JONES DAY

GOVERNANCE PERSPECTIVES

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IN SHORT

The Background: The NYC Pension Funds, which led the largely successful campaign to implement proxy access rights across corporate America, have launched a new crusade to improve the diversity of corporate boards.

The Issue: Beginning in 2014, the NYC Funds and other investors campaigned to convince public company boards to grant to shareholders proxy access rights that would give them greater influence on the process of adding and replacing corporate directors. The Funds' new diversity campaign aims to augment those efforts by creating a more structured role for public funds in the process of nominating corporate directors.

The Outcome: Improving the diversity of corporate boards is a laudable objective, and campaigns like this may help spur additional efforts. However, the NYC Funds' proposed approach, particularly its check-the-box reporting of directors' attributes and skills, is overly simplistic and could have unintended side effects.

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The NYC Pension Funds have launched a campaign to promote board diversity and to increase the participation of significant, long-term shareholders in identifying new director nominees. In September 2017, the NYC Funds requested meetings with more than 150 companies to discuss the companies' policies and processes relating to board composition and refreshment.

The NYC Funds also asked the companies to disclose the qualifications, skills, and attributes of their directors in check-the-box format on a standardized "qualifications matrix," a summary table that would include each director's age, gender, race/ethnicity, and sexual orientation, in addition to the director's skills, experience, and board tenure.

The NYC Funds' success in establishing proxy access rights makes them a credible advocate for change on this meaningful issue. While we applaud their proactivity and leadership on this issue, the substantive changes and process they request are unworkable.

Most companies and investors agree that diversity on corporate boards is an important goal. CEOs of major U.S. companies concur: the 2016 Principles of Corporate Governance published by the Business Roundtable acknowledge the value of board diversity and the need for processes to ensure that female, minority, and other diverse candidates are identified for proper consideration to fill open board seats. The NYC Funds' success in establishing proxy access rights makes them a credible advocate for change on this meaningful issue. While we applaud the NYC Funds' proactivity and leadership on this issue, the substantive changes and process they request are unworkable.

The NYC Funds' request for boards to meet with them and other significant long-term shareholders is not unusual in an era of proactive shareholder engagement. The NYC Funds' letter to companies and their press release suggest, however, that the requested meetings may go beyond standard engagement practices. The letter's sample topics show that the NYC Funds desire a far more hands-on role in the nomination of corporate directors than can realistically be afforded all outstanding shareholders.

Most notably, the NYC Funds wish to discuss with targeted companies how to "establish a process" through which director search firms would ask significant shareholders for suggested director candidates and engage organizations specialized in providing diverse director candidates, and to establish another process for the NYC Funds and other shareholders to provide potential director candidates directly to governance committees on an ongoing basis.

In addition, although the NYC Funds' letter does not directly address "board exit" tools, enhancing board diversity will generally entail adding more directors to boards, which in turn will require open board seats. Accordingly, it seems likely that the Funds or other shareholders may request that boards adopt director age and term limits, or other board tenure limitations, in order to force board turnover to make room for more director candidates of their liking.

If voluntary company disclosure of the gender and ethnicity of directors promotes greater transparency and truly acts as a "starting point" for discussion as the NYC Funds intend, a qualifications matrix of some kind may well be a valuable tool. In fact, many companies already include charts of this type in their proxy statements. Unfortunately, as designed, the Funds' proposed matrix may drive suboptimal behaviors. While the matrix is useful for quick comparison among companies, it fails to capture the full picture of a director's experience and potential value to a company. It reduces a highly individualized company-by-company and director-by-director evaluation and recruiting process to a mechanical and simplistic table. Depth of directors' experience and skills are entirely lost, replaced by a binary mark in a box in a table.

In fact, the matrix disclosure will not enhance investors' ability to evaluate board candidates; its real value is data generation and, perhaps more important, driving behavior of corporate boards. The design of the matrix would facilitate a quick-and-dirty assessment and comparison of many companies at once, possibly promoting social positions that may not be appropriate.

We hope that the NYC Funds' letter serves as a starting point for additional discussion on board diversity and as a catalyst for change. We caution companies, however, to take a nuanced approach tailored to their particular circumstances when considering changes to established processes for director nominations and board refreshment.

THREE KEY TAKEAWAYS

1. The form of disclosure regarding director diversity requested by the NYC Pension Funds reduces a highly individualized company-by-company and director-by-director evaluation and recruiting process to an overly generalized and simplistic table.
2. While the NYC Funds' intentions and goals have value, the substantive changes and the process they request are unworkable.
3. Companies are advised to take a cautious, nuanced approach when contemplating alterations to established processes for director nominations and board refreshment.

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