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Corporate Governance: Board Diversity

Introduction

A public company's board of directors is a group of individuals who have been elected to be the company's fiduciaries on behalf of its shareholders. Along with company executives—such as the chief executive officer (CEO)—who run the company on a daily basis, the board helps set the tone for the corporation. Board mandates include assisting in setting broad corporate objectives, hiring and firing the CEO, who primarily runs the company, and providing support for senior management. Key board committees include the compensation committee (responsible for setting pay packages for key executives), the nominating and governance committee (responsible for ensuring that there are quality candidates running for the board), and the audit committee (responsible for overseeing financial reporting).

Congressional and policy interests in corporate boards have increased in recent years, with one primary issue being the composition of the directors of the board. In particular, there has been a sustained movement for increased gender diversity on corporate boards. Supporters argue, among other things, that opening the pool of prospective directors to an underutilized group of often highly qualified female leaders would bring fresh, unique, and innovative perspectives to boards and their companies, and that research by Credit Suisse and others has found that firms with diverse boards tend to perform better financially. Opponents argue, among other things, that academic studies have not replicated these findings and that boards owe their primary duty to maximize shareholder value rather than to promote various social goods.

During the last decade or so, large companies have felt increased pressure from pension funds (such as CalPERS and CalSTRS) and large asset managers (such as State Street and Blackrock) to adopt more gender diverse boards. Some countries, such as Norway and Germany, have enacted laws requiring gender diverse boards, and the state of California recently enacted a similar requirement. This In Focus examines key policy developments relating to gender diversity on corporate boards, including regulatory requirements, and efforts to increase gender diversity on boards in states and other countries. It also describes various opposing views on the topic. Although the issue has primarily focused on gender diversity to date, movements exist to increase board representation of other groups as well.

Gender Diversity on Corporate Boards

There are some 3,500 public companies in the United States. Each one has a board of directors with between 3 and 31 members (on average about 9). Directors are usually split between inside directors (board members who are employees, officers, or direct stakeholders in the company) and outside or independent directors (board members with no affiliation with the company), who are generally the majority of directors on a board.

Historically, public company boards were the exclusive preserve of white males. For example, a 2013 study by Larcker & Tayan reportedly found that the average company in the Fortune 250 stock index did not have a single female director until the mid-1980s. In 2008, women reportedly held 13% of the board seats in the S&P 1500 Stock Index (which tracks nearly half of public firms). In 2017, that percentage increased to 19%. Nevertheless, a 2016 report from the Government Accountability Office (GAO) observed that "assuming that women join boards in equal proportion—a proportion more than twice what it currently is—we estimated it could take about 10 years from 2014 for women to comprise 30 percent of board directors and more than 40 years for the representation of women on boards to match that of men."

SEC Disclosure Requirements

In 2009, as part of its statutory mission of investor protection through corporate disclosure, the Securities and Exchange Commission (SEC) promulgated rules requiring corporate disclosure on "whether, and if so how, the nominating committee (or the board) considers diversity in identifying nominees for director [and] [i]f the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees."

In subsequent years, the SEC disclosure requirements have been widely criticized for their limited utility by SEC officials, members of the investor community, and a 2016 GAO report, among others. A major concern is that many firms do not include factors such as gender, race, or ethnicity in how they define diversity.

In early 2019, the SEC staff issued new corporate guidance on board diversity disclosures. The guidance said that when making a decision about nominating a particular person to be a director, to the extent that a board considers that person's self-identified diversity characteristics such as race, religion, and gender, the [SEC's] expectation was that "the company's discussion required by [the disclosure regulation] would include, but not necessarily be limited to, identifying those characteristics and how they were considered."

California and Other States

On September 30, 2018, then-California Governor Jerry Brown signed SB 826 into law, making the state the first to enact board diversity quotas. Under the law, all stock exchange-traded California-based companies are required to have at least one woman on their board by the end of 2019. By the end of July 2021, firms with five-person boards must have a least two female directors and those with six-person boards must have at least three. Failure to comply triggers the imposition of money penalties.

