

What Directors Need to Know in 2018 About Board Diversity



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Introduction – Investors Are Challenging Companies On Board Diversity

In 2017, investors challenged many public company boards¹ to improve their gender, racial, and ethnic diversity.² Institutional investors, such as CalPERS³ and NYC Pension Funds,⁴ as well as large mutual fund companies, such as State Street Global Advisers and BlackRock, Inc.,⁵ have made their message very clear to existing boards: make reasonable commitments and progress toward adding women and minorities to your board, or be prepared to be challenged for re-election. One investor explained to me that gender diversity was the initial focus, because investors can typically tell from a simple review of directors' names whether women are part of the board, while directors' names alone do not reliably reveal racial or ethnic characteristics. In the future, the investor added, better disclosure of backgrounds in proxies will allow closer evaluation of all diversity elements. Companies should expect the push for board diversity to continue in 2018 and beyond, until gender, racial, and ethnic diversity on public company boards is substantially improved.

2016 Fortune 500 Board Composition

Director Categories	Total %age in 2016	% of New Directors (426) In 2016
Women	28	27.8
Minorities	21	22.1 (i)
African American	9	9.3 (ii)
Hisp/Latino	6	6.4 (iii)
Asian American	6	6.4 (iv)

(i) Highest since inception in 2009.

(ii) Compared to 8.3% in 2014 and 9.3% in 2015.

(iii) Compared to 5.0% in 2014 and 4.0% in 2015.

(iv) Compared to 5.3% in 2014 and 4.8% in 2015.

**Source: Heidrick & Struggles Board Monitor,
<https://www.boardmonitor2017.com>**

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Why are investors pushing public boards so hard on diversity? It is certainly not about political correctness. **It's business.** Both investors and CEOs⁶ alike are now convinced that appropriate diversity on boards will substantially improve group decision making and improve performance.⁷ Further, many fund companies believe that improving diversity will resonate with young people, who are a significant target group for increased deposits for the fund industry.⁸

The push for diversity has created discomfort for some directors. At a recent director education conference at which I was a speaker, I witnessed an argument between an institutional investor and an attendee who objected strenuously to the investor's push for board diversity.⁹ After the attendee argued that diversity did not produce better performance,¹⁰ the institutional representative countered with a list of studies that support the proposition that having diversity on boards helps eliminate groupthink,¹¹ reduces financial restatements,¹² and improves overall performance.¹³ He also added that women and minorities provide boards with useful perspectives for improving marketing to the millions of women and minority consumers. The argument ended with the investor concluding: "We are convinced of the benefits of diversity, and we want it at companies we invest in."

It is clear to me, through many conversations with board members over the years, that the vast majority of directors are not opposed to increasing diversity on corporate boards. However, the conference attendee's comments revealed a certain reticence that still lingers. Many directors simply believe that business and professional skills have a greater influence on positive board performance and outcomes. Although this view is understandable, the push for board diversity is now part of the permanent landscape facing directors that may result in disruptive disputes. Under these circumstances, the best course of action may be to accept reality, be practical, and fully **embrace board diversity.**

At a minimum, directors should be ready to have a conversation with investors who want to engage about board diversity. Investors will point out that there are many qualified women and minorities for particular industries. Investors will add: if you don't have such individuals on your list of potential candidates, you are simply not looking in the right places or using the right recruiting channels.¹⁴

Adopting a Board Diversity Policy and Disclosure

The SEC does not yet require boards to adopt a diversity policy,¹⁵ despite statements by the prior Chair of the SEC in support of such an initiative.¹⁶ Cautious by nature, boards have been hesitant to adopt formal policies on diversity. Many boards try to have it both ways, publicly endorsing board diversity, while declining to adopt a formal diversity policy. Clearly, this approach will no longer be sufficient to satisfy investors.¹⁷

Adopting a board diversity policy will be encouraged by investors and considered a best practice. The chair of a board's nominations and governance committee should lead the committee, with the input of other directors, in creating the board's diversity policy (see note 18 below for examples).¹⁸ Two elements that investors will look for in reviewing diversity policies are (i) an annual report on the effectiveness of the diversity policy, and (ii) detailed disclosure of the current diversity characteristics of the board.

An annual diversity report should not be something to fear. Legitimate efforts to recruit women and minorities will be applauded, and a reasonable period to improve board diversity will likely be acceptable to investors. Of course, not all companies will have director vacancies or be able to enlarge the board to

accommodate diversity in a given year. Nevertheless, in the annual diversity report, the board's assessment of the effectiveness of the policy can be reported, along with yet unmet goals. Earnest commitment shown through the adoption of a diversity policy will help protect the board from attack by activists. Investors will also applaud including in the diversity policy maintaining a list of qualified board candidates for future consideration, which includes candidates with diverse backgrounds.¹⁹

Further, boards should consider disclosing, through a matrix approach or a narrative, each board member's specific skills and experience, as well as their background, as self-identified, including gender, race, and ethnicity.²⁰ This type of disclosure offers an opportunity to demonstrate each director's qualifications — highlighting skill sets and diverse perspectives.²¹

Initiation and Briefing of New Directors

All new directors need to receive a well-planned initiation and briefing. Ideally, the chair of the board should spend time before the first board meeting to explain the dynamics of board meetings. Every board has different norms as to the flow of discussions and questions at the meetings. Expectations for new directors should be communicated early. The management team should also provide for an orientation and explanation of the business.

Additionally, new board members should be afforded early in their tenure the opportunity to prepare a board report on a meaningful subject with the assistance of another board member. It could be, for example, a report on a particular part of the business that was not addressed sufficiently in prior board meetings and that will also require some collaboration with management. This assignment will increase the new director's understanding of the business, allow management to get to know him or her better, and allow for the new director to contribute early in a meaningful way.

Conclusion

Given the low numbers of women and minorities on boards, directors will continue to hear regularly from investors about improving diversity. Taking strong steps to improve board diversity in 2018 and beyond is a rational and soon-to-be inevitable step. The new challenge for many boards will be to adopt a board diversity policy and to provide a robust disclosure in the proxy detailing each director's skills and his or her demographics, as self-identified. Of course, new directors should be properly initiated and given early responsibilities to become fully part of the director team. Clearly, boards that seek greater diversity with enthusiasm and thoughtfulness will reap significant value and benefits over time.

¹ Thirty-five proposals (an all-time high) called for the adoption of a policy on board diversity or a report on steps to increase board diversity. As in other years, many proposals from investors in 2017 were withdrawn, likely due to commitments made by companies to adopt such policies. Gibson Dunn & Crutcher LLP, *Shareholder Proposal Developments During the 2017 Proxy Season* ¶ 3 (June 29, 2017) ("Gibson Dunn Report"), <https://www.gibsondunn.com/shareholder-proposal-developments-during-the-2017-proxy-season/>.

² Public companies often describe in their proxies how diversity plays a role in selecting new board members. For example, General Motors states that "board candidates are evaluated on criteria that include: Diversity of perspective, professional experience, age,

and background, such as gender, race, ethnicity, and country of origin.” General Motors, 2017 Proxy Statement at 16 (June 6, 2017), https://www.gm.com/content/dam/gm/en_us/english/Group4/InvestorsPDFDocuments/2017_GMPProxyStatement.pdf.

³ CalPERS, *CalPERS Expands Engagement for Greater Diversity on Corporate Boards to More Than 500 U.S. Companies* (Aug. 22, 2017), <https://www.calpers.ca.gov/page/newsroom/calpers-news/2017/engagement-corporate-board-diversity>.

⁴ Press Release, City of New York, Office of the Comptroller, *NYC Pension Funds Launch National Boardroom Accountability Project Campaign –Version 2.0* (Sept. 8, 2017), <https://comptroller.nyc.gov/services/financial-matters/boardroom-accountability-project/boardroom-accountability-project-2-0/>.

⁵ See BlackRock, *Our Engagement Priorities for 2017–2018*, <https://www.blackrock.com/corporate/en-us/about-us/investment-stewardship/engagement-priorities>; State Street Global Advisors, *SSGA’s Guidance on Enhancing Gender Diversity on Boards* (Mar. 7, 2017), <https://www.ssga.com/investment-topics/environmental-social-governance/2017/guidance-on-enhancing-gender-diversity-on-boards.pdf>.

⁶ Business Roundtable, *Business Leaders Add Boardroom Diversity to Best Practices List* (Apr. 20, 2016), <http://businessroundtable.org/media/news-releases/business-leaders-add-boardroom-diversity-best-practices-list>.

⁷ See, e.g., Vivian Hunt et al., *Why Diversity Matters* (Jan. 2015) (“2015 McKinsey Report”), <https://www.mckinsey.com/business-functions/organization/our-insights/why-diversity-matters>; Vivian Hunt et al., *Delivering Through Diversity* at 11, 14 (Jan. 2018) (“2018 McKinsey Report”) (in an update to the 2015 McKinsey Report, finding that companies in the top quartile for racial and ethnic diversity are 43% more likely to have financial returns above their national industry medians, and companies in the top quartile for gender diversity are 21% more likely to have financial returns above their national industry medians).

⁸ Bloomberg Markets, *Why Wall Street’s Finally Pushing to Add Women on Boards* (Dec. 6, 2017), <https://www.bloomberg.com/news/articles/2017-12-06/why-wall-street-s-finally-pushing-to-add-women-on-boards>.

⁹ In a 2017 survey of directors, less than half – 41% – of those responding agreed that gender diversity is very important to bring diversity of thought to the boardroom, and only 24% believed that racial diversity is very important. PwC, *Annual Corporate Directors Survey* at 9 (Oct. 2017), <https://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey.html>.

¹⁰ Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does Difference Make?*, 39 Del. J. Corp. L. 377, 384–87 (2014) (summarizing studies finding a positive relationship between board diversity and company performance), <http://www.djcl.org/wp-content/uploads/2015/01/FINAL-RP.pdf>. **But** other studies found a neutral or negative relationship. See Rhode & Packel at 387–90 (summarizing studies).

¹¹ See Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 Wis. L. Rev. 795, 795–96 & n. 2 (2005) (listing various studies), https://scholarship.law.gwu.edu/faculty_publications/731/.

¹² See, e.g., Lawrence J. Abbott, et al., *Female Board Presence and the Likelihood of Financial Restatement* (2012) (finding a significant association between the presence of at least one woman on the board and a lower likelihood of restatement), <http://aaapubs.org/doi/10.2308/acch-50249?code=aaan-site>.

¹³ *Id.*; see also 2018 McKinsey Report.

¹⁴ Many commercial recruiting firms, associations, including audit firms, assist in board searches. Several nonprofit associations focus upon recruiting board qualified women and minorities. E.g., Catalyst, www.catalyst.org (recruitment of women directors); 2020 Women on Boards, www.2020wob.com; Latino Corporate Directors Association (LCDA), www.latinocorporatedirectors.org; Black Enterprise (BE), <http://www.blackenterprise.com>; and African American Board Leadership Institute (AABLI), <https://www.aabli.org>.

¹⁵ See also Regulation S-K, Item 407(c)(2)(vi); Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,343 (Dec. 23, 2009) (if the board has a diversity policy, disclosure would be required of how this policy is implemented, and how the policy’s effectiveness is assessed).

¹⁶ Mary Jo White, Keynote Address, *International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability* (June 27, 2016), <https://www.sec.gov/news/speech/chair-white-icgn-speech.html>. (“The SEC can’t mandate board diversity, but it can make Boards provide more meaningful disclosure on it.”) In a recent Senate committee hearing Chairman Clayton indicated that while he supports diversity, he would “monitor” the diversity situation. See Bloomberg News, *Democrats Demand Improved Diversity Disclosures From SEC* (May 27, 2017), <https://www.bna.com/democrats-demand-improved-n73014451567/>.

¹⁷ *Id.*; see also n.3 above.

¹⁸ Barclays, https://www.voxmarkets.co.uk/static_files/governance/559e56bc4f386.pdf; Cathay Pacific, <https://www.cathaypacific.com/content/dam/cx/about-us/corporate-governance/20130901-cx-board-diversity-policy-en.pdf>; Detour Gold, http://s22.q4cdn.com/327131108/files/doc_downloads/governance/Diversity_Policy.pdf; Infosys, <https://www.infosys.com/investors/corporate-governance/documents/board-diversity-policy.pdf>.

¹⁹ One of two successful proposals in 2017 was submitted by the City of Philadelphia Public Employees Retirement System to Cognex Corp. requiring the company to maintain a list of diverse candidates from which nominees could be chosen. Gibson Dunn Report at 10.

²⁰ See n.4 above.

²¹<https://comptroller.nyc.gov/wp-content/uploads/2017/09/Example-Board-Matrix.pdf>.



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