prompted in part by the rising influence of institutional shareholders with a longer-term perspective.

Using case studies, preparatory readings, and interactive discussion, the Fellows at this year's program of the Salzburg Global Corporate Governance Forum highlighted a number of tangible measures to help boards and corporate risk managers grapple with emerging and disruptive risks. These solutions ranged from board and committee constructs, to business protocols, to analytic frameworks. The diversity of perspectives, expertise, and experience of individual participants in Salzburg left Fellows armed with both awareness of the specific past and ongoing cases and foresight for challenges they could face tomorrow.

The Salzburg Questions for Corporate Governance series, which continues online throughout the year, seeks to address the growing need for dialogue and answers to the question posed at the outset of this year's meeting in Salzburg: how can corporate governance adapt to these challenges? These questions will feed naturally into the 2020 program of the Salzburg Global Corporate Governance Forum (October 8 to 10, 2020), which will focus on corporate culture.

The construction of a modern board, and the culture it embraces and promotes, can have a profound impact on a corporation from the very top through to management and beyond. Corporate culture can determine – both positively and negatively – how directors can best anticipate risks and disruptions, including to their underlying business models, as well as what the implications might be for corporate culture across borders and jurisdictions.

Next year in Salzburg, yet another select international and intergenerational cohort of company directors, lawyers, policymakers, investors, academics, and representatives of key civil society interest groups will explore the interactions, innovations, and incentives needed to create positive workplace cultures, and the roles of boards and senior leadership in fostering such cultures through all levels of a corporation.

More information about the October 2020 program of the Salzburg Global Corporate Governance Forum will be available online: www.SalzburgGlobal.org/go/655.



ROBERT H. MUNDHEIM: WHAT IS THE SIGNIFICANCE OF THE BUSINESS ROUNDTABLE STATEMENT ON THE PURPOSE OF A CORPORATION?

Of Counsel to Shearman & Sterling LLP reflects on the Business Roundtable's latest Statement on the Purpose of a Corporation

On August 19, 2019, the Business Roundtable (BR) issued a Statement on the Purpose of a Corporation signed by the CEOs of 181 significant companies. The statement said companies owe a fundamental commitment to a company's stakeholders (customers, employees, suppliers, communities in which the company works) and shareholders. A number of commentators have said that the statement marks a significant departure from the traditional view of the purpose of the corporation. They read the statement as authorizing companies to take action which benefits employees, customers, or the community even though that may not enhance long-term shareholder value – even detract from it.

The overwhelming American legal view, as reflected in Delaware law, is that the objective of a business corporation is to enhance the long-term value of the corporation for the benefit of shareholders¹.

Are the BR statement and Delaware law necessarily contradictory? Larry Fink, the CEO of BlackRock and a signer of the BR statement, has, for a number of years been urging

corporate executives to take stakeholder interests into account. But his letters can be fairly read as saying that if corporations do not, they risk loss of long-term value. Thus, paying attention to stakeholders is important for value enhancement and, therefore, consistent with Delaware law.

INTERPRETING THE BUSINESS ROUNDTABLE STATEMENT

Can the BR statement be read in the same way? I think it probably can, although many commentators on the statement think it cannot. However, what has always worried me as a director is how I calculate the economic value to the corporation of taking action, which may be costly today, but in the long run will enhance the company's reputation and, therefore, profitability. Does the board have to go through an exercise which quantifies the long-term value and compares it to the cost? Do boards do that? Or do they just think that there is a rational relationship between the proposed action and long-term value and that their decision on whether or not to take action (as long as properly articulated) will be protected under the business judgment rule?

Does it matter how the purpose of the corporation is articulated? As a practical matter, I am not sure. In many states, corporations are governed by constituency statutes. For example, in Pennsylvania directors are told that in considering the best interests of the corporation, they may consider the impact of any action on various stakeholders including employees and communities where the company is located. It is specifically provided that the interests of none of the groups



¹ In its Principles of Corporate Governance, published in 1992, the American Law Institute stated that the purpose of the corporation is to enhance corporate profit and shareholder gain. It then goes on to say that the corporation may (even if it does not enhance profitability) take into account ethical considerations reasonably regarded as appropriate to the responsible conduct of business and may devote a reasonable amount of resources to humanitarian, educational, and philanthropic purposes. The Principles reflect the law and also what the Institute thought a desirable direction for the development of the law. The American Law Institute has just launched a Restatement of the Law of Corporate Governance. It will confine itself to what the law is.

(including shareholders) shall be regarded as dominant or controlling. I am not aware of any difference in the behavior of boards of companies incorporated in a constituency state like Pennsylvania or Delaware, except perhaps in defending the company against a hostile tender offer.

Conceptually, however, I think we may be at a significant point. And, in time, that can have important practical consequences.

SETTING OUT A SCENARIO

Let me pose a situation to ponder. The board of Company A has a proposal to outsource the work of a plant in a US community whose workers are predominantly 55 or older. Outsourcing the work to young people in X, a very poor country, would save substantial amounts of money and provide good work to people, many of whom are unemployed and many of whose families suffer from malnutrition. Company A has had good experience in outsourcing work to a different factory in X. The plant to which the work would be outsourced is outfitted with solar panels and would provide power in an environmentally friendly fashion. The US plant relies on oil heating and cannot practicably be converted to solar heating.

If we looked just at long-term economic returns, there is a relatively clear metric, and probably the answer would be to outsource. If we look at the impact on stakeholders, the answer is not clear. How should one weigh the impact of outsourcing on new foreign employees and current US employees? How should the more friendly environmental impact be weighed? Who should make these judgments? Is

it the board? Should the BR statement be read as a way to bolster the power of the board as decision maker by making their decisions essentially unreviewable?

If it is, should the board continue to be elected exclusively by shareholders? In deciding how to vote, won't shareholders look to how their stock is doing? Would that bring back as a dominant factor the shareholder gain perspective? Management and directors are typically compensated to a significant extent in stock to align them with shareholder interests. Would that have to be rethought in a world where stakeholder interests are of equal value to shareholder interests?

Or should stakeholders have places on the board? Which stakeholders? How will voting be organized? Senator Elizabeth Warren has authored legislation which would have 40% of the board selected by employees. How should representatives of the community be chosen? Or representatives of customers? How much weight should each of these stakeholders have on the board?

These difficult questions lead me to read the BR statement as not seeking to depart from the traditional Delaware articulation of the law governing the purpose of the corporation. The value of the BR statement is in reminding boards that the impact of corporate action (or non-action) on employees, customers, and the community can significantly effect corporate value, particularly long-term value.

STEPHANIE BERTELS: WHY IS IT INCREASINGLY IMPORTANT FOR BOARDS TO CLEARLY SIGNAL THEIR POSITION ON ESG ISSUES?

Academic explores the growing importance of environmental, social and governance (ESG) issues for the corporate sector

As an academic working at the intersection of corporate governance and sustainability, I end up chatting with executives and directors in global companies quite regularly. Lately, directors are asking whether their company should be taking a public position on one or more environmental, social, or governance (ESG) issues. "It used to be just the NGOs or the SRIs (socially responsible investors) asking for this, but

now even mainstream investors are asking," they will say. Even the central banks have started to get in on the action, viewing climate change as a threat to financial stability.

It started decades ago with the pressure to issue a sustainability report, but a string of incidents ranging from the Rana Plaza building collapse and the Volkswagen emissions



scandal to PG&E's "climate-driven bankruptcy" have raised questions about what other environmental, social, and governance risks may lurk within.

And yet despite these issues, or perhaps because of them, the world is looking to the biggest companies to clearly articulate what role they will play in solving some of our most intractable problems and to clarify how they will contribute to the achievement of the Sustainable Development Goals.

BOARDS NEED TO RESPOND

As demands for corporate social and environmental responsibility expand and intensify, investors are demanding a clear position from management and the board, one that includes specifically addressing the company's understanding of the context in which it operates and clarifying its role and commitments to address key environmental and social challenges.

But our research is showing that this isn't just a paper exercise. By developing position statements, boards and executive teams deepen their understanding of these issues in the context of their business, clarify the link to the company's overall strategy, clarify their position for other key stakeholders, and provide the direction and confidence for management and employees to act.

WHAT DOES "GOOD" LOOK LIKE WHEN IT COMES TO A POSITION STATEMENT?

That's a question that keeps surfacing in my conversations with directors. To provide an answer, we analyzed over 3,000

board position statements, finding that too often, they were lengthy documents that failed to make a clear strategic connection between the issue and the implications for business decision making.

Our guide on Next Generation Governance (www.eproj.org/governance), provides a framework to help companies produce more credible and concise position statements.

A good position statement will do three key things:

- Explain your company's understanding of the issue including what you see as relevant limits;
- Clearly link the issue to your business strategy; and
- Make a credible commitment to take appropriate actions.

It's that credible commitment piece that many companies are struggling with. It means that for each relevant issue, your company needs to talk with stakeholders to understand the key system limits and what it would take for your company to operate within them.

COMPANIES ARE INCREASINGLY EXPECTED TO TAKE A POSITION ON CARBON

One issue that is taking front and center is the climate crisis. Of the statements we reviewed, over 2,000 of them related to climate change and momentum continues to grow fueled by two key trends.

First, the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) released guidelines asking companies to engage in scenario-planning and to disclose their climate-related risks. While currently voluntary, it is expected that regulation on mandatory climate risk disclosure is sure to follow.

Second, there are a multitude of initiatives pressing companies to set a science-based target in alignment with a 1.5°C reduction pathway. Despite this, a recent study of 274 of the largest publicly traded, high-emitting companies found that almost half do not adequately consider climate risks in their operational decision-making and only an eighth are reducing carbon emissions at the rate required to keep global warming below 2°C, let alone 1.5°C.

To be viewed as credibly engaging on climate, investors and other stakeholders will want you to articulate a clear position. For those ready to do so, this guide can help.

MICHAEL LING: HOW CAN A SUSTAINABILITY COMMITTEE BETTER LOOK AT POTENTIAL RISKS?

Deputy company secretary at CLP Holdings Limited reflects on sustainability committees

Taking a step back from the usual management-led risk reporting process, a sustainability committee should actively work with management to look at potential risks. But when establishing a sustainability committee, you should ask, is the committee appropriately set up to deal with sustainability issues and potential risks?

COMPOSITION

Diversity is key. Ideally, there should be a good balance of executives and non-executives, longer serving independent directors with a deeper knowledge of the company as well as recently joined independent directors with a fresh perspective, directors who are more strategically minded, and directors who are particularly sensitive to stakeholders' concerns.

Does a committee require directors with specialist experience, such as climate change or technology? Not necessarily. The more important point is for the committee to acknowledge whether there is an expertise or knowledge gap. If there is, the committee can call on experts or specialist advisors to advise its members. The challenge of having a specialist background director is whether the experience or expertise is relevant. In addition, there is a risk of that specialist member being looked to as the default owner or director responsible for that issue.

SUPPORT

A sustainability committee should have support both from within the organization and externally. Internally, the committee should be well supported by the management's risk reporting, enabling its members to have a good sense of the key risks identified by management. The committee should also have access to external specialist advisors to provide a different perspective and to constructively challenge the committee and management's thinking and approach to the way they look at risks.

STEPPING OUTSIDE THE COMMITTEE BOARDROOM SETTING

Management-led risk reporting provides a certain view on risks and where things stand. Each committee member should

take the opportunity to meet with representatives from middle management to understand from their perspective what are the challenges and risks. Discussing with the people who are involved in assessing the risks and writing up the risk management reports will provide committee members a multidimensional understanding of the relevant issues.

A WORKSHOP APPROACH

While boards have strategy days and offsites, a sustainability committee should have similar workshop-like sessions to take a better look at the organization's emerging risks. This should go beyond a management-led briefing or a deep dive review. Participants should include senior management as well as representatives from middle management, specialist advisors, other committee chairpersons and, of course, committee members. Smaller breakout groups should be arranged to encourage participants, especially those in middle management, to speak up on sensitive topics.



The workshop approach will facilitate a more collaborative effort between the committee members and management to work together in assessing what the potential risks are, how these risks should be monitored and managed and what the corresponding opportunities are for the organization. Committee members can get to shape things early on in the process as opposed to being invited to comment and provide feedback on a management formulated risk assessment.

To better look at the longer-term sustainability issues and potential risks, a sustainability committee and representatives

JOHN CANNON & STACY BAIRD: IS THE BOARD READY TO ADDRESS DISRUPTION?

Corporate governance lawyer John Cannon and law and tech consultant Stacy Baird examine board composition, director tech literacy, and the use of expert advisors

Disruptive innovation is now a fact of life in most industries. Entrepreneurs and established businesses alike are challenging incumbent companies by creating paradigm-changing new products, services, and business models that supplant existing products, markets, and value networks. Disruption challenges traditional business paradigms, but it often also brings with it opportunity. The question to address for any business entity: is its board adequately equipped to anticipate, address or take advantage of disruption?

A board needs traditional knowledge of markets and

from management should critically examine what will the business look like in the long term? What are the longer-term goals and objectives of the company? By taking a long-term and multidimensional perspective, the committee will be better placed to look out for those potential risks.

To get the best from their directors, companies ought to work with their sustainability committee members much harder.

competition, but also an understanding of the impact of network effect and evolving customer relationships for businesses. Innovation has always – by definition – underpinned new business models, and new products and services. But a new dimension is the pace of innovation, the impact of network effect, and the fact that innovation substantially is coming from non-traditional market players. Businesses never present before in a particular sector are entering with very creative offerings to challenge, often blindside, more traditional businesses.

Another necessary board competency is an understanding of technology. For example, can your board anticipate the impact of machine learning (ML) or artificial intelligence (AI) on your company? These technologies will have profound impact on all industries. But in what way? The most recent wave of disruption has been as a result of advances in network technology, means of access to consumers, and the ability to network individuals on a mass scale to match individual service providers to consumers through new and evolving channels such as the internet, handheld devices and more recently, the Internet of Things. Companies now have many more ways to interact with consumers and can develop new products and services that take advantage of the ubiquity of the digital domain. Further, it is easier than ever for companies and individuals to network directly with consumers to provide new services that challenge old providers, e.g., online payment systems (Alipay, Apple Pay, Google Pay) v. traditional credit providers; Uber v. taxis; AirBnB v. hotels; Spotify v. traditional music distribution channels; and Netflix



content production v. traditional movie studios. Even in this context, data analytics is having a transformative impact. AI and ML will go further to transform the marketplace, but how remains the critical question.

Putting it all together, there is a substantial need for an understanding of the potential for radical new business models facilitated by new technologies.

What expertise does your board have, or need, to address potential paradigm-changing disruptive innovation, the impact of technology on the traditional market, and the potential for new business models that can be anticipated as technology evolves? It seems unrealistic to rely exclusively on educating existing directors on the accelerating pace of technological change and disruption of business models. As a consequence, board “refreshment” – already an objective of institutional shareholders – should actively be pursued and involve the identification of director candidates with expertise in the real-world applications of technology and/or business reinvention.

Technological sophistication may not alone be sufficient for these purposes. Equally important is the capacity of directors to think “outside the box” with management regarding a company’s business model. The dangers of groupthink – particularly in being wedded to the status quo operation of a business – can be mitigated through populating a board with individuals with a diversity of backgrounds and thinking as well as a leavening of knowledge of technological trends and experience with disruption.

Yet even this may not be enough for boards to successfully navigate the challenges ahead, especially given the ever-



increasing oversight and compliance responsibilities also imposed upon them. Boards of directors should consider retaining as soon as possible permanent staff, outside advisors or panels of experts to assist them in dealing with the impact and implications of artificial intelligence and other disruptive technologies.

Prompt action may mean the difference between a company being the victim or the beneficiary of technological revolution.

DISCLAIMER

The Salzburg Questions for Corporate Governance is an online discussion series introduced and led by Fellows of the Salzburg Global Corporate Governance Forum.

The articles and comments represent opinions of the authors and commenters, and do not necessarily represent the views of their corporations or institutions, nor of

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Questions about the series can be directed to Charles Ehrlich: cehrlich@salzburgglobal.org



PARTICIPANTS

All bios and positions correct at time of program – October 2019



Nicholas C. Allen, *United Kingdom*

Nicholas Allen is an independent non-executive director for CLP Group, a Hong Kong-based electric company. He is the chairman and an independent non-executive director of Link Asser Management Ltd., as well as an independent non-executive director for Lenovo. In the past, Nicholas served as a non-executive director for Hysan Development Company and VinaLand. He is a Fellow of the Institute of Chartered Accountants in England and Wales and a member of the Hong Kong Institute of Certified Public Accountants. Nicholas earned his bachelor's degree in economics and social studies from the University of Manchester. He is a Fellow of Salzburg Global Seminar.



Stacy A. Baird, *USA*

Stacy Baird is an attorney and advisor to businesses and governments on information technology and intellectual property (IP) public policy issues. Stacy is Consulting Director at the Singapore-based consulting firm TRPC. He serves as Executive Director of the US-China Clean Energy Forum Intellectual Property Program where he addresses technology transfer and IP licensing in the context of bilateral clean energy technology commercialization. Stacy served as Senior Policy Advisor to U.S. Senator Maria Cantwell, and previously to U.S. Congressman Howard Berman, on controversial issues related to IP and the then-nascent Internet. He worked as a music recording engineer with clients including Madonna, Stevie Nicks, Elvis Costello, Brian Eno, and Francis Ford Coppola. He has held appointments as Visiting Scholar at the University of Southern California College of Letters, Arts and Sciences and Visiting Fellow at the University of Hong Kong Faculty of Law. Stacy holds a B.A. in radio and television communication from San Francisco State University and a J.D. from Pace University. He is a Fellow of Salzburg Global Seminar.



Christopher Beltran, *USA*

Christopher Beltran is a successful serial entrepreneur in financial services software, board governance software, and leadership and executive coaching. He serves as a technical and strategic advisor for a variety of startups, Fortune 500 in the U.S., and internationally-based global companies, and is co-founder of Syntrina Leadership whose purpose is to bring world class coaching talent to leaders. He started his first software company serving financial institutions out of his dorm room in college, which he grew profitably to serve over seven countries and eventually exited successfully. His interests include blockchain, artificial intelligence, robotics, ethics, governance and privacy as he explores what's next. Christopher is an inaugural member of the Silicon Valley Blockchain Society (which represents \$1.2 trillion in assets). He serves on the board of Change Makers Rule Breakers bringing entrepreneurs to Richard Branson's Necker Island; CU Ledger, the first blockchain-based identity platform for over 300 million people; and in/PACT, a firm streamlining charitable giving for banking consumers. He was a mentor for kids at the MIT/Harvard Summer Launch Program and has taught graduate-level entrepreneurship at Purdue University. He obtained his bachelor's degree in industrial management and management information systems from Purdue University. Christopher is a Fellow of Salzburg Global Seminar.



Stephanie Bertels, Canada

Stephanie Bertels is the director of the Centre for Corporate Governance and Sustainability at the Beedie School of Business of Simon Fraser University (SFU) in Vancouver, Canada. She founded and leads the Embedding Project, where she works with dozens of global companies to help them embed sustainability into their operations, governance and decision-making (www.embeddingproject.org). Her most recent work draws upon a review of over 3200 board position statements and interviews with over 200 global CEOs and board chairs to explore how corporate governance and corporate strategy processes are shifting to account for environmental and social constraints. She has previously worked as an environmental engineer and is a trustee and chair of SFU's Academic Pension Plan. She has a Ph.D. in strategy and global management and sustainable development from the University of Calgary, an M.Sc. in petroleum engineering from Stanford University, USA, and a B.Sc. in geological environmental engineering from Queen's University. She is a Fellow of Salzburg Global Seminar.



Catherine Brenner, Australia

Catherine Brenner is a company director, having served in the past 15 years, on the boards of a variety of public and private companies, not-for-profit and government organizations including AMP, Coca Cola Amatil, Boral, the Sydney Opera House Trust and the Art Gallery of NSW Trust. She has chaired boards, risk, sustainability, remuneration and special-purpose board committees. Catherine previously served as a member of the Takeovers Panel and was a senior investment banker. She has worked across a diverse set of industries including: manufacturing (beverages, food, building materials); fast moving consumer goods; construction materials; infrastructure (airports, roads, public buildings); asset management; superannuation, insurance, financial services; property management and development; real estate investment trusts; logistics and supply chain management (biotech, consumer goods, building materials); telecommunications; and mining (underground and open cut). The regions in which she has had professional exposure and experience include Australia, New Zealand, the Pacific, Asia (China, Indonesia, Japan, Thailand, Vietnam, Singapore, South Korea, India and Malaysia), and the USA. She has a bachelor's degree in economics and a bachelor's degree in Law from Macquarie University and an M.B.A. from the Australian Graduate School of Management, University of New South Wales.



John J. Cannon III, USA

John Cannon is a partner in the Compensation, Governance and Employment Retirement Income Security Act (ERISA) practice of Shearman & Sterling LLP and co-chair of the firm's Corporate Governance Advisory Group. He has been at the firm since 1985. He is an Inaugural Fellow of the American College of Governance Counsel, a Member of the American Law Institute and an Adviser to the American Law Institute's Restatement of the Law, Corporate Governance project. He received a J.D. from the New York University School of Law and an A.B. from Harvard College. He is a Fellow of Salzburg Global Seminar.



Myeong H. Cho, Republic of Korea

Myeong (Mike) Cho is a professor at Korea University Business School. Prior to joining Korea University, he was an Assistant Professor at the Owen Graduate School of Management, Vanderbilt University, in the USA. Myeong's research interests lie in the areas of corporate governance and corporate strategy and his research has been published in world-renowned journals such as the *Journal of Financial Economics*. He also currently works as a director of the board at the International Corporate Governance Network based in London. He has

previously worked as an independent director for Samsung, SK, and Lotte and as a member of steering committee for the Korea Investment Corporation, the sovereign wealth fund of Korea. He received an M.B.A. from the École Supérieure des Sciences Economiques et Commerciales in France, and a master's degree and Ph.D. from Cornell University in the USA.



Gigi Dawe, Canada

Gigi Dawe leads the Corporate Oversight and Governance department at the Chartered Professional Accountants of Canada (CPA Canada). As such, she oversees CPA Canada's development of influential, thought-leading resources and events that improve board performance. Gigi launched the governance discipline at CPA Canada to facilitate enhanced board and executive response to market demands. Her history includes consulting in organizational development in a variety of industries. Gigi is a board member of Youthdale Treatment Centres. She is also on the International Corporate Governance Network's Corporate Board Governance Committee and sits on the advisory board of Simon Fraser University's Next Generation Governance Project. She is a past board member of Active Healthy Kids Canada and Family Daycare Services Toronto. Gigi is a member of the National Association of Corporate Directors, the Institute of Corporate Directors, and the International Corporate Governance Network. She teaches Corporate Responsibility and Ethics in the masters of Financial Accountability program at York University. Gigi obtained a master of laws at Osgoode Hall Law School.



Bharat Doshi, India

Bharat Doshi is the chairman of Mahindra Intertrade Limited and a director on the board of Mahindra Holdings Limited. He was nominated by the government of India as a director on the Central Board of the Reserve Bank of India in March 2016 for a period of 4 years. He served as the president of Bombay Chamber of Commerce and Industry for the year 2009-10. Bharat was also the executive director and group chief financial officer of Mahindra & Mahindra Limited, the flagship company of the Mahindra Group, before he retired from his executive position in 2013. He serves on the advisory board of Excellence Enablers, an organization committed to promote corporate governance in India. Bharat's outstanding career achievements have earned him several awards and accolades, including "India's Best CFO" from *Business Today* and "CFO of the Year" from IMA India in 2005 and from CNBC in 2007. He holds a bachelor's degree in commerce and a master's degree in law from Bombay University. He is a Fellow of Salzburg Global Seminar.



Jill E. Fisch, USA

Jill E. Fisch is the Saul A. Fox distinguished professor of business law and co-director of the Institute for Law and Economics at the University of Pennsylvania Law School, where she teaches and writes on corporate law, corporate governance, and securities regulation. Her scholarship focuses on corporate governance, the shareholder voting process, and securities litigation as well as ongoing experimental work on retail investor decision-making and financial literacy. Prior to entering academia, Jill practiced law as a trial attorney with the United States Department of Justice, Criminal Division, and as an associate at the law firm of Cleary, Gottlieb, Steen & Hamilton. She is an associate reporter for the American Law Institute Restatement of Corporate Governance, a director of the European Corporate Governance Institute, and a member of the National Adjudicatory Council of the Financial Industry Regulatory Authority. She received her bachelor's degree from Cornell University and her J.D. from Yale Law School.



Anne Gates, USA

Anne Gates has been in global consumer products businesses for over 35 years. She is currently on the Kroger board, serving on the audit and public responsibility committees as an audit committee financial expert and the chair of the audit committee. Anne is on the Tapestry, Inc. board, serving on the Audit Committee. She is on the Raymond James board, serving on the Audit and Risk Committee. She also serves on the PBS SoCal board as chair of the investment committee, and the boards of University of California Berkeley Foundation, and CADRE in Los Angeles. In 2017, Anne retired as president of MGA Entertainment, the largest privately held toy company in the United States with a global reach. She is past executive vice president and chief financial officer of The Disney Company's Consumer Products Division (\$3 Billion in revenues) and past managing director for Disney Consumer Products Europe and Emerging Markets based in London. She has a bachelor's degree in applied mathematics from UC Berkeley. She received her M.Sc. from the Engineering School at Columbia University, where she also completed post-graduate work. In 2010, Anne was named to the Power List of Britain's 100 most influential black people. Anne is a member of the Board of Directors of Salzburg Global Seminar.



Jeffrey D. Grant, USA

Jeffrey D. Grant was sector vice president and general manager of Space Systems at Northrop Grumman Aerospace Systems, from 2011-2018, a provider of manned and unmanned aircraft, space systems, and advanced technologies. In this role, Grant led the division which provided space solutions for civil, military, and restricted customers. Jeffrey joined Northrop Grumman via the acquisition of TRW in December 2002. Prior to his joining TRW in February 2002, he held a variety of government and private sector positions. Most recently, he was vice president and chief technical officer for Astrolink International, LLC. Before joining the private sector, Grant served for 21 years at the United States Central Intelligence Agency (CIA) in positions at the CIA/National Reconnaissance Office, Directorate of Science and Technology, and Directorate of Intelligence, Office of Scientific Intelligence. He is the recipient of numerous awards, including the Distinguished Intelligence Medal, the Intelligence Medal of Merit, the CIA's Engineer of the Year, the Intelligence Certificate of Distinction and the CIA Certificate of Distinction. Grant currently serves on the board of directors for the Space Foundation. Jeffrey received a bachelor of science in ocean engineering from the Florida Institute of Technology.



Kayla W. Green, USA

Kayla Winarsky Green is an adviser in the Human Rights and Business department of the Danish Institute for Human Rights (DIHR). At DIHR, she advises leading multinational companies and investors on human rights and sustainable development. She is a practicing lawyer and member of the New York Bar, experienced in working at the intersection of private and public international law with an emphasis on Business and Human Rights (BHR) and business integrity/corporate compliance. Prior to joining DIHR, she was an associate in the government investigations group of King & Spalding LLP, where she managed global anti-corruption investigations and cross-border white collar litigations and served as the founding member of the firm's BHR initiative. She earned her J.D. and a certificate in Global Human Rights from the University of Pennsylvania and a bachelor's degree (summa cum laude, Phi Beta Kappa) from Tulane University. Kayla is a Fellow of Salzburg Global Seminar.



Carol Hansell, *Canada*

Carol Hansell is the founding partner of Hansell LLP, providing expert independent legal and governance advice to boards of directors, shareholders, management teams, and regulators. Her firm is regularly engaged on matters that include special committee mandates, board investigations, governance reviews and shareholder engagement. Carol is an experienced director. She serves on the boards of Munich Reinsurance Company of Canada, Life Storage, Inc. (NYSE: LSI), and the American College of Governance Counsel. Past board service includes the Bank of Canada and the Public Sector Pension Investment Board. Carol is the author of a best-selling book for directors and a four volume loose-leaf service. She served as the only non-American chair of the corporate governance committee of the American Bar Association (ABA) Business Law Section and continues to serve as special Canadian advisor to the Corporate Laws Committee of the ABA. She teaches in the ICD-Rotman Directors Education Program across Canada. She is a fellow of the Institute of Corporate Directors and the American College of Governance Counsel. Carol is also the chair of the Business Law Advisory Council, appointed by the province of Ontario. She holds an M.B.A./LL.B. from York University, and M.A. in international relations from the University of Toronto, and a B.A. in history from the University of Western Ontario.



Eunah Hyun, *USA*

Eunah Hyun is a vice president and head of strategy legal office for SK Telecom Co., Ltd. in Seoul, Korea. She joined SK Group in 2000. Her primary focus includes strategic investments and joint ventures and corporate governance. She is interested in SK Group's social value initiative to create and measure corporate contribution to society. She received a J.D. from the University of Utah and a bachelor's of science from the University of Michigan.



David A. Jackson, *United Kingdom*

David A. Jackson is a managing director in Barclays Legal, where he is head of Group Corporate, Treasury, and Mergers and Acquisitions (M&A) Legal. He advises the group's senior management on all significant M&A transactions and corporate actions, alongside delivering legal support on issues of corporate governance, reporting, disclosure, and funding programs. Most recently, he has been deeply involved in the separation of Barclays' African operations and in advising on matters related to Sherborne Investors' failed attempt to take a Board role at Barclays. David joined Barclays in 2007 from Freshfields, where he spent 10 years as a corporate lawyer. At Barclays, he has held various roles including as legal coverage for the bank's former private equity businesses. Alongside his day job, David is the global citizenship lead for Barclays Legal and has a particular passion in this role for driving and maintaining increased diversity in the legal profession. He serves on advisory boards for several diversities focused organizations. David obtained a LL.B. from University College London in law and German law. He is a Fellow of Salzburg Global Seminar.



Thomas G. Komjathy, *USA*

Tom Komjathy is non-executive director of World Medical Relief, Inc., and chairman of its Governance and Board Development Committee. He is also director of operations for Warner Norcross & Judd, LLP, a Michigan law firm. Prior to joining Warner, Tom held operations, strategy, and general management positions in the energy and chemicals industries. Tom is a member of the National Association of Corporate Directors. He earned both an M.B.A. and bachelor of science in chemical engineering from the University of Michigan.



Anastassia Lauterbach, Germany

Anastassia Lauterbach, is an international board member, technology founder and entrepreneur. She serves as a non-executive director for Dun & Bradstreet, easyJet PLC, and Wirecard AG. Anastassia is member of the Advisory Council Next Generation Directors for NASDAQ and of the Diligent Institute of Corporate Governance. Anastassia serves on the advisory boards of the Ocean Protocol, a private global blockchain infrastructure and intellectual property company; Cogitanda AG, a private European cybersecurity insurance broker; and TM Forum, a non-profit global association of telecommunication companies and their vendors. Previously, Anastassia served as senior vice president and executive vice president at Qualcomm, Deutsche Telekom, and Daimler Chrysler. She started her professional path at the Munich Reinsurance Group and McKinsey & Company. She is CEO and founder of 1AU-Ventures and currently advises several U.S. and European based artificial intelligence (AI) and cybersecurity companies and investment funds, including Evolution Partners and Analytics Ventures. She trains boards in cybersecurity and cognitive AI and robotics-related technologies and their links to corporate governance. She advises the International Telecommunications Union, a United Nations organization, on AI policy and governance. Her book *The Artificial Intelligence Imperative: A Practical Roadmap for Business* has sold 35,000 copies. Anastassia has a Ph.D. in linguistics and psychology from the Rheinisch Friedrich-Wilhelms Universität Bonn and a diploma in linguistics from the State Lomonosov University, Moscow. She is a Fellow of Salzburg Global Seminar.



Christopher F. Lee, China

Christopher Lee is a partner at FAA Investments, a private investment group focusing on real estate, early stage companies and in-depth research on hedge funds and private equity managers. Additionally, he is a board director with expertise in financial markets, risk management, governance and leadership development. He is an Independent Board Member with Matthews Asia Funds and The Asian Masters Fund Limited. Previously, Christopher was an investment banker for eighteen years, acting as managing director and divisional and regional heads at Deutsche Bank AG, UBS Investment Bank AG, and Bank of America Merrill Lynch. He worked in global capital markets, managed derivative product development and provided equity sales and trading functions to institutional investors. He is an advocate of sustainable enterprises and environmentally conscious projects, serving on the boards of Dean's Advisory Circle, University of California Berkeley-Haas, African Wildlife Foundation, and the Hong Kong Securities and Investment Institute. He is also an associate professor (part-time) at the Hong Kong University of Science and Technology and teaches financial mathematics and risk management courses. He completed the A.M.P. at Harvard University and holds an M.B.A. and a B.S. in mechanical engineering from the University of California, Berkeley. Christopher is a member of the Board of Directors of Salzburg Global Seminar.



Michael H. Y. Ling, Australia

Michael Ling is the deputy company secretary for CLP Holdings Limited. He oversees the day-to-day functions of CLP Group Corporate Secretarial and works closely with the Board of Directors of CLP Holdings and the Board Committees. Prior to taking up this position in 2016, he was the legal counsel on the international team of CLP Group Legal Affairs for over four years. Before joining CLP, he was in the group legal function of AIA Group Ltd and was involved in the restructuring of the AIA group of companies. He also has extensive experience in corporate transactions and advisory work including public and private mergers and acquisitions and capital markets work in Hong Kong, London and Beijing. He holds an

LL.B. and a B.Com. from the Australian National University and has completed the IMD's Applied Leadership Program. He is a Fellow of Salzburg Global Seminar.



Julie A. Martin, USA

Julie Martin is a managing director in the Political Risk and Structured Credit Practice of Marsh JLT Specialty. Julie's work includes program structure, exposure analysis, insurance placement, and claims advisory for a variety of industries. She has worked extensively with both public and private political risk underwriters to address complex risks and exposures. Julie joined Marsh after twenty years of experience in the political risk business at the Overseas Private Investment Corporation (OPIC), the U.S. government agency charged with promoting U.S. investment in emerging markets. At OPIC, Julie served in a variety of positions, including chief underwriter and head of the political risk insurance department. She was responsible for many of the initiatives by OPIC in the political risk area including development of programs for institutional lenders and the capital markets. She has a M.B.A. in finance from George Washington University, a M.S. in foreign service and economic development from Georgetown University, and a B.G.S. in international relations from Texas Tech University.



Michele Coleman Mayes, USA

Michele Coleman Mayes is vice president, general counsel, and secretary for the New York Public Library (NYPL). She joined NYPL in August 2012 after serving as executive vice president and general counsel for Allstate Insurance Company since 2007. She served as a senior vice president and the general counsel of Pitney Bowes Inc. from 2003 to 2007 and in several legal capacities at Colgate-Palmolive from 1992 to 2003. In August 2016, she was elected to the Board of Directors of Gogo Inc. (NASDAQ: GOGO). In 2015, she became a Fellow of the American College of Governance Counsel. She served as Chair of the Commission on Women in the Profession of the American Bar Association from 2014-2017 and on the presidential commission on election administration from 2013-2014. She received her J.D. and B.A. degrees from the University of Michigan.



Antonella Mei-Pochtler, Italy

Antonella Mei-Pochtler is the lead independent director of Generali Group and senior advisor to the Boston Consulting Group (BCG). She was one of its senior leaders based in its Vienna office until the end of 2017. She is the former special advisor to the Austrian chancellor and head of ThinkAustria. Her other activities focus on board positions (J.A. Benckiser SE from 2005 – 2011, PPCapital from 2007 – 2014, Wolford AG from 2013 – 2017, Westwing AG from 2018) and not-for-profit organizations in the data-driven health and education areas (DKMS, Teach for All). She is also a co-initiator of BCG's educational initiative *business@school*, for which she received the Freedom and Responsibility Award from the German government in 2002, and the co-founder of the German Phorms school network. In 2008, she was voted one of the world's 10 best consultants by Consulting Magazine and in 2013 she was awarded its lifetime leadership award. Antonella was recently voted one of the 25 female CEO candidates of a DAX company. Antonella is a Fellow of Salzburg Global Seminar.



Mathilde Mesnard, France

Mathilde Mesnard is deputy director for Financial and Enterprise Affairs of the Organization for Economic Cooperation and Development (OECD), covering financial markets, international investment, corporate governance, competition and anti-corruption. Previously, she was coordinator of the New Approaches to Economic Challenges Initiative and senior advisor to the OECD Secretary-General. She launched an OECD-wide project on integrity and anti-corruption. From 2001-2009, she was an economist working on corporate governance and developed the OECD Guidelines on corporate governance of SOEs. Mathilde previously held positions as management consultant with Deloitte & Touche and Financial Analyst at Citibank. She holds a Ph.D. in economics from the École des Hautes Études en Sciences Sociales, an M.A. in finance from the École Supérieure de Commerce de Paris, and an M.B.A. from Drexel University, USA. Mathilde is a Fellow of Salzburg Global Seminar.



Robert H. Mundheim, USA

Robert H. Mundheim is of counsel to Shearman & Sterling LLP and formerly executive vice president and general counsel of Salomon Inc. Prior to joining Salomon Inc., he was co-chairman of the New York law firm of Fried, Frank, Harris, Shriver & Jacobson. He served as University Professor of Law and Finance at the University of Pennsylvania Law School, where he had taught since 1965, and was dean of the law school for seven and a half years. Among his other professional activities, Bob has been general counsel to the United States Treasury Department (1977-1980), special counsel to the United States Securities and Exchange Commission (1962-1963), and vice chairman, governor-at-large, and a member of the Executive Committee of the National Association of Securities Dealers (1988-1991). He is currently a director of Gogo LLC. He was chairman of the Board of Directors of Quadra Realty Trust, a director of eCollege, Benjamin Moore, Commerce Clearing House, Arnhold & S. Bleichroeder Holdings Inc., Union Capital Corporation, Weeden Inc., and First Pennsylvania Bank, and a member of the Supervisory Board of Hypo Real Estate Holding AG. Bob is a member of the Board of Trustees of New School University and of the Curtis Institute of Music, and a Trustee of the American College of Governance Counsel. He is an emeritus member of the Council of the American Law Institute. He served as a member of the American Bar Association Task Force on Corporate Responsibility and has been a faculty member of the Vanderbilt Directors' College, the Duke Directors' Education Institute, and the Stanford Directors' College. He was the president of the American Academy in Berlin and received the Officer's Cross of the Order of Merit of the Federal Republic of Germany. He holds an M.A. (honorary) from the University of Pennsylvania, an LL.B. (magna cum laude) from Harvard University Law School, and a B.A. (magna cum laude) from Harvard College. Bob is a member of the Board of Directors of Salzburg Global Seminar.



Melissa Obegi, USA

Melissa Obegi is Asia general counsel for Bain Capital, based in Hong Kong. She is responsible for transactional, portfolio, and operational legal matters and risk management for Bain Capital's private equity and credit businesses in the Asia Pacific region. Prior to joining Bain Capital in 2012, Melissa was a managing director and Asia regional counsel for Oaktree Capital in Hong Kong. She started with Oaktree Capital as associate general counsel at its Los Angeles headquarters in 2002. Prior to that, she held various positions with the Overseas Private Investment Corporation, a U.S. government agency that supports investment in global emerging markets with private equity investment funds, project finance, and political risk insurance. Melissa began her career with Coudert Brothers in New York as an associate in the International Banking group. She holds a J.D. from the School

of Law at the University of California, Los Angeles, and a B.Sc. in foreign service from the Foreign Service School at Georgetown University. Melissa is a Fellow of Salzburg Global Seminar.



Barak Orbach, *Israel*

Barak Orbach is a professor of Law at the University of Arizona James E. Rogers College of Law, a member of the American Law Institute, a member of the Executive Committee of the Association of American Law School's section on Antitrust and Economic Regulation, and a Fellow of the American Bar Foundation. Barak teaches and writes about antitrust, corporate governance, compliance, regulation, and the motion picture industry. Before joining academia, he served as an advisor for Law & Economics to Israel Competition Authority and worked as an associate with Cleary, Gottlieb, Steen & Hamilton, New York. He holds masters and doctorate degrees in law from Harvard Law School and undergraduate degrees in law and economics from Tel Aviv University.



Pamela Passman, *USA*

Pamela Passman is founder and president of the Center for Responsible Enterprise and Trade (CREATe.org) and vice chair of the Ethisphere Institute, distinct entities with a common mission to promote leading practices to manage key governance, compliance and risks for companies and their global supply chains. Prior to founding CREATe.org in 2011, she was corporate vice president and deputy general counsel, Global Corporate and Regulatory Affairs, Microsoft. From 2002 to 2011, Pamela led Microsoft's regulatory compliance work, including privacy, security, law enforcement, telecommunications and other issues related to cloud computing. She also led Microsoft's global government relations and public policy work and philanthropic programs and its cross-company global corporate citizenship efforts. She joined Microsoft in 1996 and until 2002 led the legal organization in Asia, based in Tokyo. Prior to Microsoft, Pamela practiced law with Covington & Burling in Washington and Nagashima & Ohno in Tokyo. Pamela serves on the Board of Kinaxis Inc., a Toronto-listed software-as-a-service supply chain management company, and served on the Board of IO, a data center infrastructure company. She holds a J.D. from the University of Virginia and a B.A. in government and law from Lafayette College.



Seda Röder, *Turkey*

Seda Röder is the managing partner at The Mindshift.Global, a boutique consultancy firm for strategic innovation and innovation management. Seda advises executives in questions regarding leadership style to dramatically increase effectiveness and innovative output in their companies. Her special areas of expertise include creative leadership, communication and community building, leadership brand, influence, reputation, as well as leading through transformation and cultural change processes. Her company is particularly well-known for its tech-literacy crash courses for top executives and board members. In addition, she is the founder of the Sonophilia Network, an international, cross-industry think-tank of top-managers from Fortune 500 Global and DAX companies as well as entrepreneurs and influencers from arts, technology, and politics. She is also a senior advisor and faculty member at the Salzburg-based accelerator Silicon Castles. Her background on international music stages as a performer and composer as well as her teaching experience at Harvard and the Massachusetts Institute of Technology constitute the foundation of her insights in creativity, performance excellence, and innovation. Seda trained as a concert pianist at the Mozarteum conservatory. She is a Fellow of Salzburg Global Seminar.



Elizabeth Savard, USA

Elizabeth Savard is the associate general counsel, corporate, at Mars, Inc. Elizabeth manages legal support to Mars corporate and business teams on global employee benefits, incentive plans, tax, and financing matters. She has extensive experience advising on people and benefits issues with corporate transactions, from the due diligence phase through post-closing transition and integration. Elizabeth serves as Secretary of the Remuneration and Talent Committee of the Mars Board and provides legal support on a broad range of corporate governance issues. Prior to joining Mars in 2014, Elizabeth was a partner in the Employee Benefits Group at McDermott Will & Emery LLP in Chicago, where she advised Mars and other clients on legal compliance for their US retirement, health, and executive compensation plans. She holds a J.D. from the University of Michigan a bachelor's degree from Loyola University of Chicago.



Dorothy Schindlinger, USA

Dorothy (Dottie) Schindlinger is vice president of Thought Leadership for Diligent, the pioneer in modern governance, provider of secure software for over 650,000 directors and senior leaders of organizations globally. In her role, Dottie promotes the intersection of governance and technology as a recognized expert in the field, serving as Diligent's key spokesperson. She is the co-author of *Governance in the Digital Age: A Guide for the Modern Corporate Board Director*, and co-hosts "The Corporate Director Podcast." Dottie was a founding team member of BoardEffect, a board management software platform launched in 2007, serving primarily nonprofit boards. Dottie's efforts helped BoardEffect expand from a four-person tech start-up to an industry. Prior to BoardEffect, she spent 15 years working in a variety of governance roles, including as a board support professional, consultant, trainer, board member, and senior executive. Dottie graduated from the University of Pennsylvania with a B.A. in English.



David J. Simmonds, Australia

As group general counsel, David Simmonds is responsible for the provision of legal and insurance services across the CLP Group and for the corporate secretarial affairs of CLP Holdings and its subsidiaries. He has extensive experience in corporate governance and in infrastructure across the telecommunications and energy sectors. David is responsible for the CLP Group's climate change strategy and has a keen interest and active involvement in the Group's Sustainability practices. He is a fellow of the Institute of Chartered Secretaries and Administrators in England, and a fellow and current vice president of the Hong Kong Institute of Chartered Secretaries. He holds a bachelor of laws (honours) and a bachelor of commerce from the University of Melbourne. He is a Fellow of Salzburg Global Seminar.



Kazim Tahir-Kheli, USA

Kazim Tahir-Kheli is a senior principal with the Portfolio Value Creation team at the Canada Pension Plan Investment Board (CPPIB). Kazim is involved in identifying and realizing value-creation opportunities across CPPIB's portfolio of material direct equity investments. He leads the governance efforts across the direct investments portfolio, as well as monitoring of the energy and resources portfolio. He has led a number of value-creation efforts across the Fund's private equity and energy and resources portfolio companies. He has over 25 years of operating executive and management consulting experience, with areas of expertise including digital marketing, marketing strategy and operations, carve-outs, and joint venturing. Prior to joining CPPIB, Kazim was chief executive officer of a business unit of WPP plc in Russia, for which he was responsible for the country profit-and-loss, and also

launched two digital ventures for the group. Previously, he spent more than ten years as a management consultant, including serving as a Principal with OC&C Strategy Consultants in London where he was part of the private equity practice in addition to focusing on strategic planning and digital transformation. Kazim began his career as a consultant in A.T. Kearney's Financial Services practice in New York. He holds an A.B. from Harvard College.



Daniel Vogel, Mexico

Daniel Vogel is chief executive officer and co-founder of Bitso. Between his undergraduate and master's studies he built Quantcast's Real Time Bidding system, which became the company's main revenue generating product-line. In November 2016 he was named by the MIT Technology Review as one of Mexico's most important innovators. He is an Endeavor Entrepreneur. He holds an M.B.A. from Harvard Business School, and a bachelor of science in computer systems engineering and a bachelor's degree in economics from Stanford University.



Jo G. Weiss, USA

Jo Weiss leads White & Case's global citizenship activities worldwide, which includes its Global Pro Bono Practice, legal education, community engagement and environmental sustainability initiatives. She also serves on the Firm's Responsible Business Working Group and the core team for its Business and Human Rights Interest Group. Under her leadership, the firm has been recognized with numerous awards for its citizenship and responsible business programs, including four-time winner of The American Lawyer's Global Citizenship/Corporate Social Responsibility Awards and ten-time winner of the Financial Times Innovative Lawyers Awards, with three "Standout" and seven "Commended" matters since 2014. Previously, she created the global philanthropy initiative at Lehman Brothers as well as the advisory services consulting practice on workplace diversity at Catalyst. As a consultant at McKinsey & Co, she served Fortune 100 clients on matters ranging from acquisitions to change management. She received her M.B.A. from the University of Pennsylvania Wharton School and her bachelor of science summa cum laude from Wittenberg University.

PARTICIPANTS BY CITIZENSHIP

AUSTRALIA

Catherine Brenner
Michael H.Y. Ling*
David J. Simmonds*

CANADA

Stephanie Bertels*
Gigi Dawe
Carol Hansell

CHINA

Christopher F. Lee*

FRANCE

Mathilde Mesnard*

GERMANY

Anastassia Lauterbach*

INDIA

Bharat Doshi*

ISRAEL

Barak Orbach

ITALY

Antonella Mei-Pochtler*

KOREA, REPUBLIC OF

Myeong H. Cho

MEXICO

Daniel Vogel

TURKEY

Seda Röder*

UNITED KINGDOM

Nicholas C. Allen*
David A. Jackson*

UNITED STATES

Stacy A. Baird*
Christopher Beltran*
John J. Cannon III*
Jill E. Fisch
Anne Gates*
Jeffrey D. Grant
Kayla W. Green*
Eunah Hyun
Thomas G. Komjathy
Julie A. Martin
Michele Mayes
Robert H. Mundheim*
Melissa Obegi*
Pamela Passman
Elizabeth Savard
Dorothy Schindlinger
Kazim Tahir-Kheli
Jo G. Weiss

*denotes returning Fellow

ADVISORY COMMITTEE

Melissa Obegi, *Asia General Counsel, Bain Capital, Hong Kong, China/USA (Chair)*

Stephanie Bertels, *Director, Centre for Corporate Governance and Sustainability, Simon Fraser University, Canada*

John J. Cannon III, *Chair, Corporate Governance Advisory Group, Shearman & Sterling LLP, USA*

Bharat N. Doshi, *Chairman, Mahindra Intertrade Ltd., India*

Christopher F. Lee, *Senior Partner, FAA Investments Ltd., China/USA*

Simon M. Lorne, *Vice Chairman and Chief Legal Officer, Millennium Management LLC, USA*

Robert H. Mundheim, *Of Counsel, Shearman & Sterling LLP, USA*

David J. Simmonds, *Group General Counsel and Chief Administrative Officer, CLP Holdings Ltd., China/Australia*

CORE PROGRAM STAFF



Charles Ehrlich, *Program Director*

Charles E. Ehrlich joined Salzburg Global Seminar as a program director in May 2014. He has particular responsibility for designing, developing, and implementing programs on justice, democracy, economics, and rule of law. He has practical experience in legal development working in over a dozen countries, including in the Balkans, the Caucasus, and the Russian Federation, advising governments and public institutions on strategic planning, drafting legislation, and implementing comprehensive reforms in the justice sector, public administration, property rights, freedom of the media, and constitutional law. Charles has also worked as legal counsel for the Organization for Security and Cooperation in Europe (OSCE) in Kosovo, in Georgia, and at its Secretariat in Vienna. At the Claims Resolution Tribunal in Switzerland, he adjudicated claims to Nazi-era bank accounts. He remains affiliated with Wolfson College, Oxford, and has published a book, *Lliga Regionalista – Lliga Catalana, 1901-1936* (in Catalan), and numerous academic articles on constitutional law, justice, and political history. Charles holds an A.B. in history and classics (Latin) from Harvard University, a J.D. from the College of William and Mary, an M.Sc.Econs. in European studies from the London School of Economics, and a D.Phil. on contemporary Spanish history from the University of Oxford.



Antonio Riolino, *Program Manager*

Antonio Riolino is a program manager at Salzburg Global Seminar. He joined the organization in 2016. Since then he has worked on a wide array of programs with topics ranging from human rights to finance, law and technology. In addition to helping organize Salzburg Global Seminar programs, he also leads internal planning meetings, helps train and on-board program staff and provides the team with software support. Prior to joining the organization, he provided tech support to private companies in Italy and translation services for lawyers and defendants in the Italian judicial system. Antonio is a graduate in foreign languages from the University of Udine, with B.A. and M.A. degrees. His M.A. dissertation was on translation technique. Antonio has also studied German and English at the University of Klagenfurt, Austria.

SALZBURG GLOBAL SEMINAR STAFF

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Benjamin Glahn, *Vice President, Development & Operations*

Clare Shine, *Vice President & Chief Program Officer*

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Pia C. Valdivia, *Vice President & Chief Financial Officer*

PROGRAM STAFF

Charles Ehrlich, *Program Director*

Benjamin Glahn, *Vice President, Development & Operations*

Claire Kidwell, *Features Intern – Fall 2019*

Minah Kim, *Program Intern – Fall 2019*

Juwon Lee, *Program Intern – Fall 2019*

Mira Merchant, *Social Media Intern – Fall 2019*

Antonio Riolino, *Program Manager*

Clare Shine, *Vice President & Chief Program Officer*

Oscar Tollast, *Communications Associate*

A full listing of all Salzburg Global Seminar staff is available online:

www.salzburgglobal.org/about/who-we-are/staff

RAPPORTEUR

Kayla Winarsky Green is an adviser in the Human Rights and Business department of the Danish Institute for Human Rights (DIHR). At DIHR, she advises leading multinational companies and investors on human rights and sustainable development. She is a practicing lawyer and member of the New York Bar, experienced in working at the intersection of private and public international law with an emphasis on Business and Human Rights (BHR) and business integrity/corporate compliance. Prior to joining DIHR, she was an associate in the government investigations group of King & Spalding LLP, where she managed global anti-corruption investigations and cross-border white collar litigations and served as the founding member of the firm's BHR initiative. She earned her J.D. and a certificate in Global Human Rights from the University of Pennsylvania and a bachelor's degree (summa cum laude, Phi Beta Kappa) from Tulane University. Kayla is a Fellow of Salzburg Global Seminar and the Cutler Law Fellows Program.

REPORT CONTRIBUTORS

Melissa Obegi, *Asia General Counsel, Bain Capital, Hong Kong*

Stephanie Bertels, *Director, Centre for Corporate Governance and Sustainability, Beedie School of Business, Simon Fraser University, Canada*

Robert H. Mundheim, *Of Counsel, Shearman & Sterling LLP, USA*

Michael Ling, *Deputy Company Secretary, CLP Holdings Ltd, Hong Kong*

John Cannon III, *Partner, Executive Compensation and Employee Benefits; Chair, Corporate Governance Advisory Group, Shearman & Sterling LLP, USA*

Stacy Baird, *Consulting Director, Telecommunications Research Project Corporate; Executive Director, Intellectual Property Program, US-China Clean Energy Forum, USA*

CONTACT

For more information contact:

Charles E. Ehrlich, *Program Director*
cehrlich@SalzburgGlobal.org

Antonio Riolino, *Program Manager*
ariolino@SalzburgGlobal.org

Louise Hallman, *Strategic Communications Manager*
lhallman@SalzburgGlobal.org

For more information visit:

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