Strengthening board diversity

A push from the SEC and Congress

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Public company boards of directors and nominating and governance committees, in particular, are under mounting pressure to take a critical look at their own board compositions in an effort to improve board diversity.

With the growing view that greater diversity leads to innovation and better decision-making, there has been increasing momentum from institutional investors, pension funds, proxy advisors and even certain state legislatures to enhance board diversity. Washington D.C. is also speaking up, and possibly influencing proxy statement disclosures for the upcoming proxy season, with a push for board diversity from the US Securities and Exchange Commission (SEC) and the US Congress.

SEC focusses on diversity disclosure

The Division of Corporation Finance Division of the SEC, on 6 February 2019 addressed board diversity disclosure through two identical compliance and disclosure interpretations (CDIs) under Regulation S-K – 116.11[1] and 133.13[2]. The CDI addresses what type of disclosure is required in connection with Items 401 (director qualifications) and 407 (director nominee qualifications) when board members or nominees have consented to the company's disclosure of certain 'self-identified' diversity characteristics, such as their race, gender, ethnicity, religion, nationality, disability, sexual orientation, or cultural background.

The Division provides that to the extent the board or nominating committee, in determining the specific experience, qualifications, attributes, or skills, considered self-identified diversity characteristics, it would expect the company's disclosure to include, but not necessarily be limited to, 'identifying those characteristics and how they were considered' (the 'qualifications' disclosure required by Item 401). Moreover, it would expect any description of diversity policies followed by the company under Item 407 to include a discussion of how the company considers self-identified diversity attributes of nominees as well as any other qualifications its diversity policy takes into account, such as diverse work experiences, military service, or socio-economic or demographic characteristics.

An interesting aspect arising from the CDI is that directors and director nominees would need to both, self-identify, with certain diversity characteristics, as well as consent, to the company's disclosure of these characteristics. Currently, it is not common practice for director questionnaires or similar forms to ask directors and nominees to identify diversity characteristics, diminishing the opportunity for self-identification. Moreover, even if a director or nominee chooses to self-identify and consents to the disclosure of this information, under the CDI, the company would only be *required* to disclose those diversity characteristics *if* the board considered such characteristics in concluding that the individual should serve as a director, or otherwise has a policy that includes the consideration of such diversity in identifying director

nominees. Even then, it appears that the company would only be required to disclose how it considered these diversity characteristics and would not necessarily be required to disclose the racial, ethnic or gender composition of the board.

As proxy season is underway, we are starting to see a few prominent companies disclosing the boards' consideration of director self-identified diversity characteristics in their proxy statements. These companies generally have robust disclosure of the board's consideration of diversity characteristics for director candidates with accompanying graphics illustrating the company's comprehensive nomination process.

Congressional proposals seek greater diversity through expanded disclosures

After the Democratic Party took command of the House of Representatives following the 2018 midterm elections, efforts by party members for greater board diversity disclosure began ramping up – the latest being the Improving Corporate Governance Through Diversity Act of 2019.[3] The bill was introduced in February by Representative Gregory W. Meeks, with a companion bill simultaneously introduced by Senator Bob Menendez in the Senate. This comes as no surprise, as certain Democratic members of the US Congress, through legislative proposals and letters to the SEC Chairman, have been for years pushing for greater board diversity disclosure.

The bill, which garnered the support of the Council for Institutional Investors and the US Chamber of Commerce, would require public companies to disclose annually in their proxy statements data on the racial, ethnic and gender composition, as well as veteran status, of its board of directors, director nominees and executive officers, based on voluntary self-identification. Moreover, disclosure regarding the adoption of any board policy, plan or strategy to promote racial, ethnic and gender diversity would be required. In addition to these disclosure requirements, the bill directs the SEC's Office of Minority and Women Inclusion to publish best practices for corporate reporting on diversity. Interestingly, while the spotlight on diversity has mostly focussed on the board, the bill goes a step further to cover executive officers as well. »

Spotlight on gender diversity shines brighter

The CDI and congressional corporate Diversity Bill are the latest evidence that efforts to enhance board diversity are quickly gaining traction. Over the past two years, investors, proxy advisory firms and state governments have also continued to ratchet up the pressure on public companies to improve board gender diversity. Importantly, consequences arising from lack of gender diversity are no longer hypothetical – with many companies under fire for failing to increase the number of women on their boards.

INCREASING WOMEN IN BOARD POSITIONS
Investors are using their position to influence elections

Investors take the lead

With board diversity at the forefront, several significant investors are using their influence in director elections to effect change in the boardroom. From launching its Fearless Girl campaign as 'a symbol of the power of women in leadership' to being the first major institutional investor to adopt a formal policy voting against directors due to lack of gender diversity on boards, State Street has been a leader in driving board diversity efforts. Other recent measures by investors to increase the number of women in boardrooms include:

- BlackRock stated it 'would normally expect to see at least two women directors on every board'
- State Street will vote against the entire nominating committee of a company with no female directors that has not engaged with State Street on gender diversity for three consecutive years, beginning in 2020. During last year's proxy season, State Street had voted against the re-election of nominating/governance committee directors at more than 500 companies in the US, UK and Australia that 'failed to make any significant efforts to address the issue'
- Vanguard joined the 30% Club, a global organisation that advocates greater representation of women in boardrooms and leadership roles
- CalPERS withheld votes or voted against more than 271 directors at 85 companies due to board diversity concerns during last year's proxy season
- Shareholders filed 29 board diversity proposals during last year's proxy season, making it one of the top environmental, social and governance (ESG) issues for shareholder proposals

In addition to institutional investors, the New York City Comptroller has also publicly advocated for greater board diversity. As part of its Boardroom Accountability Project, the Comptroller called on 151 US companies to disclose the race and gender of their directors, along with board members' skills, in a 'matrix' format – and to enter into a dialogue regarding their board's 'refreshment' process.

As Rakhi Kumar, head of ESG Investments at State Street, boldly put it: "We want them [directors] to know that we're watching. We know who you are. You have another year to be quiet, after which there are consequences to not engaging with us."

Directors should expect this sentiment to increasingly permeate among investors who will continue to probe deeper into issues of board diversity.

Proxy advisor voting policies prioritise board diversity

With investors urging greater board diversity, it is no surprise that the largest proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis & Co. (Glass Lewis), have recently updated their voting policies regarding board diversity in a continued effort to influence

governance policies and practices through the director election and annual meeting voting process.

Specifically, recognising that 'diversity benefits companies by providing a broad range of perspectives and insights', Glass Lewis, beginning with annual meetings held on or after 1 January 2019, will generally recommend voting against the nominating committee chair at companies with no female directors. In formulating its voting recommendation, Glass Lewis will take into account the company's disclosure of its diversity considerations, rationale for not having any female board members and disclosed plan to address the lack of diversity on the board.

A similar ISS policy will apply to annual meetings held on or after February 2020. ISS will take into consideration mitigating factors that may temporarily excuse the absence of a female director, such as:

- A firm commitment in the proxy statement to appoint at least one female director to the board in the near term
- The presence of a female on the board at the preceding annual meeting
- Other relevant factors as applicable

Moreover, boards should expect the increasing focus on diversity to also include management and the broader employee base. This year, ISS added new categories to its QualityScore that evaluate the number of women on the board serving in leadership positions, such as lead director or committee chair, as well as the number of women that serve in named executive officer positions.

States get tough on gender diversity

In an unprecedented move, we have recently seen US state governments stepping in to drive gender diversity in public company boardrooms. Under a bill signed into law on 30 September 2018, California became the first state to require a minimum number of women on boards.[4] The bill requires public companies (whether or not incorporated in California) with principal executive offices in California to have at least one woman on their boards by 31 December 2019. By the end of 2021, these companies must have at least two or three female directors, depending on the size of their boards. Failure to comply with the law could result in steep monetary fines for the company. According to a recent ISS paper, 89 per cent of California-based companies will need to make changes to their board composition in the next three years to meet these new requirements.

