Next Steps For California's Board Diversity Law

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With passage of California's first-in-the-nation law mandating boardroom gender diversity, corporations in the state and across the U.S. find their questions are only beginning. What are the specific diversity requirements? Who are the major players driving compliance with the law? Will the law withstand legal challenges (and, will anyone actually challenge it)?

On September 30, 2018, former California Governor Jerry Brown signed into law SB 826, a bill addressing an issue that has recently been elevated to the forefront of corporate governance concerns—board gender diversity. The legislation, the first of its kind in the U.S., requires that public companies headquartered in California, *no matter where they are incorporated,* include, as Brown phrased it, a "representative number" of women on their boards of directors. The law, while groundbreaking—or perhaps more appropriately, ceiling shattering—is undoubtedly vulnerable to legal challenge, which Brown acknowledged in his signing statement:

> "There have been numerous objections to this bill and serious legal concerns have been raised. I don't minimize the potential flaws that indeed may prove fatal to its ultimate implementation. Nevertheless, recent events in Washington, D.C.—and beyond —make it crystal clear that many are not getting the message. As far back as 1886, and before women were even allowed to vote, corporations have been considered persons within the meaning of the Fourteenth Amendment... Given all the special privileges that corporations have enjoyed for so long, it's high time corporate boards include the people who constitute more than half the 'persons' in America."

☐ ***Summary of SB826.*** The new law addresses a number of issues:

☐ *Subject companies.* Any corporation with shares listed on a major U.S. stock exchange that maintains its principal executive offices in California (as set forth on the cover page of the corporation's most recent annual report on Form 10-K filed with the Securities and Exchange Commission) is subject to the law, whether incorporated in California or elsewhere.

☐ *Minimums and deadlines.* Each company subject to the law, regardless of size, is required to have at least one woman on its board of directors by December 31, 2019. Because there is no transition or grace period for newly public companies, a company that lists its shares on a major U.S. stock exchange in connection with its IPO will immediately become subject to the new law. That minimum will increase to two by December 31, 2021, if the company has five board members, and to three women directors if the company has six or more board members.

The new law provides stiff fines for noncompliance, as well as fines for failure to meet new board diversity reporting requirements.

☐ *Permission to increase board size.* The law expressly provides that a company may increase the number of directors on its board to comply (which, depending on the company's organizational documents, could require a shareholder vote).

☐ *Penalties for noncompliance.* The law authorizes the imposition of fines for violations of the law in the amounts of $100,000 for the first violation and $300,000 for each subsequent violation. The California Secretary of State is authorized to adopt implementing regulations with regard to filing of board member information for purposes of compli-

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ance monitoring. Failure to timely file board member information in compliance with those regulations is subject to a fine of $100,000.

▫ *Public disclosure.* The law requires the California Secretary of State to publish reports on its website reflecting the level of compliance with these provisions, along with the number of corporations moving in or out of the state and the number going private.

☐ ***Anticipated impact of the law.*** A study from Equilar looked at the potential impact on public companies headquartered in California with annual revenues of $5 million or more (a total of 211 companies with an aggregate of 349 women and 1,466 men serving as board members). The study concluded that, with no changes to their board composition, 82 percent of those companies would pass muster under the 2019 requirement and not incur any financial penalties, and 37 public companies would face a fine.

However, the study also showed that meeting the 2021 requirement presented quite another story. Applying the 2021 requirement to boards as currently constituted, 79 percent of public companies would fail and face a fine, while only 21 percent would pass.

Nearly one-half of the 75 largest IPOs from 2014 to 2016 were conducted by companies with no women on their boards.

☐ ***Why was SB826 considered necessary?*** The California Legislature found that "[m]ore women directors serving on boards of directors of publicly held corporations will boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders, and retirees...." However, board gender parity has been slow in coming. The Legislature cited studies predicting that it would "take 40 or 50 years to achieve gender parity, if something is not done proactively."

For example, a quarter of "California's public companies in the Russell 3000 index have NO women on their boards of directors; and for the rest of the companies, women hold only 15.5 percent of the board seats," and the issue is even more acute for smaller companies.

Additionally, companies *going public* are not changing the dynamic: "Nearly one-half of the 75 largest IPOs from 2014 to 2016 went public with no women on their boards. Many technology companies in California have gone public with no women on their boards, according to a 2017 national study by 2020 Women on Boards."

Significantly, the Legislature did not view board gender diversity as simply a social goal. Rather, according to its findings, "numerