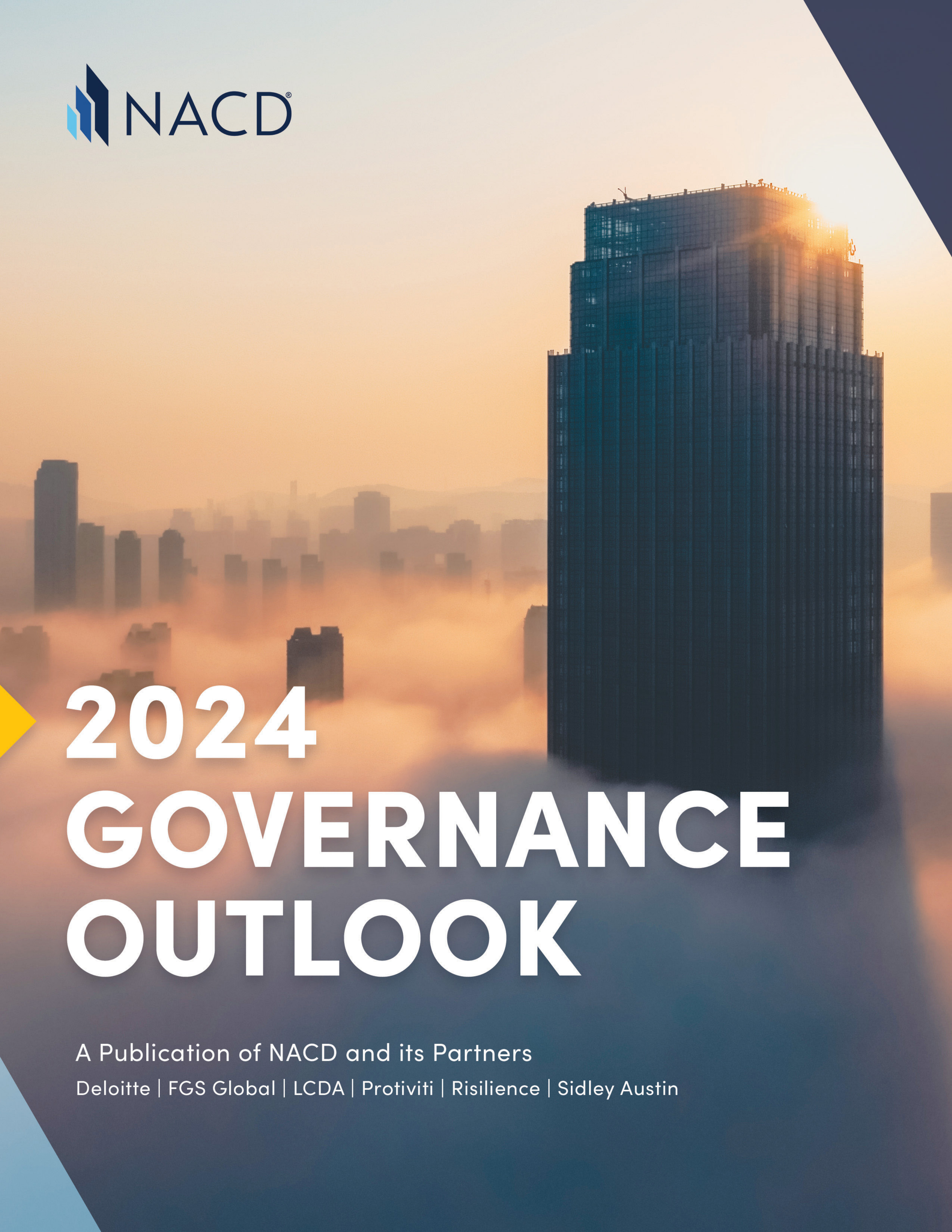

NACD

# 2024 GOVERNANCE OUTLOOK

A Publication of NACD and its Partners

Deloitte | FGS Global | LCDA | Protiviti | Risilience | Sidley Austin

# About This Report

The *2024 Governance Outlook* report provides corporate directors and senior executives with a forward-looking view of major business and governance issues that are likely to require board focus in 2024.

The report begins with highlights from NACD's annual Board Trends & Priorities Survey. Articles from six of NACD's partners follow, providing insights on a wide range of topics: M&A market constraints, climate disruption, AI and audit committee oversight, Latino inclusion in the boardroom, the universal proxy card era, and ten top agenda items for directors in 2024. Each article provides questions to help directors consider how these issues will impact their company and how the boardroom can respond.

NACD thanks our content partners—Deloitte, FGS Global, LCDA, Protiviti, Risilience, and Sidley Austin—for their contributions to this publication.

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# 2024 GOVERNANCE OUTLOOK

## Contents

# Director Outlook: Top Priorities for 2024

By Ted Sikora, NACD

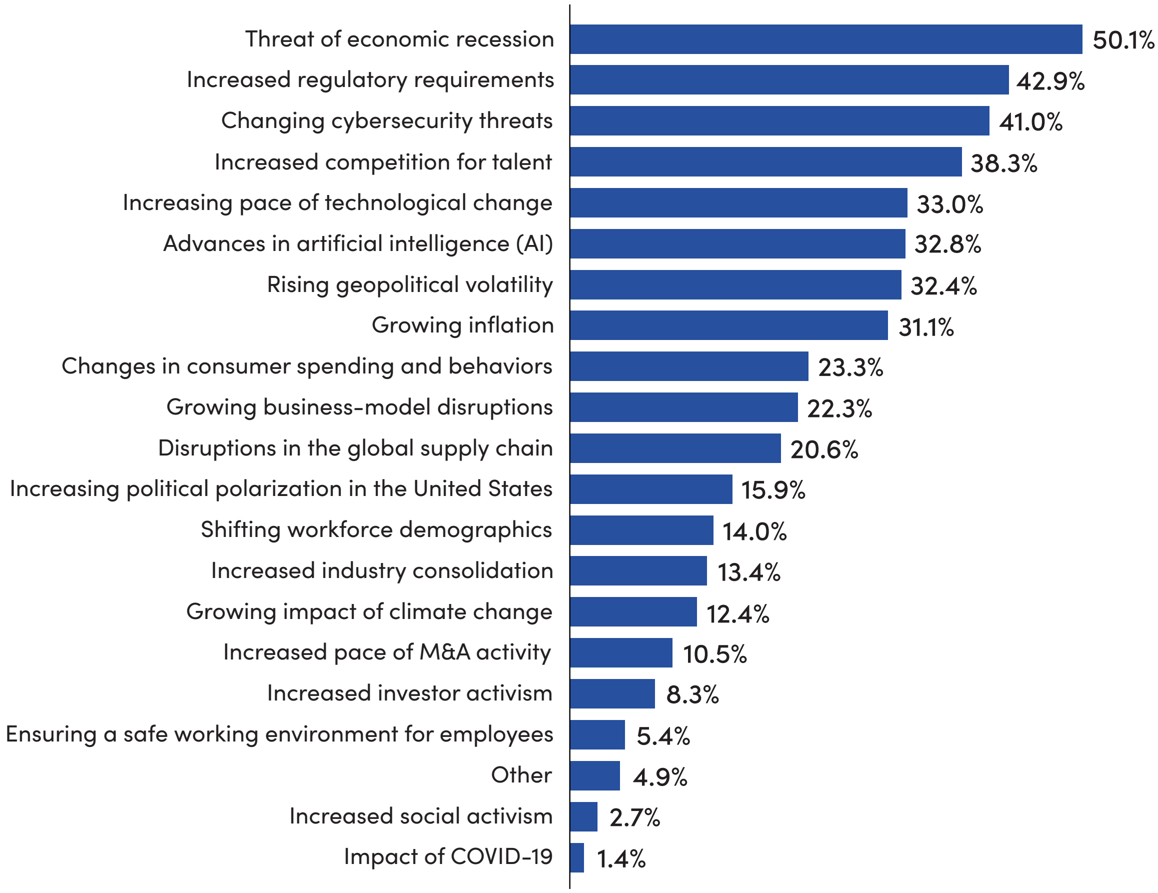
Economic volatility, technology changes, and talent concerns continue to be top of mind for directors as we head into 2024, based on the results of the National Association of Corporate Directors' (NACD) annual Board Trends and Priorities Survey. More than 500 directors responded to the annual survey, and the results build on insights captured through our quarterly Directors' Pulse Surveys. Taken together, the research tracks how the boardroom is responding to rapid developments in the business environment.

## TOP TRENDS

Directors were asked to select the top five trends that they believe will have the greatest effect on their company over the next year. Slightly more than half of respondents (50.1%) included the threat of an economic recession among their top five trends for 2024. This has consistently remained the top-ranked issue in our quarterly polls throughout the year. Nevertheless, the percentage of respondents selecting the "threat of economic recession" has decreased relative to last year's Trends Survey data, when it was selected by nearly two-thirds (64%) of respondents.

**What five trends do you foresee having the greatest effect on your company over the next 12 months?**

(Respondents could select up to five trends)

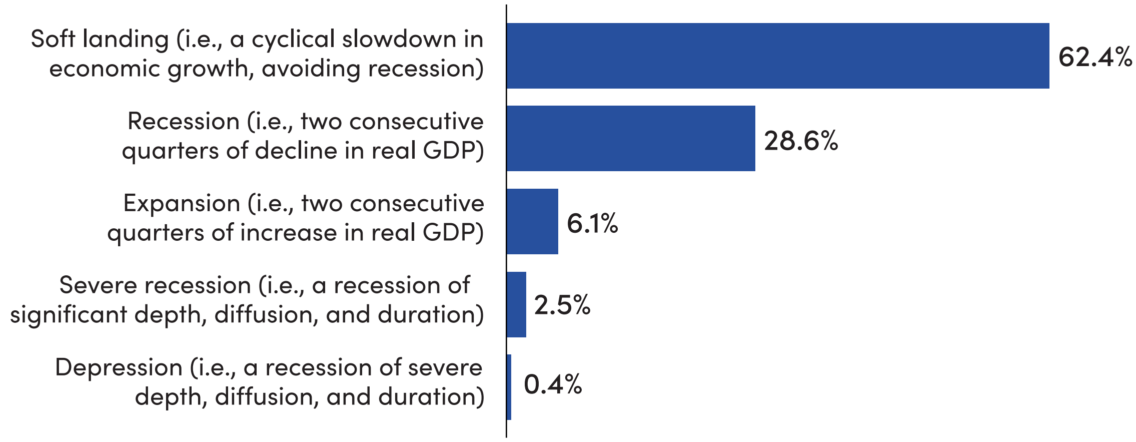



Source: 2024 NACD Board Trends and Priorities Survey, n=515

Directors' outlook on the economy has improved relative to last year. Last year, only 29 percent of respondents anticipated that the United States' economy was heading for a "soft landing," by mid-2023. This year, 62 percent of respondents feel that we are heading for a "soft landing." There have also been decreases in the percentages of those that anticipate a recession (from 65% to 29%), or a severe recession (from 6% to 2.5%). Whether the economy falls into a recession or not, the very threat of a recession has a direct implication for company strategy development and budgeting and planning for 2024.

The second most selected trend was "Increased regulatory requirements." This trend has steadily proceeded up directors' priority lists. After ranking sixth in the first quarter and fourth in the Q2 poll, it rose to the second most selected trend in Q3. Respondents cited several different specific regulations that motivated their inclusion of this issue in their top five. Many were industry specific. For example, 14 percent indicated that regulations or potential regulations affecting the banking industry are top of mind. Many in the industry expect new regulations following the high-profile failure of three banks earlier this year.

**Based on current economic conditions, in which of the following stages of the economic cycle do you believe the United States economy will be by the end of Q2 2024?**




Source: 2024 NACD Board Trends and Priorities Survey, n=479

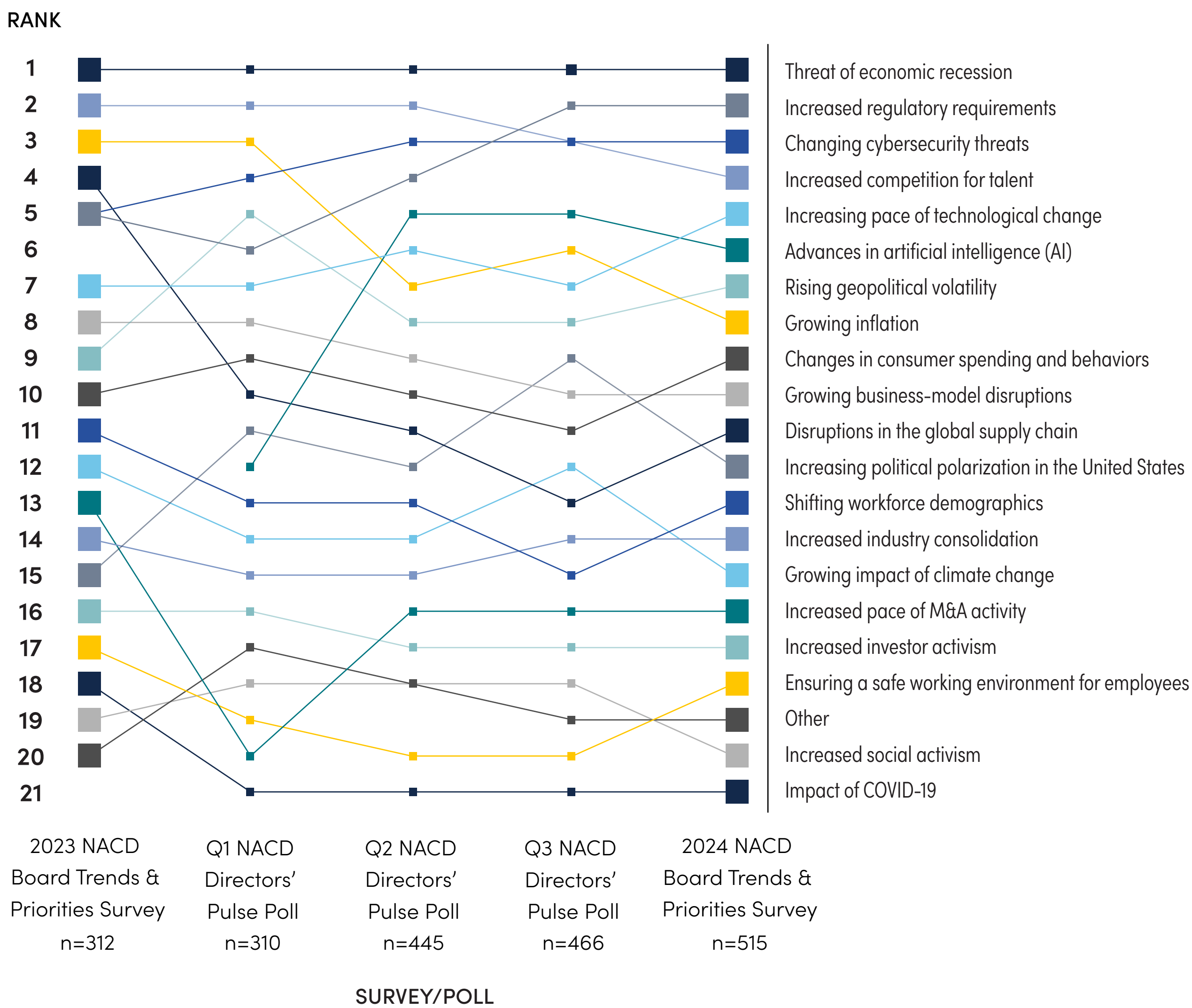
Outside of industry-specific concerns, a major theme was regulatory action related to climate change. Across the year, there have been developments at both the state and federal level. At the state level, two landmark climate-related disclosure bills were passed in California in September 2023. The Climate Corporate Data Accountability Act relates to emissions disclosures, and the Climate Related Financial Risk Act requires the disclosure of certain climate-related financial risks. Thousands of companies doing business in California are expected to be impacted by these regulations by 2026.[1] Meanwhile, at the federal level, companies anticipate that the SEC will finalize last year's proposed ruling on climate-related reporting for publicly traded companies.

It is worth noting that many of the trends interact and amplify each other. Boards should therefore anticipate the cascading second- and third-order effects of these trends. For example, growing geopolitical conflicts are increasing the risk of a global economic recession and potential supply chain disruptions. Another example, and the third most selected issue, is "Changing cybersecurity threats." Cybersecurity concerns are associated with two other widely selected trends: the general "Increased pace of technological change," and, more specifically, "Advances in artificial intelligence." Respondents' open-ended question responses illustrate specific concerns. "Threat actors are using AI and continuing to refine targeted attacks against company assets and their people," notes one respondent. "As AI and digital transformation increase, that goes hand in hand with cyber risks," advises another.

[1] See Alejandro Lazo, "Newsom signs climate bills that force large companies to reveal role and risks in climate change," posted on CalMatters.org on Sept. 12, 2023, and updated on Oct. 7, 2023.

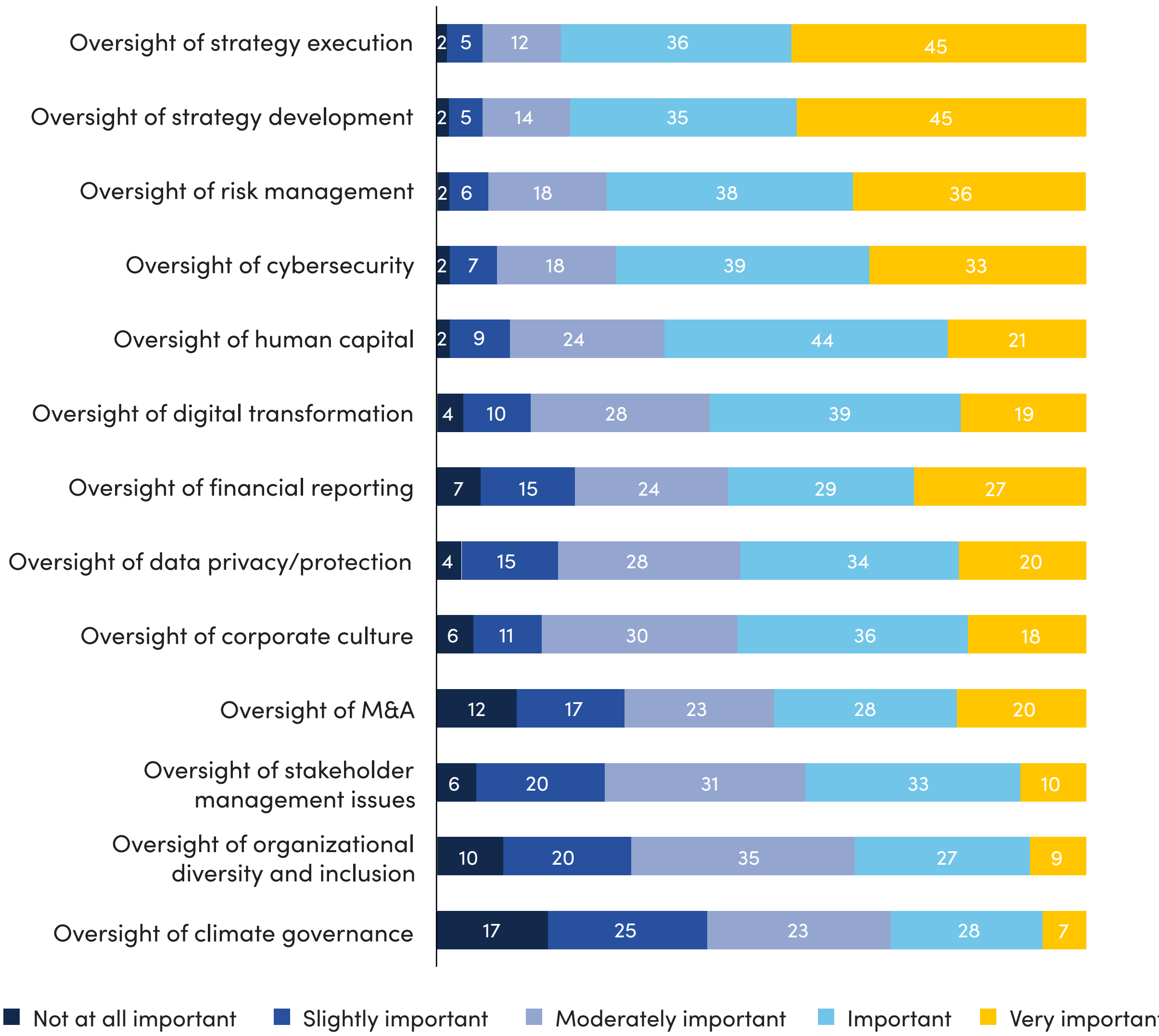
### Changes in Director Views of Key Trends Impacting Business, Quarterly Polls and Annual Surveys Conducted from November 2022 to November 2023

(Respondents could select up to five trends. Trends are ranked by percentage selection.)




The "Increasing pace of technological change" is a persistent concern for directors. This was the fifth most selected issue, with 33 percent of respondents including it in their top five. While they need not be experts, directors must remain well informed about the implications of major technological developments to provide adequate oversight of their company's strategy and risks. In fact, 58 percent of respondents indicated that it was "important" or "very important" that their board improve regarding the "Oversight of digital transformation." Even higher percentages of directors believe that their board must improve its oversight of strategy development and execution. This is one of the most crucial roles of the board, and has become more challenging at a time of major disruption.

**How important are improvements for your board in the following areas over the next 12 months?**

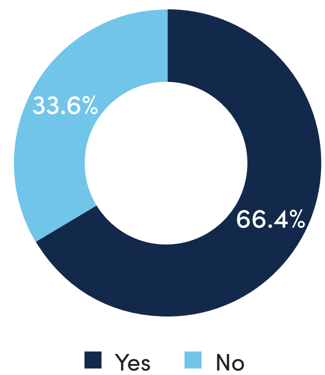



Source: 2024 NACD Board Trends and Priorities Survey, n=444-448
Percentages may sum to +/- 100 due to rounding.

Perhaps nothing exemplifies the disruptive potential of technology quite as well as recent advancements in artificial intelligence. This issue did not feature on last year's list of top trends, but it was introduced in NACD's Q1 2023 Directors' Pulse Poll, and rose rapidly from the 12th most selected issue, to among the overall top five most selected. The growing focus on artificial intelligence can be traced back to November of 2022, when OpenAI released ChatGPT. This tool is an example of generative AI, a technology that leverages vast amounts of data and statistical modeling to produce output ranging from creative prose to computer code. Many quickly saw the potential for business to harness this technology to drive efficiencies or better serve customers. Directors, too, have seen this potential. In fact, nearly two thirds (66%) of respondents indicated that they have experimented with generative AI technologies.

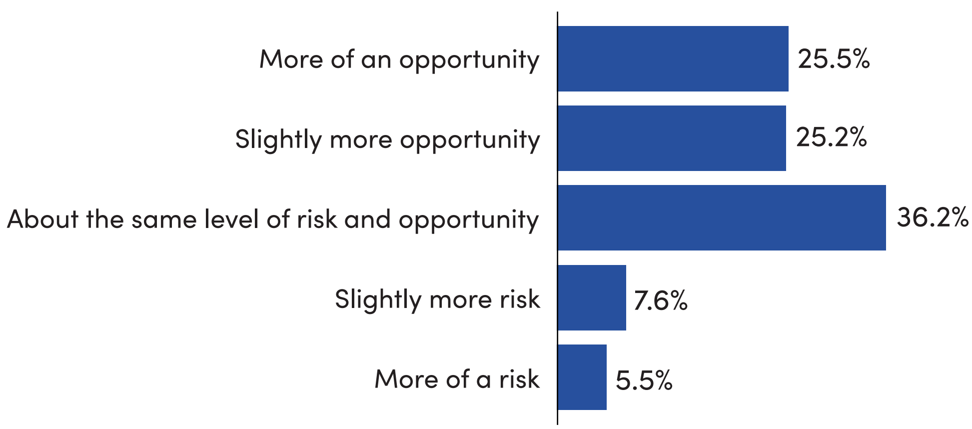
Respondents' opinions about the prospects of these technologies are mixed. One respondent cautions, "This new technology is being implemented without fully understanding the full implications." Others seem more eager to take advantage of its potential. One such respondent indicated that, at their organization, the technology was "likely to be deployed rapidly to address productivity issues." Regarding the potential that AI technologies hold for their own businesses, about a third believe they present approximately the same amount of risk and opportunity. The general sentiment seems more optimistic, however, with more than half (51%) of respondents indicating that AI presents more opportunities than risks to their organizations.

### Have you personally experimented with generative AI technologies (e.g., ChatGPT)?




Source: 2024 NACD Board Trends and Priorities Survey, n=446

### How would you characterize the potential that AI technologies hold for your organization?




Source: 2024 NACD Board Trends and Priorities Survey, n=436

Among the calculated risks and opportunities to be evaluated when adopting artificial intelligence technologies will be the impact on the workforce and recruiting efforts. Only 17 percent of respondents indicated that they had asked management about how AI could affect the company's recruiting efforts and future workforce needs. This may be a significant oversight, particularly given that the fourth most selected item in the overall top five for this year was the "Increased competition for talent." While this issue remains in the top five, it has steadily declined from its position as the second most selected issue across the second half of the year. But the challenges in securing a future-skilled workforce remains. Several open-ended responses cited the need for more "tech-savvy," “specialized,” or “skilled” workers. One director’s response was particularly illustrative of the relationships between these trends: “Talent is getting harder to get; we’re not educating the new workforce fast enough. Workers that learn how to efficiently use AI will bring an enormous advantage.”

## CONCLUSION

This year’s NACD Board Trends and Priorities Survey, along with NACD’s quarterly Directors’ Pulse Polls across the year, have shown the broad spectrum of urgent issues that are confronting boards. In our article for last year’s *Governance Outlook Report*, we noted that every year there are specific new trends that drive changes to board agendas and governance practices. That the survey informing last year’s article was in the field mere weeks before the launch of ChatGPT only helps to illustrate and emphasize this point. Directors, to be successful in their expanding role today, must be prepared to learn more and learn faster.

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**Ted Sikora** is NACD’s project manager, Surveys and Business Analytics. He specializes in questionnaire design, data analysis, and data visualization, and is responsible for generating quantitative insights that serve to elevate board performance.

# Navigating M&A in an Uncertain World

By Liz Zale, John Christiansen, Jared Levy, and Jeff Huber, FGS Global

## INTRODUCTION

Although change seems to have become the only constant, a board's role is immutable: listen, advise, approve. This is true for normal course oversight and decisions on business strategy, operations, and financial management, and especially true for capital allocation and M&A.

Today's environment of greater uncertainty elevates the scrutiny and second-guessing boards will likely face regarding their decision-making, particularly with regard to M&A. Any decision or strategic action approved will be judged by stakeholders with perfect 20/20 hindsight.

As directors consider M&A opportunities for 2024, they should also anticipate and prepare for specific challenges. They may face longer and more costly M&A processes, as well as increasingly complex financing and deal structures. Meanwhile, they can expect criticism from stakeholders—especially shareholders, activists, employees, and politicians—and enhanced scrutiny from regulators and the media. This will be against a shifting regulatory landscape as rules are finalized and implemented.

# KEY PROJECTIONS

## VOLATILE ENVIRONMENT FOR M&A

The year 2024 is expected to be yet another dynamic year, and the risks facing companies, management teams, and boards weighing major strategic decisions are as numerous and varied as ever.

The global geopolitical environment is increasingly unstable. US domestic politics will be shaped by a presidential election certain to be divisive. US monetary policy, which has major impacts on global financial markets, is unlikely to shift favorably. Although the Fed and the European Central Bank both announced rate pauses late in 2023, their "higher for longer" policies could return if inflation remains unchecked.

While geopolitics and monetary policy are not the only determinants of M&A activity, they are undoubtedly suppressing M&A volumes. Global M&A activity has fallen precipitously from elevated levels in late 2020 through 2021, with deal volume through Q3 2023 down approximately 33 percent year-to-date and down 43 percent from the comparable period in 2021.

Persistent uncertainties in 2024 will likely sustain the valuation gap between buyers and sellers. And even if this gap could be closed, an increasingly adversarial regulatory orientation in jurisdictions around the world clouds the risk assessment for both sides of potential transactions.

## GROUND SHIFTING BENEATH OUR FEET

New merger-filing rules and guidelines proposed this summer by the Federal Trade Commission (FTC) and Department of Justice cast another pall over the landscape. With these rules not yet finalized, M&A complexity for 2024 is further increased, and may yield unintended consequences. The proposed pre-merger filing process will be more cumbersome, with companies needing to disclose more information. Updates to the Hart-Scott-Rodino Form could also prolong the overall process.

## MORE HURDLES = LONGER PROCESS

Even under "normal" conditions, the greater the number of hurdles within an M&A process, the lower the probability of success. But with the number of potential impediments increasing, both targets and acquirers will need to invest more time and money earlier in the M&A process to accurately assess the probability of success.

Once a merger agreement is signed, greater antitrust scrutiny is further extending timelines to close. The FTC and other regulators have shown willingness to oppose more deals and submit legal challenges, regardless of the likelihood of victory in court. The Microsoft-Activision deal and the Meta-Within acquisition are two notable examples. Whether the FTC submits long-shot challenges as a signaling mechanism or to seed the ground for future opposition, their motives may not be understood for years, and one should assume they are playing a long game.

How these factors will impact overall M&A activity is unknowable today. For companies evaluating strategic options—whether as a buyer or seller—there are still deals to be made. However, the new rules may scare some buyers out of the market or create barriers to certain types of transactions, such as vertical mergers, or acquisitions where regulators perceive that a market-dominating company is acquiring an upstart company to kill future competition.

# MAJOR BOARD IMPLICATIONS

After two years of depressed activity, potential acquirers may take advantage of M&A to weather the stormy horizon, whether by acquiring new products, capabilities, customers, or scale.

However, M&A is rarely a silver bullet to solve a near-term business problem. In the best cases, M&A can enhance or redirect a company's ability to create long-term value. At worst, M&A may not actually improve shareholder returns, and M&A can result in steep integration curves and other issues.

For companies open to selling, there may be high-quality, well-financed suitors waiting for the right opportunity, but they may be few and far between when that time comes.

In an environment marked by a wide range of outcomes, the long-term business case and underlying rationale for a deal must be that much stronger, and successful integration becomes even harder.

All of this raises the bar for pursuing M&A. Boards of acquirers and of targets should keep in mind four principles in their evaluation of M&A opportunities:

1. Ask the right questions.
2. Protect your company's interests.
3. Ensure a fair and transparent process.
4. Manage qualitative and reputational risks.

## 1 THE RIGHT QUESTIONS

There are any number of good, complex, multipart questions a director could ask management, fellow board members, and the company's advisors when evaluating M&A. However, two deceptively simple questions should be on the top of every director's list: "**Why this?**" and "**Why now?**"

### Why this?

Rising interest rates, a more challenging operating environment, and compressed valuations may yield potentially attractive opportunities. But just as public-market investors should be cautious about catching falling knives, companies should be mindful of adopting dogs with fleas.

For targets, the same uncertainty that pushes acquirers to seek acquisitions may increase the imperative to find a partner to combat existential risks.

Asking "**Why this?**" yields many strategic considerations for boards to explore for more thorough, thoughtful diligence. Is this the right price? Does the potential transaction appropriately value the asset? Is the buyer's financing secured? Do we feel compelled to act due to external or unspoken pressures? How likely are global antitrust regulators to challenge this transaction, and what are the hurdles to overcome along the way?

### Why now?

Capital allocation is simple in theory. Companies with excess capital have four basic options: (1) reinvest in the business, (2) return capital to shareholders (dividends or buybacks), (3) pay down debt, or (4) pursue M&A. But after a decade of partying with low interest rates, the Fed just turned the lights on, and the dance floor looks different.

> But after a decade of partying with low interest rates, the Fed just turned the lights on, and the dance floor looks different.

When interest rates are low and expected to remain low, the cost of capital is not as much of a factor and the capital allocation decision matrix is simplified. On a risk-adjusted basis, all capital allocation options look relatively attractive, including M&A.

But when interest rates and the cost of capital increase, the decisions become more complex. The hurdle rate for capital projects increases. Financing costs for debt-funded buybacks and M&A go up. The relative attractiveness of dividends versus the risk-free rate of return for investments is materially altered. Even holding cash might be the optimal risk-adjusted action (if earning enough interest to avoid devaluation).

Asking "**Why now?**" allows boards to pressure test whether a transaction is truly a fit with the company's long-term strategic plan and if the opportunities for value creation outweigh the risks—or if this is simply growth for growth's sake.

## 2 PROTECT YOUR COMPANY'S INTERESTS

M&A is episodic, especially on a large scale, and few management teams and boards have extensive experience executing more than a couple of transformative M&A deals across their careers. A limited sample size of precedents creates potential blind spots.

Legal, financial, accounting, tax, governance, and communications advisors who have managed innumerable M&A transactions of all shapes and sizes can fill these blind spots. These advisors play critical roles in helping boards evaluate potential candidates for an M&A transaction and in finding creative solutions to execute deals to overcome financing and valuation hurdles.

For example, as volatility has returned, more deals are getting done with bells and whistles like contingent value rights and earn-out structures to address valuation gaps, which adds complexity. With tighter credit markets, private capital is entering the void left by traditional banks, post Dodd-Frank, in a big way. These trends are unlikely to abate in 2024, and boards can leverage the expertise of its advisor group to help see around corners and mitigate risks.

## 3 ENSURE A FAIR AND TRANSPARENT PROCESS

It's become axiomatic to focus on what you can control. In M&A, that means focusing on process, not outcome. Outcomes will ultimately be determined by many endogenous and exogenous factors and can be entirely unknowable when making a decision. But inputs are controllable.

When M&A transactions are challenged in court, judges typically consider the quality of process to determine directors and officers (D&O) liability. Was the board adequately informed of the risks? Did the board spend adequate time deliberating the risks and merits of the transaction? Were board members and advisors free from conflicts of interest? Asserting protection from liability based on the business judgment rule often depends on the answers to these questions, among others.

> Outcomes will ultimately be determined by many endogenous and exogenous factors and can be entirely unknowable when making a decision. But inputs are controllable.

The importance of strong processes and controls is magnified under uncertainty, when the range of outcomes facing companies is wider and stakeholders are more likely to question a board's decision-making.

## 4 MANAGE QUALITATIVE AND REPUTATIONAL RISKS

Managing these risks is even more complicated as the web of stakeholders becomes more interconnected, as news and misinformation travel with increasing speed, and as pundits and influencers proliferate. Political and regulatory risks are intersecting with business and capital market risk with greater frequency in more nuanced ways, especially for acquirers.

Synergies have long been central to M&A theses, and the general public is now attuned to the fact that synergies often equate to layoffs. Companies championing synergies as part of M&A transactions must be more sensitive to how various stakeholders will perceive and react to their plans.

With the balance of power shifting toward labor, achieving the cost savings necessary to make M&A successful may carry greater reputational risks and also bring legal and regulatory risks in certain jurisdictions. Employees are becoming increasingly empowered at most companies and are more likely to vocalize their concerns and advocate for their priorities. Media and public policy stakeholders are more receptive to worker issues and willing to amplify employee voices, with potential for harming a company's reputation and negatively affecting other stakeholders' perspectives.

### The Best Antidote to Complexity Is Simplicity

Here is the good news—boards do not need a crystal ball to guide their M&A decision-making. Being clear-eyed in their role as directors, adjusting to the shifting ground of M&A policy, and internalizing these four M&A survival principles will help ensure that directors will be well positioned to fulfill their duties as stewards of company value.