Following in California's footsteps, New Jersey also proposed a similar bill on 26 November 2018.[5] Under the bill, a public company with a principal executive office in New Jersey must have at least one female director on the board by the end of this year. Moreover, a company with more than five directors must have at least three women on the board by the end of 2021. Similar to California, failure to comply with the requirements could result in the imposition of fines. Going a step further, the Illinois House of Representatives on 29 March 2019, passed a bill requiring publicly held companies with principal executive offices in Illinois to have at least one female director and one African American director on their boards by the end of 2020.[6]

The California law and the other state proposals, if enacted as proposed, could be subject to legal challenge. Their constitutionality could be challenged on equal protection grounds due to the creation of an express gender classification and quota system. In addition, they could be challenged under the internal affairs doctrine, given their application to companies incorporated outside of the state. It is not clear whether any other jurisdiction, such as Delaware, would enforce them.

Concluding thoughts

We expect the push for board diversity to continue, or even accelerate, in the upcoming year. Moreover, board diversity issues will again be a significant area of focus for shareholders in 2019, including campaigns for enhanced disclosure regarding board diversity initiatives and diversity policies.

Directors and senior management therefore should be prepared to respond to the many forces seeking change, including by taking a proactive approach to evaluating their own board composition, as well as considering how to best tell the "company's story" through shareholder engagement efforts. Below are recommendations for companies as they try to meet investor and regulatory expectations to improve their own board diversity.

Companies should view proxy statements as a tool to help bring to life, among other things, company board diversity efforts

- **Assess board composition** Boards and their nominating committees should take a proactive approach to board composition and succession planning by reviewing the skills, diversity and tenure of board members in connection with the annual nomination process. Companies should be able to clearly articulate the reasons for any lack of board diversity, as well as plans to address the issue in the near term.
- **'Paint' a picture of diversity initiatives** In connection with engagement efforts to discuss matters that shareholders consider important in formulating voting decisions, including board diversity, companies should carefully consider which communication tools will be the most effective. Companies should view proxy statements as a tool to help bring to life, among other things, company board diversity efforts. Consider whether to include disclosure addressing the SEC staff's 'expectation' that to the extent the board or nominating committee considered the self-identified diversity characteristics of directors and director nominees, the company's disclosure identifies those characteristics and how they were considered.
- **Strengthen stakeholder efforts** Companies should recognise not only shareholder expectations regarding corporate diversity, but also other significant stakeholder expectations – including customers, employees, suppliers and the community from which the corporation draws its resources or that may otherwise be affected by its actions. Stakeholder outreach programmes should be tailored to meet diverse stakeholder priorities and expectations.
- **Review director and nominee questionnaires** In light of the SEC staff's recent CDI, companies with policies that actively consider and promote the disclosure of certain diversity characteristics among its board members (e.g. race, gender, ethnicity, religion, nationality, disability, sexual orientation, or cultural background), should review their questionnaires and consider adding a diversity self-identification question and option for directors and nominees to consent to the release of such information.
- **Monitor applicable state legislation** Companies with a principal executive office in California should prepare to comply with the new California law mandating a minimum number of female directors or face the consequences for any non-compliance (including adverse publicity) and follow any efforts that challenge the validity of the law. Other companies should monitor applicable state law developments in this area.

[1]https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#116-11 [2]https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm#133-13 [3]https://www.congress.gov/116/bills/hr1018/BILLS-116hr1018ih.pdf [4]https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB826 [5]https://www.njleg.state.nj.us/2018/Bills/A5000/4726_I1.HTM [6]http://www.ilga.gov/legislation/101/HB/10100HB3394lv.htm