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PERSPECTIVE

Institutional investors' role in diversifying boardrooms

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In the past three years, California has made headlines for requiring the boards of publicly traded companies headquartered in the state to meet diversity quotas. In 2018, the Legislature passed a law obligating these companies to have a minimum number of female directors on their boards. This fall it passed a similar bill requiring the inclusion of directors from "underrepresented communities" (including people of color and those identifying as LGBT). These diversity mandates have arguably inspired others to follow the same lead, and on a bigger scale. NASDAQ recently proposed a requirement for listed companies to have at least two diverse directors, including one woman and one member of an underrepresented minority or the LGBTQ+ community.

However, California's diversity quotas have been criticized as prescriptive and vulnerable to constitutional challenges. Professor Joseph Grundfest of Stanford has argued that the initiative to diversify boards should be propelled by institutional investors, instead of mandatory quotas.

That's a reasonable approach, given the level of influence that institutional investors have. Former Delaware Chief Justice Leo Strine has observed that meaningful progress in ESG initiatives will require participation by institutional investors, who wield over 75% of stockholder voting power. A recent study by Stanford academic Graham Steele posits that Vanguard, State Street, and BlackRock — the "Big Three" investment management companies, which are the largest owners in 88% of the S&P 500 — effectively constitute an oligopoly.

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In recent years, these influential firms have advocated for increasing the number of women on boards and even called for a minimum number of women directors. State Street's 2020 proxy guidelines state that the fund "expects boards of Russell 3000 and TSX listed companies to have at least one female board member" or risk a vote against the chair of the board's nominating committee or the board leader. BlackRock's 2020 responsible investment guidelines "encourage companies to have at least two women directors."

This type of proxy measure may well spur change. In 2015, in an effort to get new directors on "stale" boards, State Street adopted a practice of voting against or withholding votes for long-tenured board members at 380 companies and within a year, roughly 32% of those companies had added at least one new director.

Yet, while efforts by institutional investors have correlated with a recent increase in female directors, these initiatives have been criticized for failing to address the lack of racial and ethnic diversity at the same portfolio companies. A Russell Reynolds analysis revealed that between 2010 and 2018 the percentage of women directors at Fortune 500 companies increased by 7%, while the percentage of board members from racial or ethnic minority groups increased by only 3%. A study conducted this fall by proxy advisor Institutional Shareholder Services found that members of underrepresented ethnic and racial groups comprise just 12.5% of directors of the Russell 3000 corporations.

These days, many in the corporate governance world are talking about how to get more people of color on boards. A Conference Board survey of investors managing $12 trillion in assets found that this year investors were focused on more specific disclosure on racial and ethnic diversity of boards. But the big institutional investors have (thus far) stopped short of setting a goal for racially or ethnically diverse directors (as they did for women directors). Instead, they are pushing for increased disclosure on the racial and ethnic composition of not only boards, but also the workforce and company leadership. In August, State Street informed its portfolio companies that, in 2021, it will ask them to "articulate their risks, goals and strategy as related to racial and ethnic diversity, and to make relevant disclosure available to shareholders."

Pension funds have been similarly vocal. On Oct. 28, the Diversity Disclosure Initiative, a coalition, which includes institutional investors that collectively manage over $3 trillion in assets, published a model letter urging portfolio companies to "harness th[e] national movement and the momentum on gender diversity to consider publicly reporting the racial/ethnic and gender composition of the Board of Directors."

Some players in the institutional investor world favor voting decisions based on board diversity, while others condition such votes on data showing that a lack of diversity adversely affects a company's performance. ISS announced

that in 2022 it will recommend voting against or withholding votes for the nominating committee chair for any company in the Russell 3000 or S&P 1500 indexes that has no racially or ethnically diverse directors. On the other hand, proxy advisor Glass Lewis has rejected a minimum board diversity requirement and instead has limited its support for increased diversity to cases "where there is evidence a board's lack of diversity led to a decline in shareholder value." This looks a bit like lip service, as it is hard to imagine finding evidence that a specific company's value was diminished because its board did not include diverse members. Looking at the big picture, however, there are numerous studies undertaken by McKinsey and others showing that diversity in company leadership is linked to better earnings and metrics. The current push for more disclosure of data on race and ethnicity should generate additional market-wide data and could further support the correlation between board diversity and strong company performance.

Empirical evidence supporting the benefits of board diversity may become more crucial, in light of the Department of Labor's Sept. 4 rule proposal to stop retirement plan fiduciaries from casting corporate- shareholder proxy votes in favor of social or political positions that do not advance the financial interests of retirement plan participants. More studies linking diverse boards to tangible financial benefits could help preserve the authority of pension funds to support diversification.

It's hard to say why institutional investors have focused on disclosure with regard to racial and ethnic diversity on boards when they have advocated for minimum numbers of women directors. It could be the complexity of identity issues, or simply that gender diversity has been the subject of focus for a longer time. In any case, spurred, in part, by the recent events calling attention to systemic racism, institutional investors and their proxy advisors have sought to move their portfolio corporations towards greater board diversity. Given the ability of those investors (particularly the Big Three) to influence those corporations, it's likely that their requests will be heard — though the approach seems to be different for racial/ethnic diversity than for gender diversity. ■

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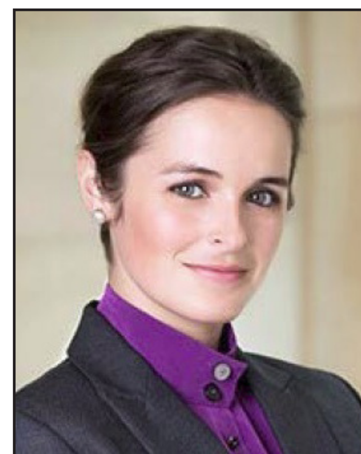

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