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5 Corporate Governance Trends Affecting the Board's Oversight Role in 2023

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Increasing stakeholder demands for transparency will drive corporate governance trends in 2023. Legal leaders must prepare to revise board and governance practices, continue to develop ESG programs and provide advice to directors so they can fulfill their expanding oversight role.

Demands for Increased Director Diversity

Alignment of ESG Goals and Incentive Compensation

Privacy and Cybersecurity as ESG Priorities

Challenging Political and Social Climate

Increase in Director Time Commitment

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Trend 1: Demands for Increased Director Diversity

Stakeholders continue to demand increased director diversity. Strategies to increase diversity include adopting a robust board evaluation process, increasing board size and adopting refreshment policies.

In 2021, S&P 500 companies added the most new directors since 2004 (this slowed in 2022).[1,2] However, the addition of new directors didn't increase overall board size. In fact, over the last 10 years, the average board size has remained steady.[2]

Further, only 22% of public company respondents to the 2022 Gartner Corporate Governance and Board Management Survey expanded their board to increase diversity.[3] Despite stakeholder demands for diversity, companies aren't adding directors to move the needle (and, at this rate, diversity won't increase solely through natural attrition).

Refreshment policies can drive board turnover and increase diversity in a less political and personal way, because the policies apply to everyone equally. However, fewer S&P 500 companies are adopting retirement policies, with the retirement age in those policies rising.[2] Only 35% of public company respondents to our survey had retirement policies.[3]

In 2022, few S&P 500 companies imposed term limits for directors.[2] Only 10% and 26% of public company and nonpublic company respondents, respectively, had term limits, with some frequently making exceptions.[3] Interestingly, directors want more turnover but don't think their board would adopt refreshment policies.[4]

What Are the Implications?

Utilize refreshment strategies. In the short term, boards need to expand and fill seats with the diversity and skills necessitated by the increasing oversight role and more fully utilize the board evaluation process to encourage director turnover. In the long term, boards must adopt and enforce refreshment policies to increase diversity while also keeping board size manageable.

Initially, directors may be reluctant to adopt formal refreshment policies, thus, the board chair must begin to establish a culture of refreshment by communicating to directors that renominations aren't perfunctory and set expectations that director tenure will be limited. This can aid in long-term strategies.

What Is the Next Step for General Counsel (GC) And Corporate Secretaries (CS)?

Adopt strong evaluation processes. In the absence of formal refreshment policies, you can encourage stronger director life cycle management and, thereby, refreshment of directors, by reviewing and revising the board evaluation process to encourage more robust discussions on board composition. Evaluations can determine which directors are fulfilling the diversity, skills and experience necessary for board service, resulting in conversations about continued board service.

Trend 2: Alignment of ESG Goals and Incentive Compensation

The alignment of ESG goals to incentive compensation continues to increase. In 2022, 83% of S&P 500 companies aligned compensation to ESG (compared to 52% in 2021).[5] This is less common among nonpublic companies (only 13% and 7% of nonpublic company respondents to our survey tied DE&I metrics and environmental metrics to compensation, respectively).[3]

ESG goals can be part of the annual incentive plan, the long-term incentive plan (LTIP) or both. If executives have ESG goals tied to the LTIP, then directors must consider the ESG goal period against the LTIP period (typically a three-year performance period), as well as how success will be measured.

We expect this trend to continue as ESG programs are operationalized and investors prioritize ESG.

What Are the Implications?

Determine alignment. Compensation committees must decide how (or if) to align ESG goals and incentive compensation, including what ESG goals will be tied to compensation; the eligible participants; and the type, form and weighting of award opportunities.[6]

What Is the Next Step for GC?

Prepare recommendations for the compensation committee. In developing recommendations on if, how and when ESG goals should be aligned to incentive compensation, consider:

