tapestry NETWORKS

ACLN SUMMARY OF THEMES

Investor perspectives, ethics of AI, and the audit committee-finance relationship

July 2024

On July 10, 2024, the Audit Committee Leadership Network (ACLN) met in New York to discuss investment funds' perspectives, the ethics of artificial intelligence (AI), and the audit committee's relationship with the finance function.

Members were joined by Eric Pan, president and CEO of the Investment Company Institute, for the investor perspectives session, and Christina Montgomery, vice president and chief privacy and trust officer of IBM, for the AI discussion. Aaron Alt, chief financial officer of Cardinal Health, and Jeff Campbell (ACLN member), recently retired vice chairman and chief financial officer of American Express, joined the conversation about the audit committee's relationship with the finance function.

For a list of meeting participants, see Appendix 1 (page 10).

This *Summary of Themes*[1] provides an overview of each discussion:

EY Building a better working world

Investor perspectives

With the significant rise of institutional equity holdings over the past few decades—from 6% of US stocks in 1950 to 65% in 2017[4]—boards are interested in better understanding these investors' expectations and goals. Members heard from Mr. Pan, whose Investment Company Institute (ICI) represents major investment funds globally, many of whom are part of the largest asset management companies in the world. He shared his perspectives on the evolving investor landscape. Key themes included:

- **The rise of passive investors has significantly shifted the investor landscape.** The passive / index fund industry now holds the largest share in most S&P 500 companies.[5] *"The whole theory behind index investing is you're tracking the market and assuming the market will optimize returns over time,"* Mr. Pan explained. This has sparked debates on shareholder power. It also raises possible questions for boards; Mr. Pan gave an example: *"Who are we really serving and what type of information are we getting from shareholder engagement efforts?"* The shift has surfaced other issues too. For example, some view certain investment funds as pushing on specific issues or agendas, like sustainability, or as *"pulling all the strings."* But that is not the reality, Mr. Pan said. Audit chairs also expressed frustration at hearing varied views from different teams at investment fund complexes. *"If you talk to the governance team, they have a different point of view from the portfolio manager,"* one said.
- **This shift is changing market dynamics.** Active fund managers argue that they conduct essential research and accuse index investors of *"free riding"* on their efforts. As a result, a small group of active investors is likely driving price discovery, not large passive funds. Jonathan Day, chief executive of Tapestry Networks, observed, *"It seems the popular understanding of how the investment system works is out of date. We need a better understanding of how it actually operates."*
- **Pass-through voting is gaining traction and could alter investment funds' voting patterns.** In response to criticism about voting power and legislative pressure, large investment fund complexes are moving toward implementing pass-through voting, which enables

Debating the impact of "common ownership"

In antitrust economics, "common ownership" is the view that firms in the same industry compete less vigorously when a few large investment funds hold significant shares in many of them. The theory has both proponents and critics. Lina Khan, chair of the Federal Trade Commission, has voiced concerns about the power of large investment funds to suppress fair competition.[2] Eric Pan argues that there has been no empirical support for the anti-competitive effects of common ownership and says that policy changes based on these concerns could be unwarranted.[3] This debate adds to the challenging political climate and misperceptions already faced by investment funds.

shareholders to direct proxy votes. *"I thought pass-through voting was still in a smaller test phase but are you suggesting that the large investment funds are quickly moving toward that*?" a member asked. Mr. Pan confirmed that pass-through voting is growing, under different brand identities—for example, BlackRock calls its system Voting Choice.[6] Initial technical and legal challenges have been overcome and it is now about implementation, Mr. Pan said. Boards should stay apprised of this trend as investment fund complexes try to align their voting strategies with shareholder preferences. This could cause concern for corporations because investment funds are often among the most reliable shareholders, and any trend in which investment funds stop voting completely could mean *"ceding ground to activists and sovereign wealth funds,"* Mr. Pan cautioned.

