Deloitte.

Diversifying the American Board
Thought leaders collaborate on current challenges and practical solutions

"While the SEC's new rule focuses only on disclosure, an indirect effect of putting a focus on a board's diversity is that boards may decide to add, or add more, minorities and women as directors. It is reasonable to expect that the process of focusing on their diversity policy and its effectiveness could likely result in greater diversity. I personally believe that companies that expand their search for new directors to include more women and minorities will find a breadth of talent that will serve to improve their performance and increase the wealth of their investors."

Commissioner Aguilar's remarks at a recent forum titled "Closing the Gender Gap: Global Perspectives on Women in the Boardroom," September 23, 2010

Contents

Introduction

A growing number of directors, investors, and regulators have begun to express the view that diverse challenges require boards with a diverse membership. The SEC's disclosure rules on a company's board diversity policy and initiatives of institutional shareholder groups are among the signs that change is in the air. However, market research indicates that progress in increasing the percentage of women and minorities represented on America's corporate boards has been slow in coming (see sidebar).

With this as the backdrop, 22 business and corporate governance leaders, including investors, corporate managers, directors, and advisors came together in New York in mid-May to open the dialogue on "Diversifying the American Board." The event was co-sponsored by the Deloitte Center for Corporate Governance, the Millstein Center for Corporate Governance and Performance at Yale School of Management, and the Financial Women's Association. Nicole Sandford, Deloitte & Touche LLP partner and Governance Services leader and co-chair of the Financial Women's Association's Directorship and Corporate Governance Committee, hosted the afternoon conference.

The purpose was to convene leading thinkers to build consensus around both issues and potential solutions related to diversity in the boardroom, and provide those thoughts to the marketplace as a roadmap for moving forward. The event was limited to invited participants to allow for candid discussion of all topics. This paper summarizes the dialogue and thoughts emanating from that discussion to serve as a basis for a broader discourse.

Participants explored the key challenges to and potential solutions for improving the diversity of U.S. corporate boards, including:

- What does "diversity" mean?
- How should the various components of diversity be weighted and considered?
- How should success be measured?
- What are the primary barriers to progress?
- What appropriate measures could regulators, investors, or others take to speed progress? Would the models adopted by other countries work here?
- Absent regulation, what can companies do to more aggressively address the issue?

Discussion participants addressed these issues by considering a number of related "Challenge Statements" in smaller groups and then presented the findings to the larger group for consensus. The five challenges, and the consensus reached related to each are summarized in the following section.

Recognizing diversity as a performance issue

There are studies that provide insights on the value companies gain from gender and ethnic diversity among corporate board members. A 2009 California Public Employees' Retirement System's (CalPERS) study entitled, Board Diversification Strategy: Realizing Competitive Advantage and Shareowner Value, for example, determined that companies with diverse boards perform better than boards composed of directors with homogeneous gender, ethnicity, and skill sets.

Moreover, the CalPERS study found that a select group of companies with a high ratio of diverse board seats actually exceeded the average returns of the Dow Jones and NASDAQ indices over a five-year period. Similarly, Catalyst, Inc., in a 2007[i] study of Fortune 500 companies found that those with the highest representation of women board members achieved better financial performance, on average, than those with the lowest representation of women board members. The results were substantive: 42 percent higher sales, 53 percent higher equity, and 66 percent higher return on invested capital.[ii]

But the representation of women and minorities on corporate boards does not approximate the representation of these groups as a percentage of most companies' management pool, employee populations, or as consumers of goods or services. Statistics compiled by the Alliance for Board Diversity in 2008[iii] about the composition of Fortune 100 company boards found that 83 percent of members were white men, while women and minorities held only 17 percent of the board seats.[iv]

Challenge Statement 1: Defining diversity

The first challenge was to reach agreement on a clear and substantive definition of diversity in the context of corporate boards. Participants discussed a definition that could be applied to the vastly different needs of a wide range of companies. It was agreed that specific attributes and characteristics should be suggested so that individual boards could use these as a framework to form their own distinctive governance philosophy and specific requirements. The consensus view was as follows:

The ultimate objective of any effort to increase board diversity is to promote effective board oversight and strategic advice in an increasingly complex business environment. To that end, the ideally diverse board will reflect an appropriate array of perspectives.

While we agree that diversity of thought is an important goal, we further agree that there are specific challenges related to improving both gender and ethnic diversity among U.S. boards that may require specific consideration.