- **ESG program maturity —** Is the organization successfully tracking, reporting and auditing ESG goals? Ideally, explicit goals should exist to inform specific metrics and compensation strategy.
- **Business case —** Are the ESG goals critical strategic priorities? Aligning ESG goals to incentive compensation should be used when ESG goals are integrated into the broader strategic goals (including financial, operating and ESG goals) and are key to the company's success.
- **Priority —** The committee must prioritize the ESG goal(s) that best further strategic goals, because there are limited opportunities to align strategic priorities to incentive compensation.
- **Industry —** The committee should evaluate whether tying compensation to ESG is the industry norm. For example, in 2022, S&P 500 companies in the energy, utilities, materials and real estate industries frequently aligned ESG to compensation (though it's common among other industries).[7]
- **Participants' location —** Similarly, the committee should evaluate what is (or is likely to become) standard or expected practice in the company's geographies. Tying ESG metrics to incentive compensation in the U.S. is becoming more common(particularly among S&P 500 companies) and is largely driven by the market.[7] More companies in Europe (e.g., France, U.K. and Switzerland) are aligning ESG metrics to compensation driven by corporate governance codes.[7]

Develop a disclosure strategy. You should engage in discussions with management and the compensation committee about disclosure requirements (including disclosing failures), the ability to rely on tracking and measuring goals and how to explain to stakeholders why alignment is strategically important.

Trend 3: Privacy and Cybersecurity as ESG Priorities

ESG reports of S&P 500 companies with mentions of data privacy, data protection and cybersecurity more than tripled between 2019 and 2021.[8] Whether privacy and cybersecurity are prioritized within the ESG framework may depend on the industry (e.g., it's more common in the financial services, communication services, IT, industrial and healthcare industries).

The U.S. Securities and Exchange Commission (SEC) has also indicated its interest in cybersecurity by proposing disclosure rules. Final rules are expected to be adopted in 2023.

What Are the Implications?

Consider the board oversight role. Boards must determine how to link oversight of privacy and cybersecurity risks with ESG oversight. Boards also must determine if any directors have cybersecurity expertise and, if not, develop an action plan for identifying, recruiting and appointing individuals with such expertise.

What Is the Next Step for GC and CS?

Develop an education strategy. Cybersecurity and privacy training must be an integral part of 2023 board education strategies for directors of companies across most industries (even if some directors have cybersecurity experience). GC should also educate directors on how cybersecurity, privacy and ESG are connected priorities (largely because of stakeholders' demands for greater transparency on data collection and privacy practices).

Revisit board escalation policies and reporting. The board should adopt an escalation policy related to cybersecurity and privacy risks. GC also should reassess the reporting cadence of cybersecurity- and privacy-related matters (including progress against stated goals). Only 30% of boards and 46% of audit committees receive cybersecurity reports according to our survey.[3]

Prepare for SEC rules. Companies subject to SEC requirements will likely need to comply with new cybersecurity rules in 2023. Now is the time to consider the processes for alerting the legal department of cybersecurity incidents (no matter the size), the information required for the potential cybersecurity disclosures and the vetting of these disclosures.

Trend 4: Challenging Political and Social Climate

Organizations frequently navigate the competing interests of contributing money to politicians promoting business policies (e.g., lower taxes) against politicians promoting social policies (e.g., climate change). Unsuccessfully navigating these interests can be a public relations nightmare.

Despite this risk, boards aren't actively overseeing these activities. Based on PwC's 2022 annual corporate directors survey, only 30% of boards discuss political activity. [4] Only 62% of S&P 500 companies have policies for board oversight of political spending, and only 56% of S&P 500 companies have board committees review direct political contributions and expenditures. [9] Boards must be more actively engaged with these activities.

What Are the Implications?

Adopt relevant policies and procedures. As part of its oversight role, the board must define the organization's approach to political and social activities by adopting policies to address:

- When and how the organization can make political donations and engage lobbyists
- When to and who can make political and/or social statements on the organization's behalf
- How to prioritize the issues the organization will engage with
- What will be disclosed to stakeholders

The policies should also clarify the perimeters of the board's involvement. The organization's overall corporate strategy and values must be considered to ensure consistency between stated values and these activities.

What Is the Next Step for GC?

Establish reporting cadence. To fulfill its oversight role, the board must receive and discuss reports on these activities and set the perimeters for escalation.

Work with the CRO, Head of ERM and corporate compliance to adopt tracking systems. As part of risk management, procedures should be adopted to track the organization's political spending and lobbying activities.

Evaluate the decision-making framework. You should periodically evaluate the board's guidance to ensure it's providing clear direction to management on political and social activities. To the extent it's unclear, consider formalizing the decision-making framework.

Trend 5: Increase in Director Time Commitment

Organizations are expected to navigate and effectively manage increased legislative and stakeholder demands for greater transparency into business practices and societal impacts, thereby increasing directors' oversight role.

What Are the Implications?

Increased time commitment. Directors' time commitment typically increases after significant economic, societal or legislative changes. Increased time spent may also translate to a more effective board. In a 2021 McKinsey & Company survey, directors on boards that were very effective at helping the organization respond to the COVID-19 pandemic spent significantly more time than others pre-COVID-19 and had much greater increases in their time spent on board work. [10]

Survey results also indicated that these effective boards strengthened collaboration with management and adopted other value-enhancing practices during the pandemic (e.g., adopting flexible agenda practices, including strategy on every meeting agenda, increasing interactions between the board and management in between meetings). [10]

Given the external environment and increasing oversight role, we expect directors to spend more time on board business in 2023. This may also result in a more effective and adaptable board.

Evolve meeting agendas. Board meeting agendas typically evolve in response to changing external factors. A McKinsey & Company survey indicated that corporate resilience increased in 2020 board agendas, compared to 2019, because of COVID-19 and the most adaptable boards spent more time on risk management, including geopolitical and/or macroeconomic risks and climate change. [11]

Risk management challenges from socioeconomic and geopolitical factors in 2022 will likely continue in 2023. Agendas must evolve to permit the board to effectively oversee risk management.

What Are the Next Steps for GC and CS?

Examine the board meeting calendar. You should review 2022 meeting calendars and identify any rushed meetings or meetings with extremely full agendas. Consider if adding additional or longer meetings, or increasing prep time before meetings, would help. You want to allow time for robust discussions.

Update meeting agendas. Apply a zero-based approach to your board agendas by clearing agendas and then adding back necessary items. To determine what is necessary and the amount of time to devote, ask yourself:

- What value does the board/committee bring to the discussion?
- Is there a clear reason for including the topic?
- Is the report at the right altitude?
- Can reporting be improved?
- Are updates at every meeting necessary?
- Are reports given on emerging risks?
- Are reports given when the risk profile hasn't changed?
- Are full updates given to the board and committee?
- Is there white space?
- Is the agenda planning process flexible to adapt for emerging or evolving risks/trends?

You should plan for more time for risk management in 2023 to incorporate new and evolving risks. For long-standing risks, we'd recommend changing the reporting cadence, or modifying the amount of time spent, if they remain unchanged or have the potential for minimal impact to the organization. You should also examine your enterprise risk management program to make sure the time allotted aligns to the material risks identified in the program.

By Alissa Lugo

Evidence

[1] 2021 U.S. Spencer Stuart Board Index, Spencer Stuart. The Spencer Stuart Board Index is based on the S&P 500 as of May 28, 2020, and an analysis of the proxy statements filed between 28 May 2020 and 13 May 2021.

[2] 2022 U.S. Spencer Stuart Board Index. Spencer Stuart. The Spencer Stuart Board Index is based on the S&P 500 as of April 30, 2022, and an analysis of the proxy statements filed between 1 May 2021 and 30 April 2022.

[3] 2022 Governance Scorecard and Board Management Report

[4] Charting the Course Through a Changing Governance Landscape, PwC's 2022 Annual Corporate Directors Survey. The survey is based on responses from 704 directors.

[5] The Current Landscape in Executive Compensation as Reflected in the 2022 Proxy Season, Pay Governance (with respect to the 2022 proxy season). ESG Incentives: Intended to Improve Corporate and Societal, Environmental, and Social Outcomes, Pay Governance (with respect to the 2021 proxy season).

[6] The Evolving Role of ESG Metrics in Executive Compensation Plans, PricewaterhouseCoopers LLP.

[7] Linking Executive Compensation to ESG Performance, The Conference Board, Inc.

[8] Privacy's Growing Role in ESG: What Companies Disclose Now and Next Steps

[9] 2022 CPA-Zicklin Index of Corporate Political Disclosure and Accountability, Center for Political Accountability and The Carol and Lawrence Zicklin Center for Business Ethics Research at the Wharton Business School of the University of Pennsylvania.

[10] How Boards Have Risen to the COVID-19 Challenge, and What's Next, McKinsey & Company. The survey included more than 800 board directors and executives.

[11] The Postpandemic Board Agenda: Redefining Corporate Resilience, McKinsey & Company. The survey included more than 800 board directors and executives.

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