- **Proxy advisors continue to be influential but may face increased scrutiny.** Members wondered about the impact of the changing investor landscape on firms like Glass Lewis and Institutional Shareholder Services (ISS). Mr. Pan noted that they remain powerful but also face political pressure. Political changes in the US, particularly a new Republican administration, could subject proxy advisory firms to more scrutiny, including disclosures of conflicts of interest, SEC registration, and greater transparency in voting recommendation processes.
- **Investors and boards both seek increased engagement.** Members expressed concern about the lack of engagement with passive investors regarding the financial success of companies. *"As boards, we work for investors, but the reality is there is very little engagement with passive investors of any kind other than activist situations. Shouldn't we get input from investors on how they feel about things like CEO selection and strategy?"* a member asked. Investment funds also seek meaningful engagement, Mr. Pan said, but the political climate has made investment funds more cautious in what they do. Members noted that board-investor engagement differs internationally. For example, one had served on a UK board that held an investor day attended by the board chair, senior independent director, and board committee chairs—without management—with discussions focused on the operation of the board. It was so well-received it became an annual occurrence. Another shared a practice that proved valuable: a board hired a firm to survey the company's investors on a variety of matters. *"We'd get a detailed report on how our investors were perceiving management and the board. It would give a baseline and help evaluate trends going forward,"* the member said.
- **ESG (environmental, social, and governance) creates highly divergent views.** The group discussed each of the three elements:
  - **For "E" (environmental), consistent sustainability-related disclosures are a priority.** Investors *"care most about the ability to do comparisons,"* Mr. Pan said. *"We don't like garbage in-garbage out disclosures,"* he added, citing Scope 3 greenhouse gas emissions disclosures as an example. Without reliable measurement, such data is not useful, he said. ICI supports the International

Sustainability Standards Board (ISSB), which focuses on the needs of investors, and standardized, comparable sustainability disclosures. Members and Mr. Pan acknowledged that sustainability concerns differ for Europeans and Americans; Mr. Pan shared a view that *“Europe has achieved some of the low hanging fruit in this area, but now as they get to some of the harder topics, people are starting to push back.”* Members asked whether investment funds considered the costs of preparing sustainability disclosures versus the benefits to investors. *"Investors say give us all the information and we will figure out if it's needed,"* Mr. Pan said.

- **Defining the “S” (social) continues to be challenging.** Diversity, for example, is often highlighted as part of the “S” but continues to have different definitions. *“I can’t imagine there is a single ‘S’ strategy that we should require everyone to follow,”* Mr. Pan said. A member noted that pay equity is becoming more prominent. *“It has been a big deal in Europe for a long time and is starting to become more so in the US,”* the member said, noting the SEC is showing interest in this area.
- **“G” (governance) has always been a focus.** Investors inherently focus on governance, so it is not controversial or new, Mr. Pan said.

The ethics of AI: a case study

As AI becomes more integrated into business products, services, and operations, companies are considering the ethical implications and risks of their AI projects. Despite varying needs—some companies produce and sell AI, others are simply users, and others do both—establishing a framework for the ethical use of AI is increasingly necessary. Members met with Ms. Montgomery, who discussed IBM’s approach to ethical AI, its governance model, and key considerations for boards of large, global companies.

A brief overview of IBM’s AI governance approach is summarized below. A forthcoming ViewPoints *will include perspectives from both ACLN and European Audit Committee Leadership Network members on this topic.*

IBM’s AI ethics and governance framework

As a company with 300,000 employees and operations in 170 countries, IBM needed to identify and mitigate ethical risks related to AI, which is a major element of its business. Ms. Montgomery summarized IBM’s approach, *“We have a governance framework and process that captures the inventory of data, AI models, and AI systems across the company and that framework is embedded into*

What is “AI ethics”?

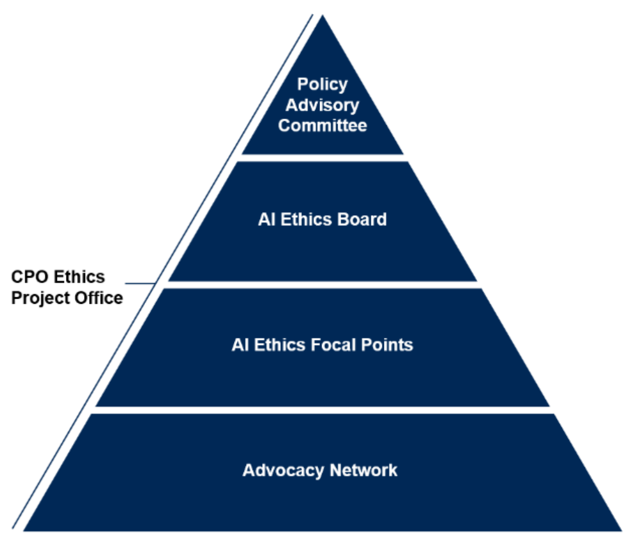
Ms. Montgomery defined it as a set of moral principles guiding organizations in discerning right from wrong. *“Each company may have different principles or a unique moral north star. It is about balancing and optimizing benefits while reducing and mitigating the risks,”* she said. Examples of ethical issues in AI include data privacy and security risks, large-scale misinformation, and copyright and intellectual property concerns, to name a few.

our product development, uses of AI, and procurement. It is largely technology-based, but there is also human involvement."

