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Corporate Governance Update: Raising the Stakes for Board Diversity

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While diversity on boards of directors has been a high-profile issue for many years, and public companies have made notable progress in diversifying their boards over the past two decades, public companies now face increased pressure to move beyond verbal commitments and incremental progress. Investors, proxy advisors, and activists are demanding data-driven, measurable changes. They are leveraging litigation, legislation, shareholder proposals, and direct engagement to push companies to increase their commitment to diversity, to disclose their diversity data, and to make significant financial investments in diversity initiatives. Both gender and racial diversity are in the spotlight now.

A recent lawsuit by a shareholder of Oracle Corporation has opened a new line of attack on companies that have been slow to diversify their board membership and executive leadership team. The complaint alleges that Oracle's failure to appoint racially diverse directors and officers—while making public statements avowing a commitment to racial diversity—constitutes securities fraud. The premise of the lawsuit, and the relief sought, are likely to provoke significant debate and some degree of change, regardless of the outcome of the litigation.

The Oracle Lawsuit

Earlier this month, an Oracle shareholder filed a complaint in federal court alleging that the company made false statements in its proxy statements. The plaintiff claims that Oracle's directors "deceived stockholders and the market by repeatedly making false assertions about [Oracle's] commitment to diversity." In view of the fact that Oracle lacks African-American directors or officers, the plaintiff asserts that "the directors have breached their duty of candor and have also violated the federal proxy laws." The complaint cited Congressional inquiries into the lack of diversity on Oracle's board as well as a Department of Labor lawsuit

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regarding underpayment of women and minorities at Oracle. The complaint also alleges that Oracle's external auditor, Ernst & Young, has been an ineffective auditor in that E&Y failed to report that Oracle's internal controls do not ensure non-discrimination and that the company is not "complying with its stated goals and initiatives regarding the promotion of diversity and the avoidance of discrimination and harassment." In sum, the complaint states, "Platitudes in proxy statements are not progress. Simply put, Oracle has no *real* commitment to diversity and its Board is turning a blind eye to the Company's miserable failure to ensure the 'diversity' trumpeted by the Directors in Oracle's filings with the [SEC] and its annual reports to shareholders."

Typically, investors and activists have sought to pressure companies to focus on diversity through a combination of shareholder proposals and direct engagement. These approaches generally have been collaborative and productive; of the thirty-seven shareholder proposals filed in the past year urging action and disclosure on board diversity, thirty-three were withdrawn following successful engagement and mutually agreeable outcomes. Lawsuits alleging securities fraud are a far more hostile and punitive method of seeking change, and the risk of backlash is high. Even companies with a strong commitment to diversity will take a hard look at their proxy statements and are likely to rephrase any "platitudes" in their SEC filings to ensure that their stated support for corporate diversity cannot reasonably be interpreted as constituting guarantees or assurances. Valuable time and effort that could be spent on improving diversity efforts will, in some cases, be redirected toward protecting the company from diversity-based disclosure litigation. Unfortunately, recruiting candidates who represent genuine diversity in both demographics and viewpoint is no easy task, particularly for smaller firms in specialized industries that historically have lacked minority participation, and many companies realistically cannot make promises as to the timing and results of their efforts to increase diversity in senior management or on the board.

Diversity Reports and Quotas

The relief sought by the Oracle plaintiff is a good example of the turn toward data-driven results that is likely to dominate the next phase of diversity activism. The plaintiff asked the court for, among other things, the replacement of three Oracle directors with minority directors, the creation of a $700 million fund to promote diversity at Oracle, the replacement of the external auditor, and the publishing of an annual Diversity Report containing "particularized information about the hiring, advancement, promotion, and pay equity of all minorities at

Oracle." The plaintiff also asked that Oracle set specific quotas for minority hiring over the next five years, with a revised executive compensation program tying 30% of executive compensation to achievement of diversity goals.

Diversity reports recently have been adopted in Canada as part of its "comply or explain" disclosure regime, which may become a model for other countries as corporate diversity begins to be measured in more concrete terms. Canadian companies are not required to have diversity quotas or targets; however, as of January 1, 2020, Canadian public companies are required to provide annual proxy disclosures regarding the diversity policies and practices pertaining to the board and executive leadership. At minimum, Canadian public companies are required to disclose information regarding four "designated groups," including women, Aboriginal persons, members of "visible minorities," and persons with disabilities. A Canadian company must disclose whether it has targets for representation for each designated group, any progress made toward achieving those targets, and the number and percentage of directors and executives from each of the designated groups. Moreover, a Canadian company must disclose descriptions of any term limits and any written policies relating to the identification and nomination of directors from the four designated groups, as well as whether and how diversity is considered in the selection process for directors and senior management. A Canadian company may also disclose additional information about its directors and executives that the company believes contributes to its corporate diversity, such as age, sexual orientation, or other elements.