The composition of any board should be in part a function of the company's size, stage of growth, and other specific characteristics. The nominating and corporate governance committee should use each director succession as an opportunity to reexamine the needs of the board in the context of the company's current and future direction. Upon the completion of this process, however, the committee should specifically consider appropriate attributes of diversity to identify particular candidates. Qualified candidates who possess the necessary business experience/background, should also meet a set of company-specific criteria of commonality (e.g., integrity, appreciation of board duties, etc.).

We identified the following "Attributes of Diversity"—the first two being particularly key among these—for the process of expanding the candidate pool:

- Ethnicity
- Gender
- Age
- Business experience
- Industry experience
- Personal skills
- Understanding of company stakeholders (e.g., customers, employees)
- Geographic background and experience

In reaching agreement on this definition, the group noted that the right "mix" of these attributes will be different for each company's board. The group also discussed that diversity, as defined above, is not to be considered in a vacuum. The essential needs of a board during a search also have to encompass very specific skill-sets required to "fill out" the board's competencies in many cases. These essential skills have primacy in considering candidates and may include backgrounds such as customer focus, global experience, and technology and innovation experience, etc.

The objective is to be specific to the needs of the company—now and for the future.

Challenge Statement 2: Defining the benchmarks companies and investors should use in evaluating the diversity of a corporate board

Consensus was reached on the premise that the ideal board will vary by company and that any attempt to define specific metrics or quotas would not be productive in the U.S. context. However, the presumption was also made that a metric of "zero" diversity with respect to gender and ethnicity is a clear indication that there is room for improvement. The decision was to measure success not on numerical values or ratios, but rather, based on the process in place for ensuring board diversity.

1. **The company's nominating committee should have a formal policy for filling board seats.** A formalized approach to balancing composition should encompass enhancing diversity along with other composition and competency goals, including the essential skills and experiential attributes to fulfill the specific needs of the board as previously described. While these considerations will vary from company to company, a formal process should require discussion of the relative importance and mix of key composition requirements, including diversity.
2. **Boards should adopt a policy of attracting and retaining qualified candidates who are diverse on many dimensions including gender and ethnicity.** The first step in filling open board positions is to profile the needs a board may have, responding to gaps in skills and other attributes. However, the progress for gender and ethnic representation on boards has been so slow that boards should consider a deliberate bias to fill open positions with appropriately qualified women or ethnically diverse candidates—and state its position on diversity publicly (see below).
3. **The nominating committee policy should be publicly disclosed.** While recent disclosure enhancements provide investors with more information to assess the composition of the board, it was agreed that companies should provide enhanced public disclosure of board objectives, policies, and recruitment and selection processes in order that investors and others can adequately measure progress. Additional disclosure supports the ability to identify best practices and ultimately motivate a "race to the top," perhaps further offsetting the need for regulatory or legislative intervention.

Challenge Statement 3: Identifying key marketplace or other challenges in creating diverse corporate boards

Consensus was reached that a significant investment in additional research on the issue of board diversity was not needed at this time. As described previously in the sidebar to this report, existing research related to board diversity is adequate to conclude on two key points: 1) board diversity helps improve performance, and 2) progress in gender and ethnic diversity has stalled in the U.S. over recent years. Several specific challenges and root causes for the slow progress were identified and agreed to as follows:

- **A small candidate pool** – A commitment to diversity requires a shift in mindset to broader candidate consideration. It is neither necessary nor practical to start each search with a bias towards current or former CEOs. In addition, many companies could improve on their internal development and grooming of female and minority managers and executives, to expand the board selection pool on a macro level.
- **Lack of corporate buy-in** – Existing research points to a compelling correlation between board diversity and improved company performance. The lack of corporate buy-in indicates a need to get the "right" people to communicate a commitment to board diversity. Leadership by respected corporate and governance leaders is very important in order to accelerate progress. Respected executives that believe board diversity can lead to better corporate performance should take a public stand on the issue.
- **Too few new opportunities** – Turnover on U.S. boards remains relatively low, especially for those without term limits. Traditional board candidate selection has been about "who you know," with the networks not always open to female and minority candidates. Nominating and governance committees should consider the tenure of the current board members, and may want to weigh the merits of policies that encourage "new blood" on the board. Term limits and mandatory retirement ages are sometimes controversial, but board members should not stay on indefinitely.