The AI governance framework includes several key elements:

- **Guiding principles.** A clear set of trust and transparency principles serves as a foundation to guide the responsible development and deployment of AI.[7]
- **Oversight body.** Top management oversight comes through the Policy Advisory Committee, which Ms. Montgomery facilitates. It is comprised of senior leaders and C-suite executives, across the company's operations. It is the final escalation point for ethical concerns related to AI. Few cases are brought to this committee, which only considers the largest and most fundamental decisions.
- **AI Ethics Board.** This cross-disciplinary group is comprised of business leaders and co-chaired by IBM's global AI ethics leader and Ms. Montgomery. *"We bring a lot of different pieces and leaders together, such as legal, procurement, ESG, and research,"* Ms. Montgomery said. The board is responsible for defining and maintaining IBM's AI ethics policies, practices, and communications, and reviewing use cases escalated to it.
- **Frontline involvement.** Corporate instructions and other guidance provide direction for IBM employees. Employees can determine if a use case requires review by the AI Ethics Board on an internal website using criteria based on IBM's trust and transparency principles. A crucial part of the model involves business unit representatives (referred to as "AI Ethics Focal Points" in the graphic on the right) who serve as the first point of contact for identifying and assessing ethical concerns within their unit. They help advocate and promote compliance with IBM's principles and policies. Additionally, a network of employee advocates promotes a culture of ethical AI throughout the company.[8]

Critical Components: IBM's AI Ethics Governance Framework



Source: Adapted from IBM and Gartner

A detailed summary of IBM's model is available here: Case Study: An AI Governance Framework for Managing Use Case Ethics, by Gartner.[9]

Principles in practice

"One of the first things we did was around general-purpose facial recognition, the kind used in mass surveillance. In June 2020, our CEO said that IBM will not sell it. The technology was too early and was being misused. We felt that we could not always assess what a client was using the technology for and were not comfortable with its accuracy at that point, so we pulled it from the market. The AI Ethics Board was at the center of that decision," Ms. Montgomery said. She also described ways IBM deploys AI internally. *"The finance team has more uses of AI than any other part of the company. We're also starting to use AI in the compliance program to bring in the business controls team. We are building it on the fly. It won't be perfect the first time, so we start small and test whether it's working."*

She highlighted several important aspects of the AI governance framework:

- **Integration with existing processes.** *"We built a lot of the AI ethics and governance program on top of the privacy program, and we use a lot of the same technology and workflows,"* she said. IBM's privacy program has been scaled in recent years to comply with the European Union's General Data Protection Regulation (GDPR). The approach enabled IBM to integrate AI governance without creating entirely new processes.
- **Efficiency.** A member wondered whether the AI Ethics Board constrained creativity, but Ms. Montgomery said it did not: *"We don't view the AI Ethics Board as slowing down business at all. We have set it up in a way that we are filtering as much as possible and reserving the board for those areas that are really truly gray and not straightforward."*
- **Ongoing reports to the audit committee and board.** Ms. Montgomery reports to the audit committee once or twice per year, providing a holistic view of the AI and privacy programs. Her first presentation to the audit committee focused on data as a source of opportunity and risk. Because investors increasingly ask about AI ethics and data protection and their impact on issues like employment and the environment, she also provides updates to the board to build their awareness of IBM's integrated approach. *"We are very much involved with other functions like ESG, enterprise risk management, and finance. We show directors how we show up in the ESG report and the proxy to ground the board in the overall program and show all of the touchpoints we have,"* she said.
- **Close collaboration with cybersecurity teams.** Effective AI governance requires close collaboration with cybersecurity efforts. At IBM, Ms. Montgomery works closely with the chief information security officer (CISO). *"The CISO has an oversight Cybersecurity Advisory Committee, which is a sister body to the Policy Advisory Committee that I run. It is essentially the same membership, and we sit on each other's committees to ensure overlap,"* she explained.
- **Preparing for a complex AI regulatory landscape.** Currently, there is no single global standard or regulatory framework that governs the responsible use of AI. This poses challenges for large, global companies. IBM advocates for regulation of specific applications

of AI, rather than of the technology itself; the company provided input to policymakers on the EU AI Act, which aims to regulate AI applications based on their risk levels. Ms. Montgomery cautioned against overregulation in the US, noting that her team's current focus is on the roughly 20 different state privacy laws that are now in place. Ultimately, *"IBM advocates for federal US regulation with preemption,"* she said.

