Institutional Investors and Proxy Advisors Raise the Bar on Board Diversity Standards in 2023

Four Best Practices for Successfully Completing Your High Jump

US – October 2022

As businesses are emerging from a COVID-19-focused environment and returning to offices, related challenging issues linger, such as global supply chain concerns, economic struggles and labor shortages. Despite these ongoing challenges and the corresponding shifts in strategic priorities in recent years to address them, for many companies, the diversity of its board of directors remains an unwavering corporate focus.

As boards adjust to the post-COVID-19 world, they should also reassess their diversity efforts to align with the "new normal," particularly as certain institutional investors and proxy advisors phase in diversity standards, some of which become more stringent in the upcoming year.

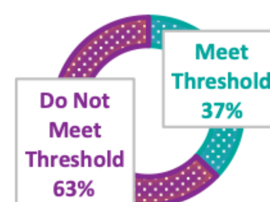
Many companies have worked diligently for years to create and maintain a diverse board of directors while other companies, although perhaps not as established on this front, are continuing the process of actively pursuing such goals. Board diversity has been making lengthy strides and steadily increasing over the last five years, particularly within the S&P 500. By way of example, in the S&P 500, the proportion of female directors grew from 22.8% to 28.9% from 2018 to 2021. While the proportion of female directors in the Russell 3000 continues to be lower, it too has grown from 16.6% in 2018 to 24.1% in 2021.[1]

Raising the Bar in 2023 for Board Diversity Standards

Institutional investors and proxy advisors continue to prioritize diversity in their respective voting standards, and many have bright-line rules about the diversity they expect in the boards of companies that they invest in or review.[2] Institutional investors and proxy advisors seek to influence companies to meet their respective standards on board diversity, by voting against the director who serves as the chair of the nominating/corporate governance committee (or, in some cases, all directors serving on such committees) if such board diversity standards are not met, as it is the role of the nominating/corporate governance committee to identify and recommend director nominees. As a result, the chair of the nominating/corporate governance committee tends to be the single director on a board that receives the most opposition. Among the S&P 500 companies, opposition against the chair of the nominating/corporate governance committee has risen from 4.6% in 2017 to 8.2% in 2022, facing more opposition than chairs of other committees or all directors on average.[3]

Many of the institutional investors and proxy advisors have heightened their respective diversity standards by both increasing the number of diverse directors they expect over time and expanding the pool of companies to which they will apply their standards (i.e., diversity standards are typically effective for the S&P 500 before they become effective for the Russell 3000 and other publicly traded companies). In 2023, certain institutional investors and proxy advisors, such as Glass Lewis[4] and State Street,[5] are moving away from static gender diversity targets (e.g., a minimum of two gender diverse directors) and implementing a gender diversity target based on a percentage of the board (e.g., 30% gender diversity on the board).

Russell 3000 with 30% Board Diversity
2021 DATA



[1] See Harvard Law School Forum on Corporate Governance, "Diversity, Experience, and Effectiveness in Board Composition" (June 14, 2022).

[2] Please see our article, "Know Who is Coming to the Party and How They Will Behave: The Evolving and Increasingly Complicated Annual Meeting Vote" (Feb. 2022), for additional detail regarding the evolving standards of institutional investors and proxy advisors as relates to Board diversity.

[3] See EY Center for Board Matters, "Four Key Takeaways From the 2022 Proxy Season" (July 2022).

[4] For meetings held after January 1, 2023, Glass Lewis will require boards of companies in the Russell 3000 index to have at least 30% gender diversity. Boards of companies outside of the Russell 3000 index or any boards with six or fewer directors will be required to have one gender diverse director. See Glass-Lewis, 2022 Policy Guidelines.

[5] Beginning in the 2023 proxy season, State Street expects the boards of companies in "major indices" in the US to have boards comprising at least 30% women (noting that this will likely result in boards with three to four female directors on average). See State Street, CEO's Letter on Our 2022 Proxy Voting Agenda (published January 12, 2022).

While BlackRock[6] and Fidelity[7] have not yet announced a move away from static gender diversity targets for the 2023 proxy season, both noted a general expectation or aspiration to have boards with at least 30% diversity. Within the Russell 3000, currently only approximately 37.1% of companies had three or more female directors and would meet the 30% threshold.[8]

The COVID-19 pandemic presented new challenges related to adding board talent, as these entities were often handling various crisis situations related to health and employee safety, leaving less time for proactive business strategic planning that would include diversification and succession planning. Additionally, finding potential candidates proved more difficult at times, as many candidates were busier than normal – both professionally and personally – during the pandemic. Further, in certain circumstances, the recruitment process could be logistically lengthy and cumbersome, with in-person meetings often not an option, since many boards highly value the director nominee's cultural fit with the larger board dynamic, which can be challenging to ascertain in a video chat or conference call. However, with businesses beginning to normalize – at least in some respects – from the COVID-19 work environment, and with enhanced diversity standards looming for 2023, many boards are now placing more urgency on diversification, especially given that institutional investors and proxy advisors are expected to continue their ongoing focus on board diversity.

Four Practical Tips for Successfully Clearing the Heightened Bar of Board Diversity Standards

- **Approach – Create or reassess your diversity expansion plan.** Board diversity can be increased by expanding the total number of directors on the board, through attrition (replacing current directors as they either resign or retire), or a hybrid of the two approaches. Let us first take a quick look at the benefits and challenges of the expansion and attrition methods.

	Pros	Cons
Expansion	• Often the easier short-term approach to implement • Often the shorter timeline	• Can increase difficulty of meeting percentage-based diversity targets (i.e., the larger the board, the more diverse directors needed to meet a percentage threshold)
Attrition	• Easier to meet percentage-based diversity standards, as the board is not simultaneously increasing, which is more attractive, by necessity, due to the shift in certain diversity standards in 2023	• Difficult approach in the short term, as it relies on director retirements and resignations • Reactive, longer-term strategy without a defined timeline

  Notably, in a recent (2022) survey of directors, 48% of directors indicated that at least one director on their board should be replaced.[9] That being said, director retirement discussions are, by their nature, sensitive conversations, whether at board level or one-on-one, and the reality is that many directors will not elect to resign to help a company's overall board diversity goals. Therefore, in many cases, attrition becomes a waiting game of replacing directors who retire in the normal course

  The pros and cons of both the expansion and attrition approaches, combined with the quickly approaching 2023 timeline for some diversity requirements moving to percentages of boards, creates a need to carefully consider (and perhaps facilitate) any upcoming board retirements, potential replacement of current directors, and the long-term impact of increasing the total number of board directors. With this information, the board can decide which method of increasing board diversity will most benefit the company.

- **Takeoff – Recruit diverse directors.** New directors need to complement the current board and should deliver additional skills and attributes that will benefit the company and its stakeholders. Although generally, most agree that increasing board diversity is, in itself, positive for companies, a board reaching a group consensus of desired attributes in a nominee may prove challenging. In a survey where 86% of the surveyed directors agreed that diversity generally enhances the board, 34% believed that such new candidates were unneeded and 31% believed that such new candidates were unqualified.[10]

[6] BlackRock believes that boards should aspire to 30% diversity of membership and encourages companies to have at least two directors that identify as female and one director who identifies as a member of an underrepresented group. See BlackRock Inc., Investment Stewardship: Proxy Voting Guidelines for U.S. Securities (effective as of January 2022).

[7] While Fidelity will oppose the election of certain directors (1) if there are no women on the board or (2) if a board of 10 or more has fewer than two female directors, Fidelity generally expects at least 30% female board representation at companies in developed markets. See Fidelity Investments, Proxy Voting Guidelines (published February 2022); and Fidelity International, Sustainable investing voting principles and guidelines (July 2021).

[8] See Harvard Law School Forum on Corporate Governance, "Diversity, Experience, and Effectiveness in Board Composition" (June 14, 2022).

[9] See PricewaterhouseCoopers LLP, "PwC's 2022 Annual Corporate Directors Survey."

[10] *Id.*

Further, current labor shortages have generally impacted all industries and are undoubtedly impacting the pool of director candidates, as many individuals have taken on expanded roles within their full-time positions and may not be seeking the additional responsibility of directorships. To counter this trend, companies can consider several solutions:

- **Cast a broader net when searching for potential new diverse directors.** More than ever – particularly with the increased focus on director expertise in areas such as cyber and environmental – new directors are often originating from executive levels outside of the C-suite. Specifically, in 2021, 50% of first-time directors appointed to the boards of S&P 500 companies did not have CEO, chief financial officer (CFO), president or chief operating officer (COO) backgrounds.[11]
- **Re-evaluate any geographical limitations on directorships**. In many ways, the residual effects of the COVID-19 pandemic made recruiting new board talent more difficult as it limited traditional recruiting methods, such as in-person interviews. However, the pandemic-related lockdown also created an environment more accepting of virtual meetings. Taking advantage of this trend may make it easier for companies to expand their pool of candidates geographically.
- **Ask for professional recruiting help and be prepared to distinguish your opportunity.** Companies can retain search firms to seek new director talent and instruct these firms to include or prioritize diverse candidates. However, in the current market, recruiting can be exceedingly difficult. In order to maximize the most optimal candidates, boards should carefully consider how their opportunity is unique from others.

- **Flight – Integrate diverse directors.** Adding diversity to a board is much more than a "check the box" exercise of merely appointing a new diverse director, as new diverse board members (diverse or otherwise) need to fit into the overall board composition and within the company's culture. As with any new directors, the board will need to determine how to best integrate them. One aspect of integration increasingly evaluated by institutional investors and proxy advisors is whether diverse directors hold committee positions and leadership roles within the board.[12] Currently, within the S&P 500, women chair approximately 30% of audit committees, 28% of compensation committees and 29% of nominating/corporate governance committees.[13] Bottom line – it is not sufficient to merely appoint diverse members to the board; they need to have active and engaged roles that are discernable to outside observers (or, in this case, institutional investors or proxy advisors).
- **Landing – Respond to stakeholders on diversity.** Regardless of whether a company anticipates it will be able to meet the diversity targets set by certain institutional investors and proxy advisory firms, the board should proactively develop its plan for responding to any institutional investor or proxy advisory communications on this topic. Our recommended best practice is to have a plan in place that makes specific commitments as relates to increasing the board's diversity (e.g., appointing a diverse director upon a future retirement, appointing new diverse directors by a certain date, instructing recruiting firms to provide diverse director candidates, etc.) and publicly disclosing this plan in the company's proxy statement or otherwise. Thereafter, this plan can be cited in any necessary response to specific stakeholders. However, regardless of the plan in place, since such standards are typically bright-line rules followed by institutional investors and proxy advisory firms, it is unlikely that any disclosed future plans will alter the current applicable voting or voting recommendations.

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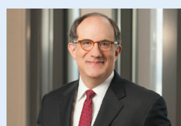

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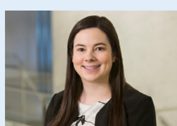

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[11] Freshfields, "Trends and Updates from the 2022 Proxy Season" (July 2022).

[12] For example, ISS reviews the number of women serving in leadership roles on the board as relates to its scoring of the Governance QualityScore. See ISS ESG, "Governance QualityScore Methodology Guide" (Dec. 31, 2021).

[13] Freshfields, "Trends and Updates from the 2022 Proxy Season" (July 2022).

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