Challenge Statement 4: Identifying the most viable company-directed solutions for improving board diversity

The board should develop an understanding of the organization's diversity profile, and, over time, drive management toward enhanced diversity of the senior management team, with one effect being improvement of the pool and pipeline of qualified executives to become future board nominees. With regard to the board's own membership recruitment, the group suggested the following specific corporate actions:

- Ensure that public disclosures of the nomination process is not boilerplate or generic, but rather addresses the substance of the company's policies and process for identifying board candidates
- Make the search a continuous effort, even when no board seats are open
- Insist on a nomination process that includes diversity considerations
- When possible, commit to keeping a particular position open until an appropriately qualified, diverse candidate can be identified (particularly valuable for boards that currently lack diverse representation)
- Expand the circle of advisors and contributors sourced on populating the candidate list
  - Consider a firm's ability to deliver the desired diversity metrics when selecting consultants and search firms
  - Tap into organizations that have access to top diversity candidates
  - Reach out to institutional investors who are active in this area
- Increase the number of candidates considered for each open position
- Ensure every search includes candidates that are not known to current members
- Ensure that strategic requirements of the board downplay collegiality and place more emphasis on creative tension and critical thinking that can contribute to improved board oversight of management in the areas of risk oversight and strategic decision making. Collegiality may have become an excuse for undiscerning homogeneity and group-think.

Challenge Statement 5: Developing the most viable marketplace solutions for improving board diversity

There was agreement that in order to make significant progress, solutions will have to focus on developing both "carrots" (rewards from shareholders and others) for supporting board diversity and "sticks" (threats of additional disclosure or composition "guidelines") for not supporting it.

Consensus was reached on several practical marketplace solutions:

- **Investor-led initiatives** – Investors can be more proactive in their approach to understanding and measuring a company's process for achieving diversity in board member selection under the model of Challenge Statement 2. Investors may follow-up on the process—or constructively exert influence on policy and process change—by writing letters to, engaging in dialogue with, or otherwise notifying the company when board diversity profiles are not sufficient. Investors could also encourage changes in policies regarding term limits and member attributes. While all members of the group did not believe proxy access would be the most appropriate mechanism to drive change, there was a general sentiment that proxy access may offer an opportunity to open the dialogue on diversity with a company. In addition, there was agreement that candidates proposed by investors under a future proxy-access regime should follow the same principles as prescribed for companies. There was general support for initiatives by institutional investors, such as CalSTRS and CalPERS, to help expand the pipeline through the development of a director database. However, there was further recognition that the diversity challenge would require a wide range of actions from a broader base of investors, including mutual funds and hedge funds.
- **Regulatory initiatives** – The group generally supported enhancing the current diversity/composition disclosure model. While there was no support for an onerous or lengthy disclosure process, discussion participants believed that there should be enough disclosure to allow investors to measure success as described throughout the group's discussion. A small minority of participants felt that quotas should be left on the table as a possible solution, but most believed quotas—whether mandated by the stock exchanges, the SEC or others—are not viable in the U.S. Beyond that, the group was not supportive of additional regulatory mandates, favoring instead corporate- and investor-led initiatives.

Will the Dodd-Frank Wall Street Reform and Consumer Protection Act impact board diversity?

Among the myriad of topics covered by the Dodd-Frank Wall Street Reform and Consumer Protection Act is the consideration of diversity in several governmental offices and agencies. Specifically, the covered agencies and offices, as included in Section 342(g) of the Dodd-Frank Act, are required to establish the Office of Minority and Woman Inclusion (OMWI) by January 21, 2011, which will "be responsible for all matters of the agency relating to diversity in management, employment, and business activities."

Additional sections of the Dodd-Frank Act cover diversity for specific purposes (such as reports, studies, etc.), but the Dodd-Frank Act does not specifically address diversity as it relates to a company's board of directors. As it relates to public companies that are not financial institutions, the only standing committee of the board of directors that is explicitly discussed within the Act is the compensation committee, primarily in discussions surrounding executive compensation, outside consultants, and disclosures. In addition to the audit committee, the nominating committee, which is typically responsible for the development and implementation of a company's diversity practices, is not directly addressed within the Act.

Conclusion and call to action: Towards a more diverse board

Participants concluded that, with a strategic and determined plan of action, board diversity can be improved without significant regulatory or government intervention, or the introduction of quotas or mandates. In fact, participants agreed that many boards and nominating committees would welcome recommendations for a few practical steps that can start to move the needle on progress.

In order to develop the foundation for a broader dialogue with companies about specific actions, following are several recommendations for follow-up by individual members of the discussion group or for the group as a whole:

- Individual participants committed to distributing this report to their contacts in companies, professional associations, and investor groups to seek support for the model described and specific recommendations for action.
- Seek endorsements for the report's findings and recommendations from relevant diversity support organizations.
- Convene a follow-up roundtable event to be dedicated to addressing issues and solutions around two major topics surfaced in the first group meeting: 1) investor involvement related to board diversity; and 2) specific ways to establish metrics and to measure progress against diversity goals.

