



The Rising Importance of Board Diversity

Public companies are increasingly putting a high priority on gender and racial diversity — especially on their boards of directors.

Many prominent shareholders, such as institutional investors and private equity firms, are putting pressure on the companies they own to report on the diversity characteristics of their board members and to increase the number of women and other groups on their boards. And many companies are responding to this pressure, creating roadmaps to improve their board diversity.

Yet significant barriers remain. One obstacle preventing an increase in the number of diverse board nominees is the common preference for CEO experience

— few women and other minorities have held such positions in the recent past. Another important issue is the slow turnover among board members: the average tenure of a board director at a Russell 3000 company is 10.4 years, according to a recent study by the Conference Board.

Nonetheless, progress is gradually being made, especially in the area of gender diversity. The percentage of women on the boards of Russell 3000 companies grew to 18.5% in 2018, according to research by Equilar.

How exactly are companies currently approaching the issue of board diversity? And what are the biggest challenges they face in improving the diversity of their directors? We spoke with three leading experts as well as one public company executive to find out.

Contents

Changing of the Guard	2
Privacy Matters	7



Changing of the Guard

The experts



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In your experience, how important is board diversity to investors when evaluating a company's ESG credentials in the current environment? Which types of diversity do you think investors are most concerned about?

Lori Zyskowski, Gibson Dunn

Diversity is definitely very important to institutional investors. If you look at large investors such as BlackRock and State Street, or large pension funds such as CalPERS and CalSTRS, they have all been very vocal on enhancing diversity on company boards.

I also think what started out being a significant focus on gender diversity seems to be moving into other areas of diversity, such as race and ethnicity. Diversity of tenure on boards is also something that institutional investors are focused on – State Street demonstrated that a few years ago when they looked at the average tenure of board directors.

John Valley, Osler

Diversity has become increasingly important over the last few years. In 2017, the momentum built with the Fearless Girl statue being installed on

Wall Street, and a change in tone from institutional shareholders and proxy advisors, including starting to talk changes in voting guidelines with respect to gender diversity. I think this has been a long time coming.

I would agree with Lori that the primary focus has been on gender diversity, particularly in the post-#metoo world. But I think you're starting to see some focus on other diversity characteristics as well. In the UK, the Parker Review committee issued a report in late 2017 that dealt with ethnic diversity at UK firms. The Lloyds Banking Group and Royal Bank of Scotland have made some public declarations about ethnic diversity targets for their senior management teams.

We're seeing it here in Canada as well, though it's not necessarily as widely reported. One example of movement in that direction here is our federal government passing legislation that would require public companies incorporated under our federal corporate statute to make disclosures relating to gender diversity and diversity characteristics beyond gender. The changes haven't been proclaimed into force and the regulations haven't been finalized, but change in this regard is coming.

**Naz Zilkha,
Dechert**

I advise a number of clients with public boards, and diversity issues have been a topic of concern. I also advise a number of private equity firms that have invested in public companies, and they are also interested in understanding how the rules are changing in this area and with which requirements their boards may need to comply. So it is definitely a hot topic.

In February, the SEC came out with their guidance on proxy disclosure, and it provided guidance on when companies should disclose information regarding board diversity in their proxy. When that came out, I think it prompted a number of questions about whether additional information on diversity is required to be included in their proxy filings.

I would also agree with Lori and John that by and large, the strongest emphasis is on gender diversity on boards. That has been more discussed than other aspects of diversity. I think part of what makes the diversity discussion complicated is that there isn't a comprehensive definition of what diversity means.

Many folks tend to think about it in terms of gender, but there are obviously all sorts of other aspects of diversity that could be considered, such as age, ethnicity, sexual orientation, religion and nationality. The SEC hasn't said what it thinks diversity really is or which types of diversity should be considered by boards – instead, the Commission has left it up to companies to decide what policies they want to adopt and which distinguishing criteria they view as important in their candidate nomination process.

"... the primary focus has been on gender diversity, particularly in the post-#metoo world."

John Valley, Osler

Mergermarket **What do you think are the main barriers to greater board diversity at the moment? Does it have more to do with discrimination or a perceived lack of qualified female and minority candidates?**

**Lori Zyskowski,
Gibson Dunn**

I think it's more a perceived lack of qualified candidates – but I think that is more often the case at highly specialized companies. Some companies are looking for very particular industry experience and think that the best people are those who have held CEO jobs at other companies in the industry. That viewpoint inherently makes it more difficult for women and minorities who haven't held those jobs historically.

There has been a new heightened focus on identifying diverse board candidates with interesting experience in a given industry, whether it be university professors or researchers or people who have held other relevant positions. Companies are also looking at people who have had a significant government role to enhance diversity. If you look more broadly than simply at other CEOs in your industry, I think there are many high-caliber women and minorities who are looking to join boards, and companies are finding that more and more.

**John Valley,
Osler**

I would agree that it's important to pay attention to which pools of talent you're using to find new directors. If you mandate your executive search provider to look more broadly and to consider gender or other characteristics specifically, which a number of companies are starting to do, that can greatly improve your chances of finding more diverse candidates.

A Corporate Perspective

Melissa Gleespen Vice President and Corporate Secretary, CMS Energy

Mergermarket: What is the importance of board diversity to CMS Energy? How exactly does CMS Energy approach the issue?

CMS Energy makes a priority to have a diverse Board of Directors, just as we place a high value on diversity and inclusion within our entire company. Our 11-member Board of Directors includes five women (one of whom is our president and CEO, Patti Poppe), four of whom have joined the board in the last five years. We strive for a board that reflects diversity in the communities we serve, which can mean racial, gender and ethnic representation. It's important, too, that our board includes people from different professional and personal backgrounds, whether they live in our home state of Michigan, have worked in the energy industry or bring other experiences.

Mergermarket: What benefits do you think come with diversity on your board?

Our board's diversity lends strength to our mission. Our company has made a commitment to our Triple Bottom Line – people, the planet and Michigan's prosperity – that takes a fresh approach to our work to serve residents across Michigan. We couldn't have developed that new mindset without perspectives and input from all 11 board members. Diversity on our Board of Directors also sends a message to our employees and our customers for the inclusive company we strive to be.

Mergermarket: How would you evaluate boardroom diversity in the energy utility sector?

The energy industry is changing rapidly in many ways. As an example, The Wall Street Journal reported in late 2018 that energy utilities have more female chief executives than any other sector in the S&P 500. That change is reflected in the makeup of our Board of Directors, and we hope to be a leader as our entire industry evolves.



Then, as Lori said, if you mandate CEO experience on your potential director nominee's resume, you're going to have a disproportionate number of men at this point. But expanding the search parameters opens the door to other qualified candidates – for example, to a woman who might not have the CEO title, but has P&L responsibility for a segment of a larger business. That individual will be well placed to make a very meaningful contribution to the board. A shift to focus on the individual's ability to contribute, rather than on the title they've held is a subtle but important one.

A focus on industry experience is another common barrier to entry. While

it's certainly a consideration – there's no question that you want some of that expertise on your board – is it the case that every member of your board has to have it? Probably not in most cases. Improving diversity on your board typically requires thinking very carefully about having an appropriate mix of skills on the board, and being mindful that imposing certain requirements can inadvertently limit the talent pool from which you have to draw.

We are also seeing some companies take interesting steps, such as putting women on their subsidiary boards to get them board experience, so that when they apply for board positions at other companies, they can point to that. It's part of their people development strategy.

