Writing Your Board Diversity Policy

by Roel C. Campos

Diversity in corporate boardrooms (or lack thereof) has become one of the world's hottest governance topics. Companies have spent years giving lip service to the idea of broader gender, race, age and experience makeup in their boardrooms, with little to show. A written board policy on diversity status, goals and benchmarks goes far in moving this issue from talk to action. The author, a former SEC commissioner and now corporate director, describes the process of writing his board's diversity policy.

You may be a director on a board that wishes to improve board diversity. Or, perhaps, as was the case with my board, your directors were contacted by large investors about the lack of women and minorities on your board. The push for diversity by investors has certainly created strong pressures for public company boards to adopt a written board diversity policy. Surprisingly, there is little guidance on establishing a board diversity policy and the corresponding disclosures about diversity.

I serve as the chair of the corporate governance and nominations committee (CGN) of Regional Management Corp. (RM), a public company that is in the consumer loan business. Like hundreds of other boards, my fellow directors and I received correspondence from an institutional investor requesting that we improve our diversity.

I am offering our experience in responding to this investor request as an instructive framework for boards that find themselves in similar situations. Our board's process included adding new directors, crafting a thoughtful diversity policy, and implementing a procedure for matrix disclosures in the annual report and proxy of the diversity characteristics of our directors.

When we received the investor letter, my fellow directors and I were quite surprised, as we viewed our board as being very diverse. After all, we reasoned, out of seven directors, three were Latinos. Latinos and Asian Americans have the lowest representation on public company boards, far lower than women.

After discussions with the investor representative, I learned some of the subtleties of these investor initiatives. For most public companies, investors must resort to looking at the names of directors to judge whether the directors are women or minorities. It was explained to me that from the directors' names on the proxy, it is easy to tell whether a director is female, but not so easy to determine whether a director may be African American, Latino or Asian, for example. As a result, our directors' backgrounds were essentially not recognized as diverse in the investor's first pass.

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Given the discussion, the investor said that our board would be given credit for the diversity represented by the Latino board members. We were also told that, while our existing diversity was commendable, we could improve by adding a qualified woman director. We agreed, as we had an ongoing search for a woman director. Institutional investors that are promoting diversity do not usually impose deadlines for diversity goals, but desire a commitment from boards to improve, and an informal ongoing dialogue to assess the board's efforts and progress.

Our board decided to set a "best practice" in our commitment to diversity. Accordingly, we decided to create and adopt a robust board diversity policy. Additionally, as some investors have also urged boards, we determined that we would also use a matrix dis-

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Uneven Progress

Fortune 500 Board Composition, 2016

Director Categories	Total % in 2016	% of New Directors (426) in 2016
Women	28%	27.8%
Minorities	21%	22.1%
African American	9%	9.3%
Hispanic/Latino	6%	6.4%
Asian American	6%	6.4%

Source: Heidrick & Struggles Board Monitor

closure of the skills and background of our directors. We did not want investors in the future guessing about the diverse backgrounds of our directors.

Several months later, in my follow-up discussion with the investor representative, I proudly pointed out that our board had appointed a woman director, now had four Latinos out of eight directors, and had great professional skills, age and geographical diversity.

I noted that we had also adopted a new diversity policy requiring an annual report detailing the progress made in meeting our goals. The investor complimented us. He added that it would be even better if there were two women on the board. I assured him that in due time, as vacancies occurred, we would consider more qualified women.

Perhaps I should have expected what followed next. The investor then pivoted sharply and said, "Let's now talk about requiring majority voting for your directors to continue service." When I said, "Whoa—that was not on the agenda," we agreed to table that discussion and revisit it later in the year.

Yes, with investor governance officers, you are *never* done. Going forward, directors can expect that institutional investors will want a regular discussion with the CGN chair or other board representatives about all of the elements of governance.

Maintaining this dialogue with investors is a good idea in most cases. This allows directors to explain their commitment and also to point out practical issues (such as no vacancies, the crucial need for a particular expertise, or commitments to growth) that will slow down progress in certain governance areas. As in all areas of life, good faith effort and commitment receives credit.

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There is no requirement for public company boards to adopt a diversity policy. The SEC's rule simply provides that, if the board has a diversity policy, disclosure would be required of how the policy is implemented, and how its effectiveness is assessed.

Quite naturally, many boards have chosen not to adopt such a policy to avoid being subjected to possible SEC review. In other words, "why voluntarily subject yourself to a review by the regulator?" Given those concerns, many boards have chosen what was considered a safe path—publicly endorsing board diversity in their proxy statements, without adopting a formal diversity policy. Increasingly, however, this approach will be challenged as insufficient by investors.

There are many formats and styles that can be used for a written diversity policy. At its simplest, a diversity policy would offer a statement of the board's support for diversity, and that the board would make a good faith effort to fill future vacancies with candidates who bring useful skills and diverse backgrounds that include women and minorities. The board would evaluate the effectiveness of the diversity policy annually.

I believe that most boards will not take shortcuts and will choose to undergo a thorough process to evaluate the board's effectiveness and how new diversity could improve its decision making.

At Regional Management, we set out to employ a careful process to capture the existing directors' views. I will use our diversity policy to illustrate the various elements of a diversity policy.

☐ ***Reaching consensus on the meaning and goals of diversity.*** A good first step is to schedule a board discussion about the concept of diversity and how it should be used in selecting new directors when vacancies occur. Such a discussion would usually be led by the chair of the CGN. This committee chair, through prior research with the assistance of company executives like the general counsel, may provide the directors examples of language for a diversity policy.

Boards have adopted many formulations of the diversity they wish to be represented on their boards. 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."

Regional Management Corp. has a significant portion of customers who are women, African Americans and Latinos. Understanding how best to market to and serve the needs of such groups is an important board skill.

The board's discussion will lead to language that reflects the board's support of diversity. My work as chair of Regional Management's CGN resulted in the following policy statement:

> "The board recognizes and embraces the value of a diverse board of directors in improving the quality of its performance and the company's success. Diversity promotes the inclusion of different perspectives and ideas, mitigates against groupthink, and ensures that the board has the opportunity to benefit from all available talent. The board also recognizes the need for its directors to understand and to be able to respond effectively to the financial needs of its diverse customer base. The promotion of a diverse board makes prudent business sense and makes for better corporate governance."

Significantly, apart from acknowledging the benefits of diversity, the statement also recognizes a business reality for Regional Management—the importance of directors understanding the financial needs of a diverse customer base. Like others who sell to the broad retail market, our company has a significant portion of customers who are women, African Americans and Latinos. Therefore, understanding how best to market and to serve the financial needs of such groups is an important skill to have on the board.

☐ ***The objectives for composition of the board.*** There may be different views reflected among the directors, but ultimately they should reach a consensus on a statement of the actual objectives for composition of the board. These objectives will serve as a standard for annually measuring progress toward achieving the desired board diversity. Our policy contains the following view of diversity objectives:

> "The board seeks to comprise itself of talented and dedicated directors with a diverse mix of expertise in areas needed to foster the company's business success, as well as a diversity of personal characteristics that include, but are not limited to, gender, race, ethnicity, national origin, sexual orientation, age, and geography."

Embracing diversity does not mean that a board ignores the need for specific skills, such as accounting, financial, marketing, technology, or cybersecurity, to name a few. In selecting new directors, most boards will reject any formulistic approaches, and insist on applying their collective judgment in balancing the skills needed with the diverse characteristics.

☐ ***Implementation of the diversity policy.*** Having laudable diversity objectives means little if there is no effective process for implementation. In the RM diversity policy, our committee was assigned the duties of identifying qualified candidates for open director positions. Alternatively, another committee or a special committee could be assigned these duties.

▫ *Maintaining a director candidate list.* A tool for advancing the objectives of the diversity policy is a director candidate list maintained by the CGN for use in filling future openings. The candidate list should contain a number of qualified diverse candidates having useful expertise for board service. Sources for this list may include directors and shareholders, as well as outside recruiters when deemed appropriate.

▫ *Statement of how directors are selected.* Directors will weigh various factors in their own manner to determine the expected value that a candidate would bring to the board. Of course, a diversity policy commits a board to take into account the candidate's diversity as one of the factors to be weighed in making the selection. Regional Management captured this concept in the following manner:

> "Ultimately, the selection of new directors will be based on the board's judgment of the overall contributions that a candidate will bring to the board, giving due weight to diverse personal characteristics that contribute to the board achieving the objectives of this policy."

☐ ***Monitoring and reporting.*** One requirement of the SEC's rule is to disclose the effectiveness of the diversity policy. To accomplish this, the CGN committee can commit to preparing an annual report to the board assessing the progress and effectiveness of the diversity policy. Such an annual report on board diversity would present the composition of the board—for example, five white males and two Asian women.

The report might describe the various skills that the directors represent (finance, accounting, marketing, manufacturing, government service, etc.). The range of ages and geography could be reported as elements of diversity. The report might also explain that the board had identified several qualified women and minorities for its candidate list and looks forward to interviewing them when the next opening occurs on the board. The diversity policy report should be available on the company's website, and summarized in the annual report and proxy statement.

Directors need not fear that such a report will indicate little progress over the course of a year. After all, there might not be any vacancies in a given year, so little progress may have occurred. It is important for such a report to demonstrate the board's commitment to diversity, and how the board intends to recruit candidates to improve it.

The board's commitment can be further demonstrated by the inclusion of qualified diverse candidates on the board candidate list. However, if over the course of several years, no vacancies are filled with diverse candidates, the board can expect questions from investors about the strength of their commitment to the policy.

☐ ***Disclosure of board diversity.*** The SEC's requirements for disclosure of the diversity policy's implementation and effectiveness means that the board, through the previously discussed annual report, will report to investors the diverse characteristics of its directors and evaluate progress. In addition to the annual report, a useful tool will be a disclosure on all of the directors' skills and personal backgrounds, as self-identified, including gender, race, and ethnicity.

This disclosure essentially documents the qualifications of each director. Such a disclosure can be helpful in countering activists who may be unjustifiably challenging directors. A matrix format is an efficient way to capture this type of information, although narratives for each director could also be used. An example of a matrix disclosure can be seen in Regional Management's annual report and proxy.

In summary, apart from the continuing pressure from institutional investors, preparing a board diversity policy is a useful exercise for all boards. Through this process, directors will have an opportunity to think deeply about the future ideal composition of the board. With the goal of improving group decision making and the company's performance, directors can carefully consider the combinations of professional skills and background diversity that will improve the board.

A company's diversity policy will be studied by investors and occasionally by the SEC. Consequently, public companies need to apply earnest effort to prepare the board diversity policy. Using the guidelines provided should help directors in navigating the various issues in constructing an appropriate diversity policy. ■

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