The attached article, Corporate Governance Update: Activism and Board Diversity, was published in the New York Law Journal on September 28, 2017

September 28, 2017

Corporate Governance Update: Activism and Board Diversity

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Activism at public companies can reduce board diversity, or it can increase it, depending on the circumstances. In recent years, activist hedge funds have installed dissident nominees who collectively have trailed the S&P 1500 index significantly in terms of gender and racial diversity. In contrast, institutional shareholders and asset managers are promoting board diversity to an unprecedented extent, with concerted public efforts already producing results. Several institutional investor initiatives, announced earlier this year, and the New York Comptroller's Boardroom Accountability Project 2.0, announced earlier this month, may be game-changing initiatives on the path to greater board diversity.

Hedge Fund Activism

Since the early 2000s, a number of studies have demonstrated that companies with women on their boards consistently experience a wide range of benefits, including higher average returns on equity, higher net income growth, lower stock volatility, and higher returns on invested capital. Whether because of improved group dynamics, a shift in risk management, increased ability to consider alternatives to current strategies, or a focus on governance generally, board gender diversity produces stronger boards. While the argument for gender diversity may have begun from notions of equality, experience has shown a compelling financial rationale.

With the evidence for board diversity very much in the public domain, the behavior of hedge fund activists seeking board representation has been somewhat puzzling. Hedge fund activism has been notably

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counterproductive in terms of gender diversity on public boards. A 2016 Bloomberg analysis of the years 2011 through 2015 found that women represented only five percent of the candidates successfully placed on boards by activist funds, a significant finding during a period in which women represented about 19 percent of S&P 500 directors and in which female candidates were nominated to fill 26 percent of open seats at S&P 500 companies. At companies targeted by hedge funds during the same years, the proportion of all-male boards increased from 13 percent to 17 percent, while in the S&P 1500 that proportion significantly declined.

An August 2017 study investigated the reasons that hedge fund activists seemingly ignore the evidence for gender-diverse boards in their choices for director nominees and disproportionately target female chief executive officers. The authors suggest that hedge funds may be subconsciously biased against women leaders due to perceptions, cultural attitudes, and beliefs about the attributes of leaders in our society. Activists may tend to view female CEOs as weaker and may be more willing to second-guess and criticize the corporate strategic plans put forth by women leaders. Indeed, one academic study found that the persistent mention of a female CEO in media coverage leads to a 96 percent probability that her company will be targeted by activists.

Boardroom Accountability 2.0

In marked contrast to hedge fund activists, significant institutional investors and asset managers are engaging in deliberate, proactive, and effective campaigns for increased diversity on public company boards. BlackRock, State Street Global Advisors, and Vanguard all have taken public steps this year to promote and advocate for greater board diversity. For example, State Street Global Advisors' "preferred approach is to drive greater board diversity through an active dialogue and engagement with company and board leadership." Using the carrot and stick approach, State Street notes that "[i]n the event that companies fail to take action to increase the number of women on their boards, despite our best efforts to actively engage with them, [State Street] will use [its] proxy voting power to effect change — voting against the Chair of the board's nominating and/or governance committee if necessary." BlackRock has noted that "over the coming year, we will engage companies to better understand their progress on improving gender balance in the boardroom." Vanguard, in an open letter, noted that one of the four pillars it will use to evaluate a public company's corporate governance is whether there is "[a] high-functioning, well-composed, independent, diverse, and experienced board with effective ongoing evaluation practices."

Earlier this month, the New York City Comptroller and the New York City Pension Funds announced the "Boardroom Accountability Project 2.0," a three-pronged initiative focusing on board diversity, director independence, and climate expertise. With regard to board diversity, the project calls for the boards of 151 U.S. companies to release "board matrix" disclosure indicating the race, gender, and skill sets of their board members, on the theory that standardized disclosure will increase transparency, accountability, and incentives for diversification. The project aims to combat a "persistent lack of diversity" on public company boards by encouraging boards to seek director candidates more broadly. The New York City Comptroller recently sent letters to the targeted companies asking them to provide the requested information.

The new project could well be successful as the NYC Comptroller's original Boardroom Accountability Project. The goal of the original project was to make proxy access a standard feature of corporate governance. Since the 2014 launch of the initial project, proxy access has indeed become widespread, with over 400 U.S. companies (and over 60 percent of the S&P 500) having adopted some form of proxy access. Boardroom Accountability 2.0 is the sequel, in that nearly all of the targeted companies recently adopted proxy access, and the current project aims to empower shareholders to use this tool more effectively with the information contained in the proposed standardized matrix disclosure.

Even if companies choose not to directly respond to the information requested by the NYC Comptroller, the combination of the Boardroom Accountability Project 2.0 and institutional investors' focus on the issue of diversity is likely to push public companies to reassess their approaches to board diversity generally and gender diversity specifically. We are already seeing changes in the way boards of directors are approaching director succession in response to these pressures. Public companies should consider using the opportunity presented by the

Boardroom Accountability Project 2.0 to communicate their approaches to board diversity generally, and gender diversity specifically, to their larger institutional investors and engage in a dialogue that will present their approach in the best possible light.

The concerted efforts of some of the largest and most influential investors and asset managers toward increasing board diversity are likely to be effective. Their support for shareholder proposals, their ongoing engagement with companies, and their consistent public advocacy for independent and diverse boards are powerful factors that will change the corporate governance landscape. Meanwhile, the advantages of diverse boards are becoming more widely understood and have been demonstrated through convincing evidence, making the business case for board diversity stronger than ever.