**Naz Zilkha,
Dechert**

Personally, I don't think it's a lack of qualified candidates. Women account for almost half the workforce, yet sources have indicated that less than 20% of Fortune 500 boards have women on them. It's a process that will take time, and I think part of it has to do with identifying which aspects of diversity are important, as we discussed earlier. I think folks are currently grappling with the decision of whether to include diversity among their characteristics for nominating folks, as well as deciding how they would define such a policy and what characteristics they should deem to be important. Diversity for the sake of diversity isn't the only reason to include diversity on boards – I think nominating committees are going to be pushed to take a more multi-dimensional approach to evaluating candidates, to build boards that can draw upon a wide range of perspectives, experience, expertise and knowledge.

Nominating committees will need to identify diversity attributes that will benefit the company in the long term and justify why they are pursuing those policies. There are studies on both sides of the issue of diversity and corporate performance, but I don't think anyone would dispute the idea that having a diverse board does have benefits. Aside from creating unique perspectives and ideas, which ultimately can mitigate risk, board diversity can help attract and motivate talented employees. It can also help companies better understand their customer base, for example.

Mergermarket **Progress is gradually being made when it comes to female representation on corporate boards, but gender diversity in the C-suite remains very low. Do you think diversity in this area of leadership carries less weight among investors? And do you think it will take longer for the situation to change in the C-suite?**

**John Valley,
Osler**

We've looked at this issue in Canada, and indeed while there has been slow but steady progress with respect to women on boards, there has been little progress on the executive officer front since our 'comply or explain' diversity disclosure requirements came into force in 2014. 'Structure' is a part of it – compared to a board, there are fewer available to fill in the C-suite, the tenures tend to be longer, and there is a cost in terms of separation payments to turn over the C-suite. That makes it harder to justify terminating your CEO in the short term without cause to facilitate a better gender balance. But that's only part of the story, and the other issues we've discussed with respect to increasing gender diversity apply to the C-suite as well.

Diversity among executive officers is an area of increasing focus, and we see institutions being increasingly interested in understanding how organizations are developing diverse talent in their organizations. However, it is harder to measure and assess in some respects. Board members are easy to identify, and board sizes typically are more comparable across organizations, but the disclosure requirements in Canada relate to 'executive officers' which can be defined very differently across organizations and makes the data harder to compare. What we are seeing is that some companies are devoting a significant amount of space in their proxy materials to talk about what they're doing throughout the organization to develop and promote gender or other diversity in the executive officer ranks. That disclosure doesn't show up in the numbers, but it does suggest that there may be change on the horizon.

**Lori Zyskowski,
Gibson Dunn**

I think the C-suite is the next frontier for diversity. I think once you have a more diverse board, the next step will be to look at diversity in the C-suite and have programs to promote women and other minorities from within.

"Nominating committees will need to identify diversity attributes that will benefit the company in the long term."

Naz Zilkha, Dechert



Privacy Matters

The experts



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Companies are increasingly being pressured to disclose personal characteristics of their board members to make it possible for investors to evaluate their diversity, and some have expressed concern about potential problems with such a requirement. What do you think about this criticism? Is it justified in your opinion, and if so, how do you think it could be addressed?

Naz Zilkha, Dechert

This is an important issue, and I think the recent SEC guidance is helpful in understanding how this will ultimately play out. It's true that dealing with diversity and describing these types of attributes for individuals is personal.

What the SEC has said is that they understand that boards may or may not consider diversity as part of their nominating criteria and policies – but if they do, then it's important to describe that in their proxy statements. Given privacy concerns, it seems clear that companies will need to obtain consent from board members to describe their personal attributes before disclosing their level of diversity.

Another key issue is how a board verifies self-identified characteristics of their board members. If someone says they are a particular nationality, does a board simply take that on faith? Are they going to start DNA-testing or some other means to test ethnicity? Some observers have wondered whether there are potential liability issues if companies make statements about their board members that turn out to be inaccurate. At the end of the day, I think some of these concerns may be overblown, but I think there is definitely a desire by companies to be more transparent about the diversity of their boards and at the same time avoid potential problems inherent in increased disclosure.

