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Thoughts for Boards: Key Issues in Corporate Governance for 2024

Over the past year, expectations for directors have continued to evolve, bringing new challenges and responsibilities to the boardroom. The remarkable speed, volume and proliferation of channels through which information travels today continue to place more scrutiny on boards and heighten expectations regarding transparency and accountability. Director reputations that have been carefully built over decades are not immune from such pressures, particularly as activist investors hunt for underperformers and revisit former targets. The business environment has also become more complex: macroeconomic uncertainty, geopolitical tensions, regulatory unpredictability, political polarization, culture wars, cybersecurity threats, the growth of generative AI, and energy transition are among the issues that boards are now expected to navigate.

Amid this change and uncertainty, we have summarized below some practical considerations and recommendations for boards as we look ahead to 2024:

Key Principles for Board Effectiveness

As directors face mounting expectations and responsibilities, there are some fundamental principles to keep in mind to help ensure that the board operates effectively.

- **Don't Lose Sight of Priorities**: The board agenda should reflect the company's key business priorities and risks. While the number of issues that may require board oversight has expanded, time and focus should be given to those issues that will materially impact the business in the near-, medium- and long-term. Allocation of appropriate issues to board committees can help boards assign priorities and distribute responsibilities. For many agenda items, board meetings should favor depth over breadth.

- **Collaborate With Management**: The board's relationship with management is central to its effectiveness. Building a relationship of mutual trust and candor is a foundational step to ensuring that information is timely received and the board's feedback is reflected in day-to-day operations. Boards should leverage management's expertise to stay informed on emerging issues and find opportunities to share feedback and receive input both within and outside regularly scheduled board meetings.

- **Don't Overlook Soft Skills**: Skills such as leadership, diplomacy, judgment and overall business acumen are not necessarily reflected in skills matrices, but are vital to effective, engaged oversight by boards. The ability to amicably raise and discuss different perspectives, and a willingness to build consensus and collaborate with other directors, are critical to a well-functioning boardroom.

- **Balance the Near- and Long-Term**: Boards are uniquely positioned to serve as a counterweight against excessive pressures on companies to deliver near-term results.

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Boards are empowered to help shape the longer-term direction of the business and should guide management to see around corners, balance competing interests, anticipate risks and competitive threats and explore new opportunities.

- **Be Prepared to Innovate**: There is no one-size-fits-all approach to governance and disclosure, and boards should be prepared to develop policies and practices that are tailored to the needs of the business. While it may be advisable to take cues from peers and the market from time to time, many new and evolving issues – such as issues relating to energy transition, cybersecurity risk management and the use of generative AI – require creative approaches to unprecedented governance, disclosure and risk management challenges.

Key Pressure Points for Directors

A confluence of factors has led to increasing scrutiny of boards and directors in recent years. In 2024, we expect these pressures to continue to manifest in the following ways:

- **Individual Director Performance**: The advent of the universal proxy card has increased scrutiny of individual director qualifications and contributions to the board in the activism context, as dissidents and proxy advisors seek to identify which directors are the most vulnerable targets for board refreshment. Investors, too, are keen to better understand boardroom dynamics and have been pressing for more transparency through engagement and disclosures. In this regard, attention may turn to measuring the performance of individual directors, including through tracking the performance of the companies where they have served as a director or the outcomes of policies implemented during a director's tenure – strategies that activist shareholders have already adopted in public campaigns.

- **Director Participation in Shareholder Meetings**: Individual directors are increasingly expected to join and be active participants in meetings with investors, particularly where investors have raised concerns about a company's policies or performance. Lead independent directors and chairs of standing board committees, in particular, should be prepared to take an increasing role in investor meetings. During engagement sessions, investors expect directors to be familiar with the company's strategy, understand and substantively engage with the investors' priorities, and demonstrate independence from management. Investors regularly comment that directors who continually look to management to answer questions in investor meetings make a poor impression.

- **Engaged vs. Overstepping Board**: As shareholder expectations continue to evolve regarding the board's role in risk management, many operational issues have been morphing into governance issues. For example, the SEC's cybersecurity rules require disclosures on the board's role in overseeing cybersecurity threats, including identifying responsible board committees and describing the processes by which the board is informed about such risks. The SEC has adopted a similar approach in its proposed climate rules, which require disclosures on how the board oversees climate-related risks as part of its business strategy, risk management and financial oversight. Glass Lewis's 2024 benchmark voting policies will also assess whether companies have codified a "meaningful level" of board oversight of, and accountability for, a company's material environmental and social impacts. However, the fundamental role of the board remains one of oversight, and directors should work to raise concerns and provide guidance to management without overstepping into management's responsibilities.

- **Focus on Director Bandwidth**: As board responsibilities grow, so has the focus on director bandwidth; directors should be realistic about their bandwidth when considering new opportunities for board service. Beginning in 2024, State Street Global Advisors will require S&P 500 companies to develop their own director overboarding policies to replace the quotas that State Street has previously enforced through withhold votes. This shift reflects continued efforts by investors to develop more tailored approaches to managing director commitments. Board roles that may require additional time, such as the board chair and audit committee chair, are now being taken into account when determining whether a director is overboarded. On average, independent directors on S&P 500 boards serve on two public company boards, a number which has remained steady over the past decade. However, the percentage of independent S&P 500 directors who serve on three or more boards has declined to 29% from 33% in 2013.

- **The Stakeholder Balancing Act**: The shift away from a myopic version of shareholder primacy, in favor of a governance paradigm that balances competing stakeholder interests to forge well-rounded business decisions, has highlighted the sometimes competing priorities of stakeholders. Heading into an election year, companies may continue to find themselves caught in the domestic culture wars and pressured to take positions on divisive social and political issues. And shareholders, too, may be increasingly divided on their expectations regarding environmental and social issues, as evidenced by the continued wave of shareholder proposals in 2023, notwithstanding the declining support for such proposals among the largest institutional shareholders.

Looking Ahead to 2024

- **ESG to Evolve**: While the trendiness, and public use, of the "ESG" acronym may be fading, many of the issues for which ESG became a shorthand will continue to impact business decisions in meaningful ways. With respect to climate change, for example, the adoption of the European Union's Corporate Sustainability Reporting Directive ("CSRD"), the consolidation of voluntary global disclosures under standards promulgated by the International Sustainability Standards Board, together with ongoing regulatory efforts targeted at improving disclosures and clamping down on greenwashing, will continue to push companies to approach ESG on an issue-by-issue basis and in a manner that is grounded in actual business practices rather than aspirations.

- **Regulatory Pressure to Mount**: A flurry of new rules and regulations proposed by foreign and domestic regulators are expected to come into force over the coming months. For example, the SEC is expected to release its final rules on climate, shareholder proposals and security-based swaps and propose new rules on human capital and board diversity. The Biden Administration's executive order on artificial intelligence will require several federal agencies to release guidelines next year on the use of AI within the industries that they oversee, adding to the nascent global regulatory regime. The Federal Trade Commission is scheduled to release its updates to the Green Guides as part of ongoing regulatory efforts to combat greenwashing. Many companies will also need to prepare to comply with the CSRD. And bipartisan support for a carbon tariff continues to grow.

- **Politics and Business Continue to Collide**: Heading into an election year, it will be difficult to keep politics on the sidelines of business. The anti-ESG backlash and its opponents have continued to apply pressure on businesses in a variety of ways, ranging from congressional subpoenas and lawsuits to public letters to shareholder proposals seeking greater transparency on political activities and spending. The growing wave of labor mobilization across sectors may be among the issues that draw political interest from both sides, and may further complicate efforts to negotiate union contracts and reach consensus on other labor-related matters outside of the limelight. In addition, diversity, equity and inclusion initiatives will continue to draw political scrutiny from politicians, the media and other activists.

- **Shareholder Activism to Remain Robust**: While the past year saw activists double down on campaigns targeting strategic and operational improvements, growing macroeconomic optimism and a loosening of the credit markets may see activists once again launching campaigns centered around classic M&A theses and stock buybacks. The focus on underperformance and operational improvements, however, is unlikely to dissipate anytime soon, and activists will continue to seek management change in some campaigns. Meanwhile, some activists will continue to leverage the shareholder proposal process to engage with companies and draw attention to key governance, environmental and social issues, and companies will need to keep abreast of the evolving expectations of their shareholder base to avoid surprises at the annual meeting.

- **Cybersecurity Threats**: The rise of generative AI and ongoing geopolitical tensions will further fuel cybersecurity threats. The SEC's new cybersecurity disclosure rules may require boards and management to reassess their processes for responding to and mitigating the impacts of cyberattacks. For companies operating in certain critical infrastructure sectors, including the transportation, communication, financial services, healthcare and information technology sectors, the Cyber Incident Reporting for Critical Infrastructure Act of 2022 will introduce new disclosure requirements for significant cyber incidents and ransomware payments in 2024.

- **Demand for Board Oversight of AI to Grow**: As generative AI continues to have a transformational effect throughout the economy, demand from stakeholders for board oversight and guardrails will expand. Already regulators across the globe are exploring legislation that would curtail the use of certain types of AI. Pressure is also growing within the private sector as stakeholders, particularly employees and union groups, look to understand how companies are planning to deploy AI technology and the processes being implemented to identify and mitigate risks. The 2023 proxy season saw the first shareholder proposals calling for disclosure on the board's oversight of AI and ethical guidelines on the use of AI, and scrutiny of board oversight on AI will only grow as this technology is woven into long-term strategy and business operations.

- **Energy Transition Comes Into Focus**: The UN Climate Change Conference, COP28, recently concluded with a pledge by over 190 nations to transition "away from fossil fuels in energy systems, in a just, orderly and equitable manner." While it remains to be seen what concrete steps governments will take to facilitate a transition to green energy, the latest developments reaffirm the need for companies to reorient and revamp their operations for a global energy transition over the coming years. Already, investor focus has started to pivot from disclosure to climate transition planning. Companies that have or plan to set emissions reduction targets and initiatives to mitigate climate risk will need to credibly demonstrate the feasibility of such targets as well as strategies and interim progress.

- **Executive Compensation Remains Under Scrutiny**: New Item 402(x) of Regulation S-K will come into force for companies whose fiscal year commences on January 1, 2024, and will require companies to include in their 10-K or proxy statement narrative disclosure regarding their policies and practices on timing of awards of stock options and other similar option-like instruments in relation to disclosure of material nonpublic information. Companies will also be required to include tabular disclosure of awards made in the four business days before a periodic or current report filing that discloses material nonpublic information and ending one business day after the filing or furnishing of such report.

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While the expanding responsibilities and expectations of boards have created new challenges, the dynamic business environment propelling this evolution will also create new opportunities and winners. Engaged boards, working as a strategic partner to management and exercising their business judgment to identify priorities and weigh competing interests and objectives, are uniquely situated to forge new paths toward long-term value creation for all stakeholders.

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