## BOARD OVERSIGHT QUESTIONS

1. Have we adjusted our M&A process and playbook to account for regulatory changes—both final and pending?
2. Do our M&A plans and processes appropriately reflect the uncertainties in the current external environment, including longer potential timelines?
3. Are management's compensation and incentives appropriately aligned with other stakeholders, both pre- and post-M&A?
4. How do we guard against allowing sunk cost fallacy to cloud judgment at any point in the evaluation process?
5. Do we have a clear, well-articulated M&A philosophy for use with various stakeholders who may criticize a deal?
6. How would we feel if the *Wall Street Journal* were to run a cover feature about our deal and M&A process?

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# Business Transformation for the Era of Climate Disruption

By Andrew Coburn, Risilience

We have just lived through the hottest year on record. Countries across the globe have experienced extreme heat waves, devastating wildfires, as well as unprecedented storms and flooding.

Dangerous weather events impact economies and have financial consequences for business: the Allianz 'Global Boiling' report estimates the overall costs of this summer's heat waves, which saw record high temperatures across the United States, Europe, and China, at 0.6 percent of global gross domestic product. These are the impacts of climate change, with only 1.2°C of global warming.

Future projections of temperature rise anticipate a new era of climate disruption. The World Meteorological Organization warns that global temperatures are highly likely to exceed the critical 1.5°C warming threshold within the next five years.

Climate-change driven disruption to business is happening now. Supply chains are already feeling the effects of a warmer, wetter, and more volatile climate. The Carbon Disclosure Project warns that environmental supply-chain risks will cost companies $120 billion by 2026.

Astute boards are increasingly alive to climate-related risks as they work their way up the business agenda. Near-term transition risks emerging from the shift to a low-carbon economy include increasing regulation and the rise of climate litigation. Material physical risks include damage to facilities, disruption to output, and shifts in supply chain—all too disruptive for corporations to ignore. The *2023 NACD Public Company Board Practices and Oversight Survey* found that 44 percent of respondents indicate that the frequency of climate-change-related board discussions has increased.

The year ahead will test the resilience of companies and boards. The global low-carbon transition is triggering one of the greatest economic transformations in history. The Economist Intelligence Unit cites climate change, environmental regulations, geopolitics, and AI as presenting the biggest challenges facing business in 2024. Directors cannot afford to underestimate the financial consequences of risks in the era of climate disruption, which include insufficient planning for the transition to a low-carbon economy, rising regulation, and increased litigation. Those making strategic transition plans for the positive business transformation that underpins sustainable growth will be best placed to succeed.

# A

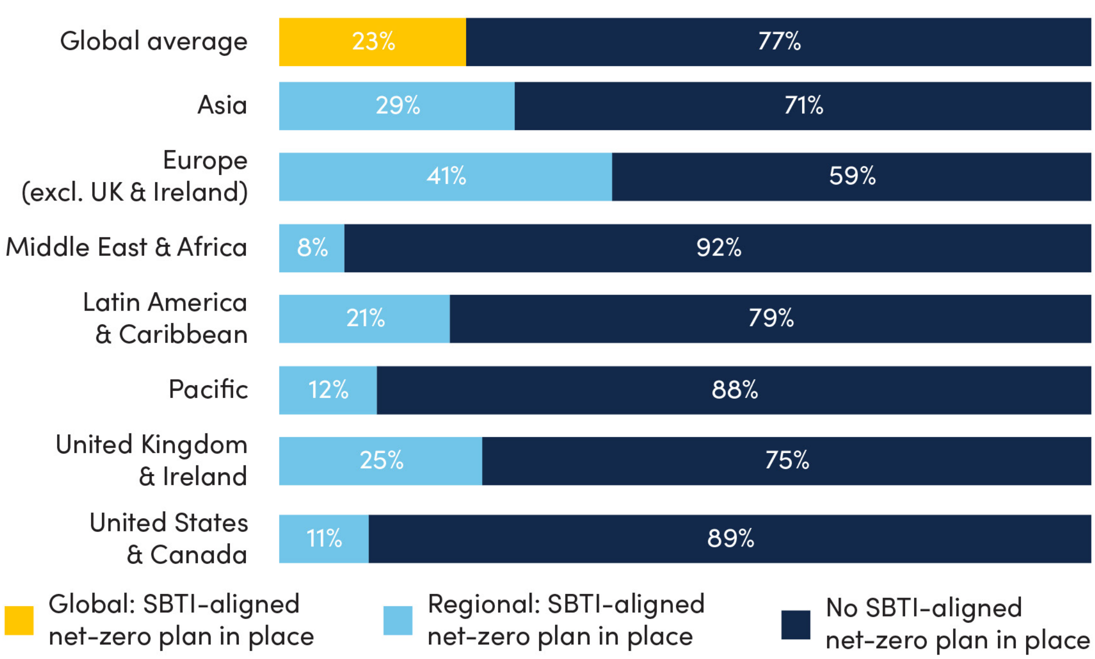
# EMERGING CLIMATE RISKS

## 1 TRANSITION RISKS LOOM LARGE FOR BUSINESS

While increasing numbers of corporations have set net-zero targets, there is a growing recognition of the complexity and challenges in developing plans to achieve them.

The Risilience report, *Quantifying Your Net-Zero Strategy: A Balancing Act Between Decarbonization, Risk and Opportunity*, a collaboration with global insurance broker and risk advisor Marsh, presents analysis of more than 400 companies throughout 2022, of which only around 23 percent have completed a transition plan in line with the Science Based Targets initiative (SBTi).

### Proportion of companies by region adapting a net-zero transition plan aligned to SBTi




Source: *Quantifying your net-zero strategy: a balancing act between decarbonization, risk and opportunity*, Risilience

Without a transition plan, organizations risk being left behind in a world that is decarbonizing and potentially may face existential transition risks that include carbon taxes, access to capital, reputational damage, climate litigation, and stranded assets. Developing a credible transition plan does require financial investment, but the returns can include benefits beyond reducing emissions. These include a competitive advantage to meet opportunities of emerging markets, enhancing resilience in supply chains, and improving resource productivity. Positive business transformation also delivers long-term value creation in relation to reducing earnings-value-at-risk, mitigating costs from future carbon taxes, and meeting the criteria for green finance.

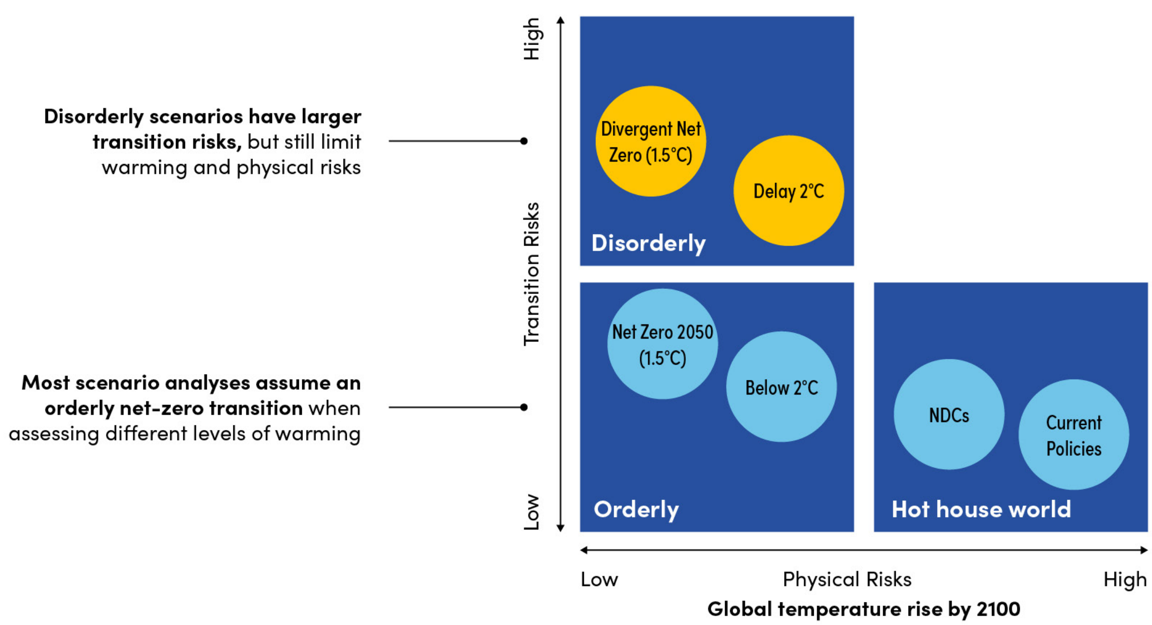
## IMPLICATIONS FOR DIRECTORS

Resolving the discrepancy between ambition and action will be a key focus for directors in 2024, driven by global regulatory and investor pressure demanding disclosure of climate- and nature-related financial risks and opportunities.

## 2 STRINGENT REGULATION IS DRIVING CHANGE

Global climate regulation is driving decarbonization with an array of mandates, incentives, and penalties, presenting significant transition risks to business. Despite the global consensus to target net zero, the chosen policy mechanisms of each country are fragmented. Government ambitions have been tempered by economic headwinds and climate policies are raising geopolitical tensions.

### A disorderly transition still represents a path to net zero but with greater transition risk.




Source: Adapted from NGFS (Network for Greening the Financial System): Sustainable Futures 2023, based on the Network for Greening the Financial System Scenarios www.ngfs.net/ngfs-scenarios-portal/.

This points to a disorderly low-carbon transition, whereby the global path to net zero is more disparate and uncertain, strewn with greater transition risks, and harder for corporations to navigate. A patchwork of environmental regulations is targeting multinational businesses in different ways, and directors need to ensure their organization is prepared for change.

These regulatory mandates and disclosure expectations herald a new era for businesses. Organizations must reset how they perceive, engage with, and report on nature. Company boards will be required to embed nature into their financial and business decisions, and their strategy. Business leaders should not underestimate the time needed for organizations to locate, gather, interrogate, and report the information required.

Firms must also recognize the reach of regulations beyond their borders. The Corporate Sustainability Reporting Directive (CSRD) may well become the de facto global standard. There are approximately 10,000 non-EU multinational companies that will be in scope of CSRD. Reporting for large, listed, non-EU companies will commence in 2024, with reports to be published in 2025. Over the next four years, more non-EU companies will be brought into the scope of CSRD.

## IMPLICATIONS FOR DIRECTORS

The financial and systemic risks associated with the era of climate disruption will continue to have serious implications for directors' fiduciary duties to ensure legal compliance and disclosure obligations. The year ahead will be marked by investor pressure for directors to demonstrate accountability for climate strategies and integrate climate risks and opportunities into their governance roles.

## 3 SOARING CLIMATE LITIGATION CASES

Climate-related court cases are on the rise—the total number has more than doubled since 2017 and growth is global. More than 2,341 cases have been captured in the Sabin Center's climate litigation database with around two-thirds of these cases (1,557) filed since 2015, the year of the Paris Agreement. While climate litigation is a global challenge for businesses, nearly 70 percent of cases are played out in US courts. Win or lose, companies can suffer damage to brand reputation, customer attrition, and expensive legal action.

Targets of climate litigation are not limited to big oil. Companies in many sectors and geographies are facing lawsuits for their emissions contribution to climate change, or for failing to recognise and/or adapt to the risks posed by the climate crisis. No business is exempt, and activist plaintiffs are exploring novel legal arguments to expose the failings of companies and their directors. Legal commentators have reflected that cases against directors could grow.

Corporate marketing has been rife with the overstatement of green credentials, and, in response, regulators in Europe, the United Kingdom, and the United States are defining tighter legislation to clamp down on the sustainable claims companies can make. Accusations of greenwashing by non-governmental organizations (NGOs) and consumers to hold companies to account for their net-zero pledges and strategies present a risk to corporations, but green hushing, when an organization actively takes steps to stay quiet about their climate strategies, is not the answer.

## IMPLICATIONS FOR DIRECTORS

Pressure on directors to ensure their organizations comply with the evolving regulatory landscape and disclosure requirements will not abate in 2024.