For boards that are still early in their AI journeys, Ms. Montgomery emphasized that ethical AI should first focus on data. *"The processes you put in place for AI ethics are the same ones needed to derive value from AI. You will not get value from AI built on bad data—it will produce poor results, create ethical issues, or both. Establishing effective governance processes is essential, and each company's approach will differ, but it all starts with data."* She advised boards to ensure their companies understand what data they have, where and how it is stored, who has access to it, and how it is used.

Considering the sustainability implications of AI

AI-powered tools consume significant energy. Ms. Montgomery emphasized the need for companies to assess when AI is truly necessary: *"We don't ask often enough, 'Why are we using AI for this use case? What is the point of AI in this context?' Part of a company's AI strategy should be how and why you need generative AI or a general purpose large language model versus a more purpose-built model or technology."* She stressed the need for companies to make decisions holistically, including considering the sustainability impact. Importantly, she also highlighted AI's potential to help address climate change, underscoring its potential to improve sustainability.

The audit committee's relationship with the finance function: a dialogue with CFOs

One of the most critical relationships that audit committees have is with the finance function, especially as technology, sustainability, and risk landscapes continue to evolve. Members were joined by Mr. Alt, a current CFO, and Mr. Campbell, a recently retired CFO and current audit chair. Several other members have served as CFOs and contributed their insights. Key themes included:

- **More than ever, CFOs must be a strategic partner to the CEO and board.** Core financial functions like treasury, controllership, and tax remain essential priorities for CFOs, Mr. Alt and Mr. Campbell said, but both noted an increasing need for CFOs to also drive value creation. *"I divide it into two halves,"* Mr. Campbell said. *"The first part is where you're running the 'factory,' which is the foundational finance function. That part is more complicated and regulated now, but that aspect has not changed a lot in the past 25 years. The second part is really driving value for the business, which you do by being an extraordinary partner to the CEO and business team."* How a CFO drives value can look *"radically different"* depending on the company and industry, he said. A member added that CFOs must adapt to each CEO: *"When I was a CFO, I had to step up and do the things the CEO was not willing to do, so the role changes depending on who you are working with."*

Close collaboration does not imply identical roles, said Mr. Campbell: *"The CEO and CFO have different roles and the best partnership is one where they both realize that."* He added, *"CEOs need to be comfortable enough in their skin to understand that they are managing people who have their own views."*

- **A CFO's enterprise-wide perspective is crucial.** *"The CFO is one of the few individuals with a comprehensive view of the entire enterprise,"* a member said, *"and the institutional context is critical for helping to steer the business, including capital allocation and aligning it with the overall strategy."* Another member, a former CFO, emphasized the importance of CFOs partnering with business leaders to understand key drivers and metrics and design accountability structures that ultimately enable a move from reactive to proactive business management.
- **An effective CFO-audit chair relationship is built on trust, candor, and independence.** Mr. Campbell and Mr. Alt both emphasized the importance of transparency and open dialogue. *"There should be no surprises at audit committee meetings,"* Mr. Campbell remarked.
- **Audit chairs can help CFOs prioritize.** *"I rely on the audit chair to help me see the forest for the trees,"* Mr. Alt said. *"My worry list is a mile long and our conversations help me prioritize what is really important, and identify best practices compared to our company's practice. I get a lot of value from that."* As an example, he cited enterprise risk management (ERM). *"The audit chair helped us realize we had a gap. When I became CFO, one of the first expectations of how we can make the company better was to look at ERM, not just in finance but across the company and start improving how we think about risk."*
- **Audit chair relationships with other finance leaders are important.** *"As an audit chair, I really value building relationships beyond the CFO, such as with the controller, head of internal audit, and external auditor,"* Mr. Campbell said. *"There is value for the CFO too. When the CFO's peers and direct reports have the opportunity to be in front of the audit committee, it raises their game and creates more shared accountability,"* Mr. Alt said. Beyond finance, members said that coordinating across various functions can be challenging, but depending on a company's circumstances, different points of contact may be needed. *"For example, one company was dealing with a lot of legal issues, and I was talking with the general counsel more than I was talking with the CFO,"* a member said. Despite this, the CFO often plays a crucial role in bringing these elements together and assisting the audit chair in managing complex issues, ensuring a coordinated approach. *"You*

