



GOVERNANCE
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Board Diversity: Are Your Directors Ready for 2019?

IN SHORT

The Background: The spotlight on board diversity—particularly gender diversity—will continue to be a central theme in the 2019 proxy season.

The Issue: Public company directors should anticipate that their board's composition will remain under close scrutiny by investors and others—and that diversity may be a tipping point issue for lead directors, heads of nominating committees, and long-tenured directors.

Looking Ahead: The attention to board composition and board refreshment issues is not new, but the focus on board gender diversity has never been sharper. There is no optimal composition for any public company board, and it is imperative that directors consider not only whether their boards are "diverse," but also other factors that drive board composition, and prepare to discuss the issue clearly and cogently in their 2019 proxy materials.

The movement to increase the diversity of public company boards has gained significant momentum in recent years and will again be a key issue in the 2019 proxy season. The absence of women and minority directors on corporate boards has long been a concern, particularly in industries like technology and communications.

Recently, however, many companies, institutional investors, and industry groups have recognized the benefits of a diverse board of directors, and have advocated for public companies to increase the representation of women and minorities on their boards. These advocates include the Business Roundtable, an association of U.S. public company CEOs, which highlighted board diversity in its 2016 Principles of Corporate Governance, expressing the view that board diversity strengthens board performance and promotes the creation of long-term shareholder value.



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In recent years, many prominent institutional investors have also promoted board diversity, particularly the inclusion of women on corporate boards. BlackRock has stated that its portfolio companies should have at least two women directors. Other institutions, including State Street, have voted against boards that lack female directors. Other groups, such as the Thirty Percent Coalition, have been vocal advocates for the inclusion of more women directors worldwide.

Some European countries—including Germany, France, Spain, and the Netherlands—have imposed specific quotas for female directors on corporate boards. Although the quota approach does not have traction in the United States, California made headlines earlier this year by enacting a law that requires public companies with principal offices in California to have a certain number of female directors on their boards, depending on board size. This new California law is almost certain to face legal challenges, and its future is uncertain. In fact, its proponents acknowledge this. But the law signals that the push for increased board diversity is likely to gain increasing momentum.

For better or worse, one of the most significant drivers of change in this area may be the voting policies of proxy advisory firms, particularly ISS and Glass Lewis. During the 2018 proxy season, each firm highlighted companies with boards that lacked any female directors but did not issue any adverse voting recommendations on that basis. Beginning in 2019, however, if a board lacks women, Glass Lewis will recommend votes against the election of the nominating committee chair (and possibly other committee members). ISS has adopted a similar policy that will take effect in 2020. Both firms will consider mitigating factors, such as a commitment to add a woman director in the near term, when making their voting recommendations. We expect that the policies will spur companies without women directors to diversify their boards. Of course, proxy advisors change their voting policies annually, and it remains to be seen whether the policies will be expanded to require additional women directors or to require ethnic diversity on boards in years to come.

The impact of these proxy advisory firm policies on many large companies in 2019 and 2020 may, however, be negligible. According to Spencer Stuart, the boards of S&P 500 companies currently have 2.6 female directors on average, up from 1.7 a decade ago. Moreover, only three S&P 500 companies have no female directors. The impact on smaller companies, particularly those in the Russell 3000 index, however, may be more pronounced. Reports indicated that there are 377 California-based companies in the Russell 3000 without any women members. In addition, the ramifications of these policies could have immediate and unexpected consequences if a sole female director were to leave board service unexpectedly.

Practically speaking, boards should continue to evaluate diversity as a key factor in board composition and should evaluate their policies that affect board attrition, including director evaluation, retirement, and term limit policies, to assess whether they facilitate optimal board refreshment. Moreover, boards should ensure that their companies' 2019 proxy statements include thoughtful and compelling disclosure about the board's current composition, evolution, and future goals and demonstrate how they support the company's strategy and long-term objectives.

TWO KEY TAKEAWAYS

1. Board diversity continues to be a key issue for companies and investors, and investor voting policies are expected to continue to focus attention on the issues of board composition and board refreshment.
2. Directors should examine the disclosures about board composition in their companies' proxy statements in order to ensure they present a compelling basis for the board's current composition and its future evolution.



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