In response, major global corporations are investing in expertise to provide the clarity they need, and some have formed multidisciplinary panels to investigate their own company's environmental claims to avoid claims of greenwashing and to mitigate risk.

Directors have been specifically targeted by NGOs using the law to progress climate action. Legal experts warn that business leaders must ensure that they are paying due regard to material climate risk and factoring this into the business's strategy. Looking ahead to 2024, this should be a concern for directors because other claims are likely to follow seeking to impose personal liability on directors as a way to further ESG agendas.

The nature-positive agenda is expected to gain momentum in the coming year, and directors should note a new legal opinion published in Australia, which makes clear that Australian company directors have a duty under corporations law to consider their company's exposure to nature-related risks.

# B

# TAKING ACTION: DEVELOPING A TRANSITION PLAN

Developing a credible business transition plan for the era of climate disruption is a balancing act between multiple risks and opportunities played out against a backdrop of economic and societal uncertainty.

For a board to make sense of this uncertainty about the future and how their strategy and financial performance might be impacted by the various dimensions of transition risk, "what if" scenario analysis is an essential tool.

## 1 GAINING FORESIGHT: ASSESSING RISK AND OPPORTUNITY

Applying a range of scenarios to understand the different ways a company can be affected by risks and the potential financial impacts enables a business to develop a plan for sustainable growth. Charting where and how risk reduction provides positive return on investment and identifying and quantifying risk and opportunity across the entire operation provides a strategic decision-making lens. There will be upsides to business transformation in a low-carbon economy with new commercial opportunities available to businesses ready for them.

Scenario analysis helps to factor in future uncertainty to decision-making. A company should assess a spectrum of plausible climate policy and emissions pathways, from a 1.5°C-aligned, net-zero future to a worst-case climate-change scenario, because the severity of risk differs under the various emissions pathways.

## 2 ENABLING POSITIVE BUSINESS TRANSFORMATION

The current global transition to a low-carbon economy requires many large organizations to recalibrate their business models. Building a business case for decarbonization is essential to justify the investment required for progressing transition plans and driving positive transformation and growth.

Our report, *Quantifying your net-zero strategy*, uses the lens of risk and opportunity to inform the business case and recommends five practical actions directors can review with management teams to determine how the business can positively transform for net zero.

### Quantify baseline risk

For a global corporation with a large emissions footprint, understanding the most carbon-intensive parts of the business to prioritize decarbonization efforts across operations is key. Also, it is vital to identify risks that could impact the organization financially and, using analytics, quantify these transition risks as potential losses to its earning value. This approach makes clear the quantified baseline risk to the company.

### Set goals and targets

Having assessed the value of earnings at risk, the organization is able to set tangible emissions targets to reduce some of the company's transition risk. Setting achievable targets requires a robust set of analytics to determine which investments will best achieve the necessary reduction of emissions to reduce transition risk.

### Quantify bottom-up strategies

A credible strategy requires components that an organization can continually adjust, improve, and realign. Principally, the components are these:

- Establish an emissions trajectory.
- Identify decarbonization initiatives across operations and emissions scopes.
- Quantify decarbonization-emissions reduction for each initiative.
- Adjust reduction in emissions trajectory.

### Optimize the cost-benefit road map strategies

Once initiatives are quantified, it is useful to reevaluate the transition earnings-value-at-risk. This can identify additional benefits beyond emissions reduction pertinent to making the business case for sustainable growth.

### Implement, monitor, and report

The rollout of the strategy will require involvement from across the organization, so communicating to win the understanding and support of stakeholders is key. The plan is not static and will be refined over time as circumstances require.

## IMPLICATIONS FOR DIRECTORS

Directors must ensure goals are tangible for the year ahead. The challenge for business leaders is to carve a path that acknowledges both the uncertainty and the pressing need to act. Climate-related risks are real, and they are impacting companies, now.

Using the next year to get to grips with untangling, analyzing, mitigating, and monitoring transition risks will help boards to build climate resilience and a path to sustainable business growth. The financial quantification of climate- and nature-related risk and opportunity is essential for informed board decision-making.

Directors taking a climate-literate approach to implementing a credible transition plan will enable the positive business transformation required to survive and thrive in the era of climate disruption.

## BOARD OVERSIGHT QUESTIONS

1. What does the board require to oversee a credible transition plan?
2. Has management identified if their organization is subject to current or proposed regulations (e.g., European Union or California), assessed potential impact and considered the process to locate, gather, investigate, and report the information required?
3. Where are the current hot spots of climate-related risk and opportunity across the organization's entire value chain?
4. Is the board able to identify the organization's dependence and impact on nature?
5. Is the business plan accounting for the likely impacts of environmental risks on financial performance and position?
6. Is the board confident that the organization is sufficiently equipped and agile to maintain commercial relevance in a changing market?
7. Does the board have the right skills to address climate and nature, including how they emerge in existing material areas such as policy, supply chain, and geopolitics?
8. Will changes in regulations affect the organization's supply chain and ability to sell products domestically and globally?

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# Artificial Intelligence: An Emerging Oversight Responsibility for Audit Committees?

By Brian Cassidy, Ryan Hittner, and Krista Parsons, Deloitte & Touche LLP

The audit committee has many discrete duties, including overseeing financial reporting and related internal controls, the independent and internal auditors, and ethics and compliance, to name just a few. However, these and other duties are part of a broader audit committee responsibility: risk oversight. While the audit committee does not manage all risks, it is responsible for overseeing the procedures and processes by which the company anticipates, evaluates, monitors, and manages risks of all types. Recent developments in artificial intelligence (AI), including the emergence of generative AI, are leading businesses to evaluate AI's potential impact to their business technology strategy. As businesses expand their use of AI, especially into core business processes, the audit committee will need to understand the challenges and opportunities presented by AI to address risks related to governance and stakeholder trust.

## WHO'S MINDING THE AI STORE NOW?

According to a 2023 survey conducted by Deloitte and the Society for Corporate Governance, corporate secretaries see AI strategy and oversight as still evolving. The findings show that few respondents (13%) had a formalized AI oversight framework, although many (36%) were considering the development and implementation of AI oversight policies and procedures.

These results are particularly interesting when compared to a 2022 Deloitte survey, in which 94 percent of respondents said AI was critical to their company's short-term success.[1] This may suggest some level of information asymmetry between management and the board, congruent with the notion that AI is in a state of flux. Thus, at least for now, the AI landscape might best be characterized as an abstract governance puzzle.[2]

## THE AI GOVERNANCE PUZZLE

**Oversight Structure**
29% reported that AI oversight was not assigned to any committee or the full board; 16% placed it with the audit committee.

**[Not] on the Agenda**
44% indicated that AI has not been on any agenda (full board or committee); 37% have discussed on an ad hoc or as needed basis.

**Risky Lack of Opinion**
68% didn't know (or didn't respond) when asked how the company mitigates AI-related risk.

## RISKS AND OPPORTUNITIES

### FAMILIAR AND DIFFERENT SET OF RISKS

With new technology comes the possibility of new risks. Some AI risks present well-trodden challenges that arise in other technology areas and can be overseen and understood in the context of an ongoing enterprise risk management (ERM) process,[3] such as the COSO ERM framework. However, other risks may be unfamiliar and/or amplified. A few illustrative examples are highlighted below.

- **Shadow IT Environments:** Use of IT assets by personnel without the knowledge or oversight of IT security professionals can occur with any type of software or hardware. However, unauthorized use of generative AI by personnel may compound data-related risks. This risk may be increased given the lack of AI policy in many organizations. Further, employees leveraging generative AI to write code may inadvertently introduce vulnerabilities through code generated by AI.

[1] Business leaders were defined as company representatives who met one or more of the following qualifiers: (1) responsible for AI technology spending or approval of AI investments, (2) responsible for the development of AI strategy, (3) responsible for implementation of AI technology, (4) acting as AI technology subject-matter specialist, or (5) otherwise stated they were influencing decisions around AI technology. See Nitin Mittal, Irfan Saif, and Beena Ammanath, *Fueling the AI transformation: Four key actions powering widespread value from AI, right now, State of AI in the Enterprise, 5th Edition* report, Deloitte, October 2022.

[2] Natalie Cooper, Bob Lamm, and Randi Val Morrison, "Future of tech: Artificial intelligence (AI)," *Board Practices Quarterly*, Deloitte, August 2023.

[3] Alexander J. Wulf and Ognyan Seizov, "'Please understand we cannot provide further information': Evaluating content and transparency of GDPR-mandated AI disclosures," *AI & Society* (2022).

- **IP Ownership and Infringement:** Generative AI users can input confidential or protected data, which may result in an array of adverse outcomes, including disclosure of such confidential or protected data to third parties. Outputs using this type of data may also constitute infringement of intellectual property.[4] Furthermore, as generative AI applications are used to craft increasingly sophisticated media across multiple formats, it may not be clear who owns the rights to any resulting intellectual property.
- **Cybersecurity Bad Actors:** A frequent concern across many types of technology stems from malicious actors who circumvent security protocols. Generative AI use cases may amplify some types of cybersecurity risks. For example, hackers may use generative AI to write code for purposes of infiltrating data environments or create phishing messages that more accurately mimic human language and tone.

Finding the appropriate balance between AI's benefits and risks depends on a constellation of factors. Outputs produced by generative AI change over time as the technology learns from data. But just like with humans, it is possible for this subcategory of AI technology to learn things that are incorrect. For that reason, traditional risk management strategies may not be well-equipped for the challenges that arise from generative AI use.

## GENERATIVE AI RISK EXAMPLES

**Low Transparency**
How generative AI derives its output can be a "black box," making it difficult to explain and/or audit.

**Hallucination**
Generative AI products and services may generate output that seems accurate but is actually false or cannot be justified.

**Bias Potential**
When trained on nonrepresentative data, generative AI output could exhibit systematic errors.

**Value Alignment**
Even with safe-guards, generative AI output may contradict its intended purpose.[5]

[4] Christian Heinze, "Patent infringement by development and use of artificial intelligence systems, specifically artificial neural networks," in *A Critical Mind: Hanns Ullrich's Footprint in Internal Market Law, Antitrust and Intellectual Property,* eds. Christine Godt and Matthias Lamping, MPI Studies on Intellectual Property and Competition Law, vol. 30 (Heidelberg, Germany: Springer, 2023), pp. 489–515.

[5] Vic Katyal, Cory Liepold, and Satish Iyengar, "Artificial intelligence and ethics: An emerging area of board oversight responsibility," *On the Board's Agenda*, Deloitte, 2020.

Regardless of whether the risk is familiar, completely new, and/or amplified, the resultant consequences may be notable. Failure to mitigate any subcategory of AI-related risks may lead to many adverse outcomes such as reputational damage, financial losses, legal action, and regulatory infractions. A starting point for addressing such concerns might include using mitigation strategies that are already known to work in other contexts, such as the COSO ERM framework referred to earlier. For AI-centric guidance related to implementation and scaling, it may be worth considering the benefit of systems such as the NIST AI Risk Management Framework.

## WITH RISKS COME BENEFITS, TOO

If AI presented nothing but risk, it seems unlikely that it would have emerged as "the" technology of the future. Clearly, AI has benefits, some of which may not be known for some time. One particular set of benefits is squarely in the audit committee's wheelhouse—namely, the potential to streamline and enhance a company's internal audit, financial reporting, and internal control functions. There are also aspects of generative AI technology that, while still evolving, may one day fundamentally change an organization's financial systems. While there is much uncertainty, the future transformative potential of generative AI may add much to the current array of use cases. In the shorter term, various subcategories of AI are already capable of improving the quality of financial reporting via reviewing transactions, identifying errors, addressing internal control gaps, and detecting fraud. If AI isn't being used within these areas, the audit committee might ask if the company is exploring potential use cases—and if the company is not, the committee might ask to hear the reasons behind that decision.