The information used in these disclosures is obtained by questionnaires that ask individuals to self-identify as belonging to designated groups. While it is common for companies to have gender diversity targets, many Canadian companies will face for the first time the question of whether and how to expand their diversity policies to include the other three designated groups, and possibly others as well. Canada's new disclosure requirement includes an official review after five years. It is possible that if companies have not made sufficient documented progress toward increased diversity, the government may consider adopting stronger measures, such as mandatory quotas.

Quotas have been widely implemented in Europe and in some parts of Asia. In 2018, California became the first state to enact legislation imposing gender quotas on corporate boards; the constitutionality of this law is currently being challenged in state court. Earlier this month, a California lawmaker introduced legislation imposing similarly designed quotas for "directors from underrepresented communities," defined as people who self-identify as African American, Hispanic, or Native American. This legislation, if passed, is certain to be challenged as well. While California remains the only U.S. state with mandatory minimum numbers of female directors, Maryland, Illinois, and New York have enacted mandatory diversity disclosure requirements. Several other states are considering mandatory board diversity legislation at this time.

In the private sector, some prominent U.S. firms have begun to implement quota-based policies. The chairman of Goldman Sachs announced in January 2020 that the investment bank would, as of July 1, decline to take a U.S. or European company public if the board lacked "at least one diverse candidate, with a focus on women." Goldman's requirement may be increased to two "diverse candidates" in 2021. Similarly, BlackRock stated in 2019 that they expect to see at least two women directors on every public company board. Institutional investors and policy leaders are likely to continue to pressure companies to increase the diversity of their board and leadership, and specific target numbers are likely to become more widespread.

In the United States, disclosure is generally viewed as preferable to mandates, as it allows greater flexibility for firms to calibrate their own progress. Disclosure is a powerful tool: It informs and empowers investors; it demonstrates whether, and how quickly, companies are progressing toward their stated goals; it makes possible data-driven assessments of the impact of diversity on financial performance; and—if it reveals a lack of meaningful change over time—it provides activist legislators with ammunition for advocacy. Detailed disclosure of policies and practices, as well as company-specific data, would provide institutional shareholders and proxy advisors with the information needed to make more particularized shareholder proposals and voting recommendations.

The SEC currently has limited disclosure requirements regarding diversity. Public companies are required to describe "the specific experiences, qualifications, attributes or skills that led to the conclusion that a person should serve as a director" as well as how the board implements any diversity policies in the nominating process. A SEC Compliance and Disclosure Interpretation from 2019 adds that if board members or nominees self-identify with specific diversity characteristics and consent to their inclusion in company disclosures, the company is expected to identify those characteristics and discuss how they were considered.

More robust diversity disclosure requirements in the United States, like mandatory quotas, may be largely a private sector initiative in the near future. Earlier this month, ISS sent a letter to companies asking them to provide the race and ethnicity of each of their directors and named executive officers, to the extent that the company and the individuals are willing to report the information. In its letter, ISS states its intention "to engage with a broad cross-section of stakeholders on the potential need to expand the use of self-identified race and ethnicity director data within our ESG ratings methodologies, voting research and policies, and other offerings as it applies to this topic."

Going forward, it is possible that lawsuits and private sector requirements may become popular alternatives to shareholder proposals and engagement. This would be unfortunate. Neither the adversarial process of litigation, nor the dictatorial posture of mandates, generally creates a highly productive relationship between a company and its investors. Quotas are a blunt instrument, generally using demographic diversity as a proxy for true diversity. Yet as some activists have found, there is not necessarily a correlation between demographic diversity and diversity of skills, experience, and viewpoint. It is of course essential that new directors have relevant, not merely unrepresented, professional backgrounds. Moreover, the board culture, and the onboarding process, must be such that new directors with diverse perspectives are valued for their contributions.

Strong evidence indicates that meaningful diversity is a valuable asset. As Ann Cairns, Chair of the 30% Club, a "global campaign led by Chairs and CEOs taking action to increase gender diversity at board and senior management levels," stated: "As the challenges of doing business become more intense it is time to ensure we have the best and brightest minds at the boardroom table and beyond." Indeed, the case for diversity is no longer seriously debated; the question now is how best to achieve genuine diversity. In the current moment, there is a sense that U.S. corporations are more committed than ever to increasing the diversity of their boards and leadership. Each should have the latitude to implement its own initiatives, as neither platitudes nor quotas will be adequate to achieve this goal.