Endnotes

[i] The Bottom Line: Corporate Performance and Women's Representation on Boards

[ii] *Id.*

[iii] Women and Minorities on Fortune 100 Boards Presented by The Alliance for Board Diversity

[iv] *Id.*

Appendix A: Summary considerations

The following represents a summary of considerations and actions companies can utilize to jump start their efforts on building a diverse board.

1. **Diversity criteria** – The nominating and corporate governance committee should use each director succession as an opportunity to reevaluate the needs of the board in context of the company's future direction.
2. **Diversity** – Diversity as it relates to ethnicity and gender should not be considered in a vacuum – the company must determine what skills and attributes are necessary to fill in all "gaps".
3. **Establish a formal policy** – A formalized approach to balancing composition should include enhancing diversity along with other composition and competency goals. While these considerations will vary from company to company, a formal process should require discussion of the relative importance and mix of key composition requirements, including diversity.
4. **Nomination process** – The board should insist on a nomination process that includes diversity considerations.
5. **Public disclosure of the nominating committee policy** – Additional public disclosure of board objectives, policies, and recruitment and selection processes is needed in order that investors and others can adequately measure progress. Eliminate boilerplate or generic language.
6. **Increase and develop the potential candidate pool** – Companies can improve the internal development of female and minority managers and executives to expand the board selection pool on a macro level.
7. **Encourage board turnover** – Nominating and governance committees should consider the tenure of the current board members, and may want to weigh the merits of policies that encourage "new blood" on the board.
8. **Board search** – Make the board search process a continuous effort, even when no board seats are open. When possible, commit to keeping a particular position open until an appropriately qualified, diverse candidate can be identified (this is particularly valuable for boards that currently lack diverse representation).
9. **Expand candidate search** – Increase the number of candidates considered for each open position and broaden the search to include candidates who are unknown to current board members.
10. **Board search resources** – When hiring an outside search consultant, consider each firm's ability to deliver diverse candidates; tap into organizations that have access to top diversity candidates; and consider reaching out to institutional investors who are active in this area.

Appendix B: Roundtable participants

Kenneth Bertsch, Executive Director, Morgan Stanley Investment Management

Francis Byrd, Senior Vice President Corporate Governance and Risk Practice Leader, Laurel Hill Advisory Group LLC

Janice Reals Ellig, Co-CEO of Chadick Ellig

Stephanie Hauge, Director of Corporation and Foundation Relations, Seton Hall University Advancement Division; President, Financial Women's Association (2009-2010)

Joseph Keefe, President and CEO of PAX World Investments

TK Kerstetter, President and CEO, Board Member, Inc.

Andrew Kaslow, Retired Senior Vice President and Chief Human Resources Officer, American International Group, Inc.

Charles King, Senior Client Partner, The Korn/Ferry Institute

Robert Kueppers, Deputy CEO, Regulatory and Public Policy, Deloitte LLP

Joanne Landau, Director, Hudson Holding Corp

Jill Kanin-Lovers, Director, Bearing Point, Dot Foods, First Advantage, and Heidrick & Struggles

Kathleen McQuiggan, President, Catalina Leadership

Ira Millstein, Partner, Weil, Gotshal & Manges LLP; Senior Associate Dean for Corporate Governance, Yale School of Management

Annette Nazareth, Former SEC Commissioner; Partner, Davis Polk & Wardell, LLP

Mark Preisinger, VP of Public Policy and Stakeholder Engagement, The Coca-Cola Company

Nicole Sandford, Partner, Deloitte & Touche LLP; Co-chair, Financial Women's Association Directorship and Corporate Governance Committee

Laurie Shahon, Director, Knight Capital and The Antioch Companies

Anne Sheehan, Director of Corporate Governance, The California State Teachers' Retirement System (CalSTRS)

Howard Sherman, President and CEO, GovernanceMetrics International

Pam Snyder, Executive Director of Mizuho Securities USA and Head of Financial Institutions Coverage; Member, Financial Women's Association Directorship and Corporate Governance Committee

Paul Washington, SVP, Deputy General Counsel and Secretary, Time Warner, Inc.; Chairman of the Society of Corporate Secretaries and Governance Professionals

Kelvin Westbrook, Director, Archer-Daniels-Midland Corporation, Stifel Financial Corporation, Camden Property

John Wilson, Director of Corporate Governance, TIAA-CREF