### USE OF AI TECHNOLOGY MAY HAVE MANY BENEFITS

**Cost Savings**
Process automations and improvements may improve task efficiency.

**Boosted Revenues**
AI-infused products and services may provide new growth opportunities.

**Development Time**
AI may shorten time to market by increasing the speed of early-stage testing.

**New Insights**
Appropriate generative AI use may bolster employee creativity.

## COMMON AI USE CASE EXAMPLES

| USE CASE | DESCRIPTION | OPPORTUNITIES | RISKS |
|---|---|---|---|
| **Invoices and Payments** | Use of intelligent automation to match invoices to payments, including classification of expenses | The technology may reduce costs by processing a large volume of transactions with a high degree of accuracy. | Poorly designed or maintained systems may generate errors that are time consuming to undo. |
| **Contract Review or Generation** | Leverage of natural language and generative AI processing to create legal documents or review them for errors | By producing the initial drafts or identifying common errors, generative AI may create efficiencies and lower legal liability in a cost-effective manner. | Natural language and generative AI trained on biased data may misapply the law or make up precedent. |
| **Forecasting and Modeling** | Incorporating predictive analytics to improve the accuracy of functions like inventory management and revenue forecasting | Modeling and analytics AI technology may be capable of identifying patterns at a speed that outpaces human-led data analysis efforts. | Lack of robust testing and regular updates can cause modeling and analytics AI to become more inaccurate over time. |
| **Code Development** | Use of generative AI to develop models or applications that create efficiencies for routine personnel activities | Employees may use generative AI to drive efficiencies in day-to-day tasks and help identify possible generative AI use cases. | The technology may expose confidential data with generative AI inputs or may create outputs that involve intellectual property infringement. |

## AI AND THE AUDIT COMMITTEE

The tendency to assign oversight of emerging risks to the audit committee means it is sometimes described as the "kitchen sink" of the board. However, as noted earlier, this is consistent with the audit committee's overarching role in risk oversight. It's also worth considering that it is common for topics taken on by the audit committee at the outset to eventually be overseen by other committees. Some aspects of AI oversight seem more aligned with the audit committee's work than others. And when it comes to considering such congruence questions, it may be helpful to think about the audit committee's current levels of technology fluency and comfort. For instance, given the audit committee's traditional governance areas, it may be prudent for it to oversee AI use in financial reporting.[6]

[6] The audit committee may want to also think about indirect impacts. Depending on the use case, AI technology may have an array of indirect effects on financial measures (GAAP or otherwise).

In other parts of AI oversight, it may be less clear whether the audit committee is a "good fit." For example, the impact of generative or natural language AI on the workforce may be more aligned with the oversight of the compensation/talent committee or the full board.

The "temporary assignment" of AI to the audit committee may make sense for other reasons, as well. First, AI remains an emerging technology and is likely to continue to change rapidly. Second, there is extensive governmental interest in AI, which may result in legislation that will require adjustments in its oversight. Thus, determining now that AI, or aspects of AI, should be overseen by another committee or committees may turn out to be premature.

An audit committee might choose to assess its AI risk tolerance across oversight areas such as auditing, financial reporting, and internal control functions. It may be helpful to contextualize that analysis by comparing it to other areas of the company. For example, company divisions that routinely use technology enhancements in client-facing operations may have a higher appetite for risk. But a higher risk tolerance in operational settings does not necessarily correlate with how risks are viewed when it comes to financial reporting impacts.

An important part of the AI governance puzzle for the audit committee is assessing risk. But, at least for now, this task is currently made more difficult by a shifting regulatory landscape. Governments and regulators around the world are considering whether regulation and policy can address AI risks. Their progress toward developing and enacting policies and regulations over AI is uneven across the globe and in different stages of development and enactment. And to make things more complex, stakeholder groups—shareholders, customers/clients, employees, suppliers, and community—all have varying and sometimes conflicting expectations around use and governance of AI. For these reasons, there may be a benefit to continuously assessing AI risks and benefits over waiting for emerging and future legislative proposals or regulatory guidance. But to accurately make such continual assessments, it's important that the audit committee and the board have sufficient knowledge to ask questions around the organization's adoption and use of AI.

## POTENTIAL AUDIT COMMITTEE OVERSIGHT QUESTIONS TO CONSIDER

- What are the company's current and potential future use cases for AI, and do any of them have an impact on financial reporting or other audit committee oversight areas?
- Has management considered opportunities to use AI that may enhance or improve financial reporting processes?
- What processes are, or will be, used to evaluate dependencies that may arise in other areas where the audit committee may have primary oversight, like cybersecurity or data management?
- Are processes for use of AI congruent with the company's risk appetite in terms of level of proactiveness and mitigation strategy?
- Given the speed of AI technology development, are existing processes being assessed and updated with appropriate frequency?

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# Beyond Appearances: The Invisible Struggle for Latino Inclusion in the Boardroom

By Ozzie Gromada Meza, Latino Corporate Directors Association (LCDA)

In the corridors of corporate America, where power intricately shapes the business landscape, a disheartening truth remains—there's an invisible struggle for Hispanic/Latino[1] inclusion on corporate boards. While the glass ceilings for women, non-whites, and LGBTQ+ individuals have been hotly debated and gradually cracked, the underrepresentation of Latino professionals in boardrooms remains a deeply rooted problem. It is an issue that transcends mere appearances, existing beyond the surface-level optics of diversity and requiring our collective attention to bring about real change.

As we prepare for 2024 and beyond, the evolution of corporate inclusion concepts and approaches will, and should, encompass and uplift the Latino community. It is one of the fastest growing and most influential demographics in the United States that is generating $3.2 trillion in GDP as measured by expenditure.

## THE INVISIBLE STRUGGLE

The United States has always been celebrated as a land of opportunity, a place where hard work and determination can open doors to success. While this is undoubtedly true for many, there remains a stark contrast when we look at the composition of corporate boards. Latino professionals, despite their talents, drive, and contributions to the nation's economy, are disproportionately underrepresented in these influential positions. The Latino Corporate Directors Association (LCDA) *2023 Latino Board Monitor* presents a compelling snapshot of progress and shines a light on the journey toward greater Latino representation in corporate boardrooms. The statistics paint a promising picture, showcasing a noteworthy 1.7 percent increase in Latino representation on Fortune 500 boards since 2020, a trend that mirrors similar progress on Fortune 1000 boards.

[1] Americans who identify themselves as being of Spanish-speaking background and trace their origin or descent from Mexico, Puerto Rico, Cuba, Central and South America, and other Spanish-speaking countries.

As we applaud these achievements, we must also confront the truth that looms on the horizon. A recent report from the Alliance for Board Diversity delivers a sobering forecast: by the year 2060, Latinos are projected to make up a substantial 27.5 percent of the US population, yet concurrently, it is estimated that they will hold a mere 9.2 percent of Fortune 500 board positions. This stark contrast highlights a pressing need for change and increased representation. What's even more disconcerting is the projection that other marginalized communities, specifically the African American/Black and Asian/Pacific Islander communities, are on track to achieve proportional representation to their US population as early as 2030, leaving Latinos effectively invisible in the boardroom.

## THE CONSEQUENCES OF UNDERREPRESENTATION

The presence of Latinos in corporate boardrooms is not solely a matter of fulfilling social responsibility; it represents a strategic imperative with far-reaching economic significance. With the Latino community experiencing rapid growth and wielding significant influence in the United States, their involvement in corporate leadership becomes an essential pathway to draw on an extensive, untapped market potential. Neglecting to incorporate Latino perspectives into corporate decision-making poses a risk, as it hinders the ability for businesses to engage with this dynamic consumer base, and its estimated untapped market potential of over $660 billion.

Latino consumers play a pivotal role in driving the US economy. With their purchasing power steadily on the rise, they represent a significant and growing market segment. According to the latest report by the Latino Donor Collaborative, the US Latino cohort GDP places the US Latino economy as the fifth largest in the world, surpassing the economies of France, the United Kingdom, and India. Companies that overlook or underestimate the influence of this demographic risk missing out on a substantial source of revenue and growth. By having Latinos in corporate boardrooms, businesses gain a competitive advantage through a deeper understanding of the preferences, needs, and aspirations of this consumer base. This insight can lead to the development of products, services, and marketing strategies that resonate with Latino consumers, ultimately driving increased sales and market share.

Furthermore, diversity in corporate leadership fosters innovation and creativity. When different perspectives, experiences, and cultural backgrounds are represented at the highest levels of decision-making, organizations are better equipped to develop innovative solutions and products. Research consistently shows that diverse firms outperform their peers. By tapping into the talents and experiences of Latino professionals, businesses can bolster their competitive edge and position themselves for long-term success.

In conclusion, the business case for Latino inclusion on corporate boards is not only about achieving social equity but also about capitalizing on a burgeoning consumer market, fostering innovation, and ensuring a sustainable future for companies in an increasingly diverse and interconnected world.

## THE INVISIBILITY FACTOR: ENDURING RECRUITING BIASES

While progress has been made in increasing Latino representation on corporate boards, the enduring recruiting biases within corporate America continue to act as a formidable barrier. These biases often stem from deep-rooted stereotypes and an overreliance on visible, physical characteristics as indicators of underrepresented talent.

Using visible physical characteristics and diversity markers such as Hispanic surnames and ability to speak Spanish as a means of identifying Latino talent is not only unfair but also perpetuates a fundamental misunderstanding of the Latino community. Latinos, like any other group, are incredibly diverse, and their backgrounds, experiences, and appearances vary significantly. Reducing the rich tapestry of the Latino community to a set of physical characteristics, the ability to speak Spanish, or a common Hispanic surname is not only ineffective but also fails to acknowledge the individuality and unique talents that each Latino professional brings to the table.

One of the key reasons why this approach is shortsighted is that it overlooks the fact that Latinos are not a monolith, particularly in their appearance. The misconception that all Latinos have a specific skin tone not only ignores the diversity within the community but also feeds into stereotypes and unconscious biases. By reducing Latinos to a specific physical appearance, we perpetuate the harmful notion that one must fit a particular mold to be considered a valuable asset or diverse enough in the corporate world. In reality, Latino professionals encompass a wide range of appearances, reflecting their diverse heritage and backgrounds.

Moreover, the assumption that all Latinos speak Spanish or have common Hispanic surnames is another misconception that unfairly excludes many talented individuals. The Latino community is multilingual, with individuals speaking a variety of languages, including English, Portuguese, and indigenous languages. Some Latinos may not have Hispanic surnames due to their mixed heritage or other familial factors. Using language and surnames as a sole marker for identifying Latino talent is not only inaccurate but also limits the pool of potential candidates.

In essence, this form of talent identification perpetuates the notion that diversity is merely a matter of optics, rather than a commitment to inclusivity, equity, and the recognition of the unique skills and contributions that Latino individuals bring to the corporate table.

## SOLUTIONS TO SOLVE THE INVISIBILITY FACTOR

Addressing enduring recruiting and unconscious biases about the Latino community necessitates a multifaceted approach that involves not only companies but also their allies, recruiting professionals, and society as a whole. By recognizing and actively dismantling these biases, we can create a corporate landscape that values skills, qualifications, and diversity without relying on superficial characteristics.

### SOLUTION 1 Incorporate Recruiting Policy Requiring the Use of Diverse Sourcing Tactics

To tackle enduring recruiting biases, organizations must adopt a recruiting policy that actively seeks candidates from diverse sources. This means reaching out to a broader array of networks, educational institutions, and professional organizations like LCDA to identify potential talent. To help, develop a source checklist for each executive and board search to ensure you engage each resource. By expanding the pool of candidates, companies can increase the chances of discovering skilled professionals who might have been overlooked under traditional recruiting practices. This approach not only broadens the talent pipeline but also challenges the perpetuation of unconscious biases by promoting diversity as a fundamental recruitment strategy.

### SOLUTION 2 Promote Disaggregate Disclosure in Company Filings

To uncover pools of talent not before discovered, companies should take proactive steps to promote transparency through disaggregated data disclosure in their filings. This approach goes beyond mere transparency; it also places a strong emphasis on reducing the misidentification of ethnic and racial identity, which is a common issue in the Latino community. By adopting this approach, it offers a pathway to accurate and fair representation.