**Lori Zyskowski,
Gibson Dunn**

I have clients who have told me their directors do not want their personal characteristics disclosed with respect to them individually, because it is a privacy issue. As Naz mentioned, the SEC came out with a new C&DI in February that said companies should look at individual diversity characteristics that have been self-disclosed. When disclosing those personal diversity characteristics, I think it's a question of getting approval from each individual if you're going to do it on an individual basis. Many companies have done pie charts showing the gender or racial characteristics of their boards in aggregate, but when you're showing them on an individual basis, I think that has many more privacy concerns attached to it.

One perspective that I think exists among some directors is that they don't want to be perceived as having been chosen for a board solely because they are of a particular race or ethnicity, or solely because of their gender. These are very

highly qualified people who deserve to be on these boards, and they don't want it suggested that the only reason they were given the role is because of a diversity characteristic.

So if companies do gather this information, they need to be respectful of their directors' privacy and clearly note that providing such information is optional on the part of the director, and companies need to obtain consent to actually disclose that information. One way that I've seen this work is through the director and officer questionnaire – directors fill out these questionnaires annually to provide various information that needs to be disclosed in the proxy statement as they're being nominated for reelection. And for companies using a questionnaire like that, I think that's the most effective way to obtain diversity information.

**John Valley,
Osler**

Diversity disclosure in many cases relies on having individuals self-identifying, meaning a company can practically only disclose the information it receives from its board members. So diversity disclosure requirements will need to recognize this limitation and companies will need to think about how to balance the desire for 'better' disclosure with any privacy or other concerns that board members may have in this regard.

"If companies do gather [diversity] information, they need to be respectful of their directors' privacy."

Lori Zyskowski, Gibson Dunn



Mergermarket **California has become the first state in the country to pass a law mandating a gender diversity requirement on the boards of companies based in the state. What do you think of the law? Do you think legislative action such as this is necessary to improve board diversity?**

Naz Zilkha, Dechert The California statute is fairly transformational. It has some opposition on constitutional and other grounds that does raise interesting questions. Studies have shown that a huge number of California companies will need to make changes to their boards to meet the new requirements, and how it plays out will almost certainly influence whether other states consider adopting similar

statutes. The California law in particular is interesting because it applies both to companies that are incorporated in California as well as those with headquarters in the state. That means that companies with a principal office there, but that aren't necessarily California corporations, will fall under the statute. Some opponents of it argue that this could create legal issues, because of a choice of law rule called the Internal Affairs Doctrine, which says the rules governing how boards should conduct themselves should consist of a single set of rules of the state in which the company is incorporated.

The other thing that I think some people haven't considered is that removing someone from a board to appoint a woman could violate the constitution by

imposing gender inequality. Companies may simply increase the size of their boards in order to appoint more women, but we don't know how every company will act in practice. Some boards may not want to increase their size – they may be large enough already, and it's costly to add more people.

But you know, the California law is not a new concept. Europe has been doing this for quite some time – in fact, there are a number of countries that have gender quotas or disclosure requirements for diversity on their boards. So this is a new area in the U.S., but not in Europe.

**Lori Zyskowski,
Gibson Dunn**

It does seem to be the case that the California law is encouraging greater board diversity at a faster pace than might happen otherwise. I've seen many clients based in California that are very focused on adding a woman to their board by the end of this year as is required by the law. They're also looking out for the next few years as they look to see whether they're going to need two or three female members of the board by 2021, depending on their board size. So while I would hope that such a measure is not necessary, I have to say that it does have an impact.

Whether or not the law is constitutional is a different issue. I think Governor Jerry Brown even said there were some questions as to whether it would withstand court scrutiny. But I don't believe there have been any cases against it, because in such a lawsuit, a company would have to argue that this law is wrong. It would almost certainly hurt their reputation both with their employees and with potential customers or other stakeholders.

"Companies may simply increase the size of their boards in order to appoint more women, but we don't know how every company will act in practice."

Naz Zilkha, Dechert





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