need a quarterback. As an audit chair, I want to know the head of compliance and general counsel, but I still look to CFO to bring it all together or to help me understand the internal dynamics," Mr. Campbell said.

- **Effective talent development and succession planning requires continuous, proactive efforts.** *"Talent is hard. You have to constantly invest in it,"* Mr. Alt said, emphasizing the need for multiyear plans at all levels. He highlighted the importance of a talent pipeline, especially considering offshoring trends. Mr. Campbell stressed the importance of regular, in-depth discussions on talent and succession planning, ensuring the audit committee sees beyond the CFO to the next level of leadership. He also recommended that CFOs gain board experience: *"Encourage the CFO whose board you're on to sit on a board themselves—one where they are not familiar with the industry. There is just no substitute for learning what it is like to only show up a handful of days a year."* Relatedly, he added, *"I think boards are also best when it's a mixture of people who are still working full-time and people who are retired. You need those who are working to help the board stay thoughtful about the line between management and the board."*

Involving the CFO in audit committee evaluations

One member solicited input on how to enhance the audit committee evaluation process: *"I'm trying to rejuvenate the process, and one idea is asking the CFO, chief internal auditor, and external auditor to provide comments on how they would evaluate the committee members."* Another member endorsed the idea: *"I do this as a conversation as part of the annual audit committee evaluation process, and some of the best ideas and feedback on what we should address in the next year come out of those discussions."* Various evaluation methods were mentioned, including surveys and one-on-one conversations. One member noted using the company's law firm, while another engaged a third-party firm. *"Every three years they talk to management as well. Because it is done with a third party, I feel that it is likely better, more candid feedback,"* the member said.

About this document

Appendix 1: Participants

The following members participated in all or part of the meeting:

Joan Amble, Booz Allen Hamilton
Jeff Campbell, Aon
Pam Craig, Merck
Lynne Doughtie, Boeing
Lynn Elsenhans, Saudi Aramco
Bob Herz, Morgan Stanley
Akhil Johri, Cardinal Health
Lori Lee, Emerson Electric
Ann Marie Petach, recent ACLN member
Leslie Seidman, board member of Janus Henderson and Moody's Corporation, and recent ACLN member

The following EY representatives participated in all or part of the meeting:

Julie Boland, US Chair and Managing Director and Americas Area Managing Partner
Pat Niemann, Partner, Americas Center for Board Matters

The following Tapestry Networks representatives participated in all or part of the meeting:

Beverley Bahlmann, Executive Director
Jonathan Day, Chief Executive
Kelly Gillen, Senior Associate
Todd Schwartz, Executive Director
Abigail Ververis, Project and Event Manager

Endnotes

[1] *Summary of Themes* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from members and guests in connection with the meeting but may be edited for clarity.

[2] US Federal Trade Commission, "FTC, DOJ Submit Joint Comment to FERC Warning of Common Ownership Competition Risks in the Public Utilities Industry," news release, April 25, 2024.

[3] Eric Pan, "US Retail Investment Under Attack from Bunk 'Common Ownership' Theory," *Financial Times*, July 19, 2024.

[4] Raymond Fisman, "Investing in Influence: Investors, Portfolio Firms, and Political Giving," *Harvard Law School Forum on Corporate Governance* (blog), February 3, 2023.

[5] Jan Fichtner, Eelke Heemskerk, and Javier Garcia-Bernardo, "Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk," *Cambridge University Press*, April 25, 2017.

[6] "Empowering investors through BlackRock Voting Choice," BlackRock, Inc., accessed August 1, 2024.

[7] IBM, *IBM's Principles for Trust and Transparency* (Armonk: IBM, 2018).

[8] "Case Study: An AI Governance Framework for Managing Use Case Ethics," *Gartner*, September 20, 2023.

[9] "Case Study: An AI Governance Framework for Managing Use Case Ethics," *Gartner*.