Proponents of the board quota, including women's groups, cited research that found that increasing female directors would benefit the California economy in many ways. Critics, including dozens of business interests—such as the California Chamber of Commerce—argued that the law conflicts with existing California civil rights laws because it requires a person to be promoted, while disqualifying another candidate at the same time. Another concern is that Delaware-chartered firms based in California, of which there are many, would be subject to the California statute. Some observers consider this unfair because corporate governance issues such as board composition are typically governed by the laws of the state in which a corporation is chartered, not where it is physically located. The chamber also reportedly criticized the way in which the legislation prioritizes gender over other dimensions of diversity, such as ethnicity. The group, however, may be unlikely to support board quotas based on ethnicity or any other demographic attributes. Many observers expect lawsuits to be filed challenging SB 826.

Some observers say that one potential legacy of the California law is likely to be its effect on other states, a development that already appears to be in progress. As of early April 2019, two states, New Jersey and Massachusetts, were reportedly considering bills along the lines of the California statute.

Board Diversity Mandates Globally

Beyond the United States, other countries—largely European nations—have mandated certain levels of board gender diversity. A precedent for the practice began in 2003 when Norway first required that its corporate boards be composed of at least 40% female directors. Since then, Germany, Spain, and France are among the nations that have imposed minimum requirements for female board representation.

Research and Varying Views on the Benefits of Board Diversity

The so-called shareholder-centric view of capitalism is the conventional notion that a company's only stakeholders are its shareholders. Under that view, the role of the board of directors is to provide value for the company's shareholders. In 2016, studies by Credit Suisse, the investment bank, and McKinsey and Company, the consulting firm, found that diverse boards lead to improvements in a firm's profitability. Research conducted by academics, however, has frequently not supported that view. For example, two meta-studies—studies of related multiple studies—by Post and Byron (2015) and by Pletzer, Nikolova, Kedzior, and Voelpel (2017) found that greater board diversity had an insignificant impact on a company's financial status.

There is, however, research linking heightened board diversity to a number of nonfinancial corporate benefits. For example,

- A 2018 study by Banahan and Hasson compared S&P 500 Stock Index firms with boards containing three or more women with firms whose boards had two or fewer women. It found that the firms with more gender diverse boards outperformed their counterparts on environmental, social, and governance metrics—nonfinancial performance indicators that include sustainable, ethical and corporate governance issues.

- Research published by Adams and Ferreira in 2009 suggested that female board members may be superior monitors of senior executives.
- Work published in 2018 by Kamalnath indicated that greater board diversity may help mitigate the prospect of potentially harmful board "groupthink."
- The *2014 MSCI Executive Summary of Women on Boards* found that firms with boards with more than average levels of female directors may be less prone to bribery, corruption, and fraud.

Lisa Fairfax, a corporate governance expert and law professor at the George Washington University Law School, advocates that nonfinancial board diversity benefits provide robust support for efforts aimed at expanding board diversity. In this context, Professor Fairfax thinks that there has been too much emphasis on "business rationales" for board diversity and too little appreciation for "social and moral justifications for board diversity efforts."

Fairfax's view is consistent with the so-called stakeholder-centric view of capitalism wherein companies are said to be responsible for multiple stakeholders—not just shareholders, but also workers, suppliers, and their communities, etc.

The stakeholder-centric view largely stands in contrast to the aforementioned shareholder-centric view, a more orthodox perspective embraced by many, including SEC Commissioner Hester Peirce. Commissioner Peirce, the first federal official to publicly come out against the California law, observed that "The California legislation effectively forces corporations, including non-California corporations, to consider all women as stakeholders. That is a big group... We have a deep and well-developed body of corporate law. It rests on the assumption that the board owes its principal duty to the shareholders collectively, not to an amorphous group of stakeholders…."

Legislation in the 116th Congress

H.R. 1018 (Meeks) and S. 360 (Menendez) would require public companies to disclose the gender, race, and ethnicity of their board members and their plans for achieving board diversity.

H.R. 1611 (Maloney) would require publicly traded companies to disclose their board members' gender.

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