SOLUTION 3

### Request Inclusive Recruiting Teams

Request that the team responsible for your search demonstrate racial and ethnic diversity. As a first-generation Mexican American, I've had a firsthand view of the challenges and biases inherent in the recruitment process. My own experiences have shown that a diverse recruiting team can infuse a wide range of perspectives into the process. These inclusive teams can recognize the unique qualifications, skills, and potential contributions of candidates, transcending surface-level attributes. My personal journey within the search industry has underscored the critical role of diverse voices in positions of influence, serving as advocates for equity and inclusion.

As we continue to push for progress, it is essential to note that we have not met our goal set in 2020 of tripling Latino representation on Fortune 1000 corporate boards by 2023. Despite our efforts, we have seen only a 1.7 percent increase from 2020 to 2023. This underscores the immediate need for a systematic, solution-based approach to inclusive sourcing and recruiting, with a particular focus on marginalized communities, beginning with the Latino community. Increased Latino representation in corporate governance is both a moral imperative and undeniably advantageous for business.

## BOARD OVERSIGHT QUESTIONS

- How is the company actively working to identify and mitigate unconscious bias in the board recruitment process to ensure a fair and equitable selection of candidates?
- How does the company ensure that the inclusion of candidates from any community, particularly those that are underrepresented, is integrated with business strategies, including market growth, product development, customer engagement, and employee satisfaction, rather than being solely a diversity-focused, feel-good initiative?
- What strategies does the nominating and governance chair and the head of talent employ to source candidates from diverse networks and channels to broaden the talent pool for board positions and C-suite roles?
- Is the company leveraging the influence of Employee Resource Groups (ERGs) effectively in terms of raising awareness of talent internally and externally?
- How will the company address self-identification, including race/ethnicity, gender, and LGBTQ+ status, of the board members and executive leadership and ensure the information is easily accessible to the consumer and employee?
- Do you believe the board's and executive leadership's culture welcomes peers to discuss their lived experiences and leverages the unique strengths and facets of diversity of each individual?

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**Ozzie Gromada Meza**, president and CEO of the Latino Corporate Directors Association (LCDA) is dedicated to advancing Hispanic/Latino representation on corporate boards. Formerly, as vice president of Member and Talent Services at LCDA, he played a significant role in establishing best practices and solutions in accessing diverse talent for the boardroom through collaboration with board leaders and search firms. Prior to joining LCDA, his diverse background in talent intelligence spanned across search firms, consulting, and Fortune 1000 corporations, including Allstate Insurance. Recognized as a trailblazer in ESG, he has received numerous awards, including the Modern Governance 100 Award and the Business & Finance Impact Award. He currently serves as a board member of the Association of LGBTQ+ Corporate Directors, the Thirty Percent Coalition, and The Center for Inclusive Governance®.

# Lessons for Directors from the First Universal Proxy Card Campaigns

By Holly J. Gregory, Kai H. E. Liekefett, Derek Zaba, and Eric S. Goodwin, Sidley Austin LLP

The introduction of the universal proxy card in contested director elections a year ago has altered the shareholder activism landscape, exposing new corporate vulnerabilities as well as reshaping activist and corporate defense strategies. The first activism campaigns under this SEC-mandated regime have also given fresh emphasis to the principles of an effective board, whether or not an activist ever targets the company.

The first universal proxy card campaigns have revealed the following four critical lessons for directors, which are discussed further in this article:

- **Serving as Change Agents:** Boards should embrace the role that their oversight plays in catalyzing change when change is appropriate—or activists will be knocking on the boardroom doors to do so.
- **Thinking Like Your Shareholders:** Boards should understand how the company and the board are perceived by their diverse shareholder body as a part of furthering the best interests of the company and its shareholders.
- **Reviewing Board Composition from First Principles:** Boards should ensure that their composition is "fit for purpose"—that is, closely aligned with the needs of the business such that its members have appropriately diverse experience and other qualifications.
- **Taking Action with Prudent Urgency:** Boards should not wait until an activist approaches the company to make appropriate changes in board composition, strategy, or any other areas of underperformance.

## DEBRIEF ON UNIVERSAL PROXY CARDS

Universal proxy cards have been mandatory in contested director elections since September 1, 2022, under new SEC rules. A universal proxy card allows shareholders to vote for any combination of validly nominated director candidates on a single proxy card. All companies (even those without proxy access bylaws) and all nominating shareholders are now required to use a universal proxy card for proxy contests. There is no corporate opt-in mechanism, nor are there any shareholder ownership requirements as seen with the proxy access bylaws adopted by many companies today.

Despite expectations that the universal proxy card would supercharge proxy campaign activity, the actual number of contests during the last year were generally in line with previous levels. Between September 1, 2022, and August 31, 2023, there were 72 proxy fights (as categorized by FactSet) at US-headquartered companies (other than funds), compared to an average of 77.4 per year in the prior five years. Among these proxy contests, there were 32 settlements (average of 25.8 per year in the prior five years), and 18 contested elections that went to a vote (average of 25.2 per year in the prior five years). These levels were arguably a result, at least in part, of the enormous economic uncertainty at the outset of the spring proxy season, when macroeconomic effects such as high inflation and bank failures deterred activists from pursuing contested elections.[1]

Presenting both the board's and activist's nominees on one proxy card enables shareholders to vote for any nominee from either slate. This new ability for shareholders to "mix and match" appears to have contributed to a greater number of partial activist slates being elected than in prior years.

The universal proxy card rules have also contributed to increased attention by companies and boards on the state of their structural defenses to activism, including ensuring that their advanced notice bylaws that regulate the contested election process reflect current market practices. In the last two years, we have seen many companies adopt specific bylaws intended to ensure that activists comply with the obligations created by the universal proxy card rules.

## SERVING AS CHANGE AGENTS

The increase in support for partial activist slates under the universal proxy card rules has been particularly pronounced in recommendations by influential proxy advisory firm ISS. Since these rules came into effect, ISS has supported one activist nominee at an unusually high rate and full company slates at an unusually low rate in Russell 3000 contests, as compared to the prior five years. In the three Russell 3000 universal proxy card contests where ISS recommended in favor of just one activist nominee, ISS explained its recommendation in part on the grounds that the board would benefit from someone who could create urgency, challenge consensus, or enhance the board's credibility with shareholders.[2]

These rationales echo a common investor perception that boards can develop an insider mentality at the expense of objectivity. To combat this potential critique, boards should embrace the role of change agent when appropriate for the circumstances. Failure to do so can make the company vulnerable to the election of one or more activist nominees, even if the change advocated for by the activist is unwarranted and not in the best interests of shareholders.

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[1] Source: FactSet.

[2] Source: FactSet and ISS Voting Analytics.

In order for the board to be an effective change agent, directors must challenge themselves and management to take the following steps:

- Consider alternatives and reassess long-held assumptions of management and the board, including by reviewing issues through the eyes of an outsider and considering the best arguments that a critic could make about the company's strategy, management, and corporate governance.
- Identify additional relevant information, factors, and perspectives that should be considered by the board that may not have been covered by a presentation or discussion.
- Ensure that sufficient time is dedicated to board discussion, that diverse views and perspectives are welcomed and explored, and that challenging questions are raised in a constructive manner in the effort to reach a decision.
- Build an open, respectful, trusting and collegial culture that supports constructive challenge and fosters the foregoing behaviors by working together with the board, board leadership (chairs, lead independent directors, and committee chairs), and the CEO and senior management.

## THINKING LIKE YOUR SHAREHOLDERS

It is commonly said that boards and companies should "think like an activist" in assessing their vulnerabilities to activism, which means understanding what issues an activist could attack and what actions an activist could demand be taken. The universal proxy card has increased the salience of another analytical lens for directors: thinking like their shareholders.

Understanding how shareholders think about the company and board is critical for assessing vulnerabilities and successfully defending against an activist. While few campaigns go to a contested vote, an activist has leverage over the company to force a settlement only insofar as the company expects shareholders to vote for the activist's nominees. Misunderstanding shareholder sentiment can cause companies to misjudge the appropriate response to an activist, such as by failing to address shareholder concerns during a proxy contest or giving up more in a settlement than the activist could have achieved at the ballot box.

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Thinking like shareholders means understanding and duly considering their views and expectations regarding the company's board, management, strategy, and performance. Doing so not only supports the board in anticipating areas where change may be needed, but also helps the board address vulnerabilities to activism, assess the risk presented if an activist targets the company, and communicate with shareholders during a proxy contest.

Directors should not seek to think like a generic, hypothetical shareholder, or only like one type of shareholder, but rather should engage with their current shareholders' actual views. It is critical to remember that shareholders are not a monolith. Shareholders have different time frames for their investments and may have different views on corporate strategy and key issues facing the company. The various types of investors (actively managed long-only funds, index funds, hedge funds, public pension funds, individual and retail investors, etc.) often have pronounced differences in preferences and viewpoints.

To be clear, this approach is not deference. Ultimately, the board must determine what actions are in the best interests of the company and its shareholders as a whole, and directors do not fulfill their fiduciary obligations by delegating their business judgment to the judgment of one or more shareholders or types of shareholders. But nor should informed fiduciaries simply ignore shareholders' views. Rather, directors should seek to understand the panoply of shareholder perspectives as one factor of many in board decision-making.

Boards should fully utilize their shareholder engagement programs and processes to understand their shareholders' views and expectations. These should include a robust investor relations program reporting to the board about investor sentiment, and might include presentations to the board by select shareholders or participation by directors in regular shareholder engagement activities (especially with more governance-oriented investors).

We wish to emphasize that individual directors should not engage in ad hoc communications with shareholder representatives. Director participation in shareholder engagement requires appropriate coordination and preparation, as well as processes to ensure that material nonpublic information is not shared in violation of insider trading and tipping prohibitions and the requirements of fair disclosure regulation (Regulation FD).

## REVIEWING BOARD COMPOSITION FROM FIRST PRINCIPLES

Some have feared that the ability to "mix and match" between nominee slates on a universal proxy card could empower the proxy advisory firms as "external nominating committees" in proxy contests. We are not aware of any proxy contests in the universal proxy card era that have turned solely on differences in candidate qualifications. Instead, activists have had success where they have been able to link a compelling case for change at the company to their nominees' qualifications, particularly those qualifications that are missing from, or superior to, the skills on the board.

Going forward, we expect that activists will continue to exploit the universal proxy card to target vulnerabilities in board composition. The most vulnerable boards have a skills gap related to an area where the company is underperforming or have a number of particularly vulnerable directors up for election (particularly based on board leadership positions, tenure, and relevant skills).

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To minimize their vulnerability, boards should annually evaluate their composition in light of the company's strategic and operational priorities, including areas of underperformance that would benefit from enhanced board expertise and oversight. Gone are the days when boards could assume that each director continues to serve based on their own preferred timeline, with age limits or average tenure considerations the driving factor in refreshment efforts. Rather, boards, through their nominating and governance committees, should assess their composition from first principles as if every incumbent director was a prospective candidate and every seat was available to be filled based on the board's needs in providing effective oversight.

Each director should also reflect on whether he or she is still the right person to serve on the board—and should not hesitate to raise a hand when the answer could be no. Stepping down as a director should not be viewed as a reflection on the director's talent, performance, commitment, or conduct.

## TAKING ACTION WITH PRUDENT URGENCY

While we encourage boards and management teams to regularly evaluate their vulnerabilities to activism, this assessment is only the starting point. Boards that put off addressing their vulnerabilities are leaving the activist door open, and once an activist appears, the board's options to address issues may become constrained.

While a board can undertake board refreshment or strategy changes after an activist has gone public in an effort to moot the activist's criticisms, these actions could be viewed as too little and too late by shareholders and proxy advisors. Companies making changes may be able to convince an activist to withdraw or enter into a more favorable settlement, especially if the board's action leads to a significant increase in stock price or undermines a significant plank from the activist's platform. However, there is significant risk that proxy advisors and shareholders will discount changes (particularly governance changes) that are made after an activist initiates a campaign or even credit the activist for instigating the changes.

While making governance or strategy changes during an activist campaign should not be taken as a signal that the board was not appropriately attentive or is entrenched, an activist campaign may well cast that shadow for shareholders and proxy advisors. Accordingly, boards are advised to act with prudent urgency to address vulnerabilities to the extent they deem appropriate for the company and its shareholders while they are in a "clear day" prior to an activist approach.

## CONCLUSION

As we enter the second year of the universal proxy card era, shareholder activism remains in flux while market participants learn how to best utilize the universal proxy card to advance their particular governance and investment goals. But as much as the universal proxy card rules have changed the activism landscape, they have not changed the critical role of effective boards in sustainable value creation for their companies, shareholders, and other stakeholders.

## QUESTIONS FOR DIRECTORS TO CONSIDER

- Does our board consider and periodically assess board culture to ensure we have an open, respectful, trusting, and collegial culture that supports constructive challenge?
- What do our largest shareholders think about the company's performance, strategy, and board composition? Have independent directors spoken to any of these shareholders as part of shareholder engagement efforts in the last year?
- How should our board incorporate shareholder feedback into its decision-making processes?
- List out the main areas that the company plans to prioritize in the next three to five years. Which directors have recent qualifications that line up with those areas? Are there profiles of potential new directors that line up with any of them better than those already on the board?
- If an activist shareholder published an open letter about the company and board tomorrow, what changes in corporate strategy or governance would you like to make to position the company for success in a proxy fight? Why haven't you made them yet?

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# 10 Topics Board Agendas Should Address in 2024

By Jim DeLoach, Protiviti

I often refer to the 2020's as a decade of disruption. The pandemic, while a profound event, was only the beginning. Government shutdowns disrupted workplace environments, forced many out of work, and affected sources of supply as demand collapsed for many products. When most government restrictions lifted, the surge in demand exceeded supply, congesting supply chains that had scaled down during the imposed shutdowns. Total production within many industries lagged as businesses couldn't source inputs and find workers, resulting in higher costs. While these issues have been unwinding for some time, they fueled inflationary pressures. Rising labor costs, outsized government stimulus, increasing shelter and food prices, Russia's war in Ukraine, and the West's de-risking its reliance on China are adding further pressure. If the war in the Middle East were to spread uncontrollably, oil prices would likely soar and affect many businesses.

With this backdrop, here are 10 issues that should be on the board's agenda in 2024.

## 1 THE ECONOMY WILL BE FRONT AND CENTER

The drivers mentioned above create uncertainty over central bank policies, particularly those of the US Federal Reserve, which is unequivocally committed to reducing inflation to the Fed's target rate. By the time it paused rate increases on November 1, the Fed had raised rates 11 times since March 2022, bringing its benchmark rate to the highest level in 22 years. It has stated that it intends to keep interest rates "higher for longer," even in the face of declining long-term bond prices and rising yields. Is the Fed willing to drive a resilient economy into the recessionary ditch to cool labor markets and reduce wage growth and inflation? Clearly, it commands the stage to do so. For the board, the question is whether market developments and central bank policies will lead to some form of soft landing or to either a mild or severe recession—or worse, a sustained period of stagnant growth.

The impact of persistent inflationary pressures and higher interest rates presents several challenges. First, economic indicators should be on the board's 2024 watch list. Second, directors should understand how the economy is affecting the company's strategy and operations, e.g., its growth opportunities, cost of capital, pricing strategy, product profitability, margin management, and liquidity. Third, sustained higher mortgage rates will have pervasive effects on consumers. Finally, the board should recognize that many CEOs and their teams are used to cheap capital; they haven't yet made strategic decisions to deploy capital in a high-interest-rate environment. The institutional memory is lacking.

## 2 A CHALLENGING GEOPOLITICAL LANDSCAPE CONTINUES TO EVOLVE

Today's companies compete in a highly interdependent and competitive global marketplace in which countries and regions are taking a closer look at trade relationships through the lens of national security. For example, they are assessing and managing risks of continued interdependence, encouraging diversification of the sourcing of materials and components, and increasing their understanding of logistics and material sciences—all in the name of national security.

These geopolitical developments feed a difficult and challenging trading environment. The aforementioned wars in Ukraine and the Middle East, proliferation of disinformation, and convergence of China, Russia, Iran, and North Korea in opposition to Western democracies provide a combustible mix that is impacting leaders' assessment of the global risk landscape. Where this picture of geopolitical strife is headed is anyone's guess. But evolving global markets and potentially dangerous geopolitical scenarios bear watching by the board in 2024.

## 3 CYBERSECURITY, DATA PRIVACY, AND TALENT REMAIN ON THE RADAR

No list of potential 2024 boardroom topics is complete without including cybersecurity, data privacy, and talent. Evolving cyber threats and proliferating data privacy regimes all over the world will be prominent topics on boardroom agendas. As geopolitical tensions escalate, the risk of attacks by nation states increases. Ransomware events are a major concern. Artificial intelligence (AI) systems can augment both sides, enabling more sophisticated phishing campaigns as well as cyberattack monitoring systems. Cyber risk also deserves more due diligence attention in the M&A space. As for managing the creation, processing, storage, use, archiving, and destruction of sensitive data, regulatory requirements are impacting business models and contractual relationships.

As for talent, there simply isn't enough walking the streets. Effectively led talent is needed to fuel future growth and prosperity. The task of managing human capital is transforming with a shift in focus:

- Winning hearts and minds
- Directing development activities to skills rather than roles or jobs
- Emphasizing succession planning, leadership development, and upward mobility
- Building technology competencies
- Differentiating retention strategies for the different generations
- Fostering a culture founded on core values and trust that serves as a magnet for talent
- Improving onboarding effectiveness
- Adapting to the emergence of union bargaining power

## 4 AI, UPSKILLING, AND RESKILLING REQUIRE ATTENTION AND INVESTMENT TO SUPPORT INNOVATION

With continued advances in AI, automation in all of its forms, ever-increasing connectivity, quantum computing, blockchain and digital currencies, and the metaverse, the market is poised to experience the largest wave of disruption since the turn of this century. At the present time, the buzz around generative AI is commanding the airwaves. The resulting disruption will likely manifest itself in many ways—e.g., new business models, rapid product innovation, changing customer value propositions, and disintermediation of distribution channels—and will sweep away obsolete strategies, traditional moats, legacy-laden architectures, conventional management playbooks, and old-school employee skills. The never-ending question for directors: "Is our business model being disrupted and, if so, how and when would we know?"

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As they face 2024, directors should ensure there is sufficient expertise in the boardroom and C-suite to review and understand the organization's core technology strategy and operations, determine how best to allocate capital to current and future technology investments, and, if appropriate, hedge innovation bets through joint ventures and partnerships. In addition, the state of current labor markets fails to fit the expected adoption of digital technologies; significant efforts will be necessary to upskill and reskill existing employees to realize fully the promised value from these transformative investments. The groundwork for planning and executing these skilling initiatives should begin now.

## 5 MODERNIZING INFRASTRUCTURE IS IMPERATIVE FOR INNOVATION

In an environment dominated by emerging technologies, disruption of business models, and universal acknowledgement of the importance of agility and resiliency to corporate success, innovation is a strategic imperative. However, directors are discovering the importance of understanding the extent to which the organization's legacy infrastructure either enables or constrains the organization's innovation efforts.

Accumulation of legacy systems and application solutions that were easier to implement over the near term but not the best overall solution long term has culminated in infrastructure that is difficult to maintain and support. While there are many aspects underpinning innovation initiatives, this "technical debt" can be a powerful restraint. All efforts to inculcate an innovative culture can be thwarted when technical debt has "accrued" to such a level that it slows organizational response to emerging market opportunities, stifling the organization's ability to compete in a digital world.

A key takeaway for directors: understand the impact of technical debt on innovation goals and strategies and on management's plan to modernize infrastructure to improve agility. The speed of "born digital" players can punish incumbents lacking the flexibility to adjust business models to changing customer behaviors. Be realistic about the cost, time, and training required to upgrade technology.

## 6 THIRD-PARTY RISKS INCREASE IN COMPLEXITY

Third-party risks continue to elevate in importance, with organizations becoming increasingly boundaryless as they redirect their reliance on outsourcing and strategic sourcing arrangements, ecosystem partners, IT vendor contracts, and other partnerships to achieve operational and go-to-market objectives. The geopolitical climate may also be a factor, with the West reducing reliance on China and dealing with newly restrictive laws and regulations around the globe.

Throughout 2024, the company's third-party risk-management framework will be an important topic for directors. For example, who are the most significant third parties in the company's ecosystem, and what assets and services within the organization are delivered through them? Have these third-party relationships been evaluated against appropriate risk criteria? What significant threats and vulnerabilities have emerged from this evaluation? Has a continuous monitoring program been established? Cyber criminals are finding success exploiting vulnerabilities due in large part to the complacency with which many businesses manage their third-party relationships.

## 7 THE BAR RISES ON SUSTAINABILITY, BUT DATA MANAGEMENT LAGS

Regulators in the European Union have set effective dates for expanded ESG-related disclosures and sustainability reporting beginning as early as 2025 for the year ended in 2024 for some companies. The marketplace continues to anticipate the issuance of climate disclosure rules in the United States. The standard-setting group known as COSO has issued recent voluntary guidance on internal control over sustainability reporting. In this business milieu, demand for sustainability data is growing, sparking a plethora of new risk questionnaires and surveys. Insurers' underwriting processes, banking partners' lending applications, and customers' requests for proposals are creating greater demand for ESG-related documentation. As these disclosures are usually authored by different company stakeholders, they may lack consistency with the company's mandated reporting to investors.

The data that feeds these disclosures must be trusted, accurate, complete, and well-defined. What directors may not know is that satisfying this need represents a massive challenge for most companies, given that ESG data is predominantly unstructured, stored in different formats, and pulled from numerous systems, applications, and sources throughout the company and its third parties. Progress needs to be made on this front in 2024.

## 8 BOARDROOM CULTURE TAKES A FRONT SEAT

An important NACD Blue Ribbon Commission Report asserts that, in these unprecedented times, culture lays the foundation for a high-functioning board. It offers recommendations for defining the optimal board culture, reinforcing the importance of the board having "firmly established behavioral norms and values that promote trust, candor, courage, inclusion, confidentiality, continuous learning, and accountability, and that support better decision-making," and addressing major cultural fault lines. These recommendations merit close attention by boards in 2024 to assess the strengths and shortcomings of their culture and increase accountability in the boardroom.

## 9 DIVIDED GOVERNMENT CONTINUES IN THE UNITED STATES

While forecasts for the Senate and House in the 2024 elections vary, both could flip. In an unprecedented presidential race, polling of the two prominent candidates continue to be nip and tuck. One candidate faces legal peril and the likelihood of a steady stream of negative media running all the way to the November election. The other must still gain the electorate's confidence that he is up to the task of running the country for another term. Is there someone else in the wings prepared to step into either's place?

While the picture will clarify itself in time, we have no reason to believe that government inside the Beltway after the election cycle will be anything but divided. For boards, this generates increased negativity in the electorate, impacting trust in American institutions, social activism, and political unrest.

## 10 A NEW GLOBAL MINIMUM INCOME TAX MAY EMERGE

Two years ago, the Organization for Economic Co-operation and Development (OECD) orchestrated agreement among more than 130 countries (including all of the G20) to a two-pillar plan to effect significant changes to international tax rules. The agreement calls for large companies to pay more taxes in countries where they have customers and less in countries where they are domiciled. The rules are complex and have implementation issues but are intended to ensure a global minimum tax of 15 percent in each country in which multinationals operate. As the targeted timetable calls for 2024 implementation, directors of multinationals should be mindful of this possibility.

## FINAL THOUGHT

The complexity of the global marketplace creates the potential for blind spots in the boardroom, i.e., matters of which directors are not aware that can damage the organization's reputation, brand image, market standing, and competitive position. Market, competitive, and scenario analysis will enhance the company's resiliency in facing unexpected events.

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