GETTY IMAGES

Oversight of Reputation in Riskier Times

By Nir Kossovsky

When markets emerge on the other side of this pandemic, company leaders will face massive pressure to boost share prices. Although share buybacks are traditionally a common strategy for meeting this end, the federal government has placed a one-year ban on buyback programs for companies that applied for aid through the $2 trillion Coronavirus Aid, Relief, and Economic Security Act.

There are, however, other steps companies can take to restore their reputations among investors. One approach is to improve strategic reputation-risk management, the dutiful oversight of the enterprise's entire risk-management apparatus—collectively, its governance, leadership, controls, and financial instruments. Reputation-risk oversight can boost share prices if two conditions are met:

1. There is an objectively effective enterprise risk-management apparatus already in place.
2. Credible and convincing details of that apparatus are communicated to stakeholders so that they can appreciate it.

Overseeing the management of reputation risk begins with the understanding that if there are angry, disappointed stakeholders whose expectations of corporate conduct have not been met, their subsequent economic behaviors will result in cash flow problems for the company. These groups are most concerned with issues such as ethics, innovation, safety, security, sustainability, and quality. Here, the board should ask management the following key questions:

- Who are our key stakeholders, and what do they expect of us?
- What are the gaps between their expectations and what the company can reasonably achieve?
- What options do we have for closing the gaps? What are the risks of not closing the gaps?
- What are our options for protecting the assets of the firm should a risk manifest in a crisis?

Under the operational control of the CEO and the oversight of the board, those members of executive leadership who are traditionally charged with risk-management oversight—such as the general counsel, chief risk officer, or chief financial officer—then need to:

- codify the organizational roles and responsibilities of enterprise risk management;
- delegate operational control to others within the organization who will make decisions with an eye toward both compliance and reputation-risk management;
- validate the charter of a board-level authority overseeing reputation and its risk;
- centralize the gathering and analysis of intelligence regarding stakeholder expectations and operational capabilities from each business unit within the organization, creating a unified context for optimal business operations;
- coordinate and moderate communications, including employee handbooks, corporate social responsibility promotional contents, and litigation counsel communications, to minimize corporate puffery and align expectations among stakeholder groups; and
- stress test the crisis management plans and continuously improve the company's risk-management apparatus.

Communicating Effectively

The surge in corporate disclosures of reputation-risk management is the culmination of events originating from the 1999 "Turnbull Report," which highlighted the value of corporate risk-management disclosures for social, ethical, and environmental (ESG) issues. Since then, there has been an emergence of enterprise risk management, with more than 90 percent of the S&P 500 now disclosing reputation risk in their 10-Ks, and a tsunami of ESG concerns

crashing over nearly every traded equity. Although financial institutions have a statutory obligation to manage reputation risk and to disclose their practices in their 10-Ks, nonfinancial firms are now also telling the world about their strategic risk-management efforts through proxy statements, 10-Ks, S-1s, and employee newsletters.

PepsiCo, for example, in its 10-K detailed its water supply and other environmental risks, in addition to publicly sharing at a gathering of enterprise risk managers how its enterprise risk management and marketing teams were collaborating to inform its stakeholders.

Omnicom Group reported in its 2019 10-K that the company not only had cyberinsurance, but had also deployed cybersecurity risk-management systems "to protect against, detect, prevent, respond to, and mitigate cybersecurity incidents," and that it implemented employee-training programs to further reduce threats.

In addition, Jeff Gravenhorst, CEO of Denmark-based International Service System Group, the world's fifth-largest employer, emphasized in an employee publication the importance of risk management, committing to position the company as the industry leader in risk management and compliance. "By building risk reliance for our customers," he wrote, "we ensure that they experience consistency, transparency and sustainability and that we retain our reputation as a safe, reliable partner in the markets where we operate."

The Stock Price Connection

Long before COVID-19 harshly underscored the need for effective risk management generally, there was evidence that the capital markets rewarded strong, strategic reputation-risk management. For years, bond rating professionals were factoring into their algorithms an issuer's reputation risk. This year, a Weber Shandwick survey of leaders from top-performing public companies reflected their belief that reputation represents 76 percent of their firms' value. Also this year, nearly half of global institutional investors surveyed by the consulting firm Morrow Sodali, which collectively manages $26 trillion in assets, said that reputational risk ranks second after ESG, playing a greater role in its investment decisions.

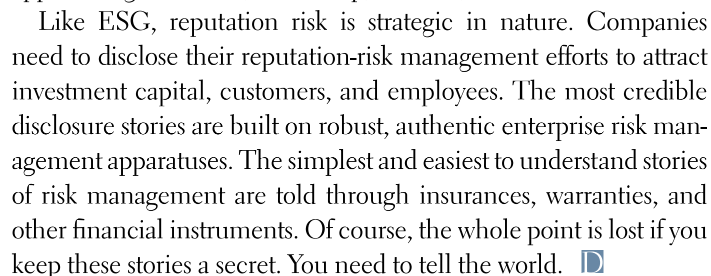
In addition, *Agenda* featured a study of the 12 most significant reputational crises of the past decade. The authors found that evidence of better reputation-risk management, presumably communicated effectively prior to an adverse event, can reduce initial equity loss and accelerate equity-value recovery.

Telling a good story that is more aspirational marketing than substantive risk management, however, does not confer economic protection. The risk in aspirational marketing is that equity investors focusing on all-things ESG rely on such disclosures. In March, Signet Jewelers reached a $240 million settlement with investors in a securities class action suit that questioned whether statements in corporate codes of conduct can qualify as material misrepresentations under securities law. Experts believe that going forward, much of the aspirational marketing language in ESG-related publications, corporate statements of ethics, and codes of conduct that previously had been routinely dismissed in courts of law as "corporate puffery" and unactionable can serve as the basis of similar derivative litigation when reputational crises manifest.

This is a growing trend. Last year, I wrote in *NACD Directorship* (May/June 2019) about how reputational issues were increasingly prevalent in director and officer litigation. Later that year, Wells Fargo & Co. paid $320 million to shareholders, including a disgorgement of $80 million from executives and board members, as a result of litigation that claims the board failed to fulfill its fiduciary duty to oversee the company's reputation-risk management framework. It was touted by plaintiffs as the largest derivative suit settlement ever.

Long before COVID-19 underscored the need for effective risk management generally, there was evidence that the capital markets rewarded strong, strategic reputation-risk management.

A study by reputation-risk management firm Steel City Re found that for the year ending June 2019, 25 lawsuits were filed or amended in federal court alleging board-level responsibility in connection with corporate reputational damage. That's an increase from only six the preceding year. The major lesson for boards is that reputation-risk management needs to evolve from a notion of aspirational marketing and public relations to a notion of authentic risk management involving the entire enterprise risk-management apparatus: governance, leadership, controls, and insurance.



Like ESG, reputation risk is strategic in nature. Companies need to disclose their reputation-risk management efforts to attract investment capital, customers, and employees. The most credible disclosure stories are built on robust, authentic enterprise risk management apparatuses. The simplest and easiest to understand stories of risk management are told through insurances, warranties, and other financial instruments. Of course, the whole point is lost if you keep these stories a secret. You need to tell the world.

Nir Kossovsky is CEO of Steel City Re, which measures, mitigates, and transfers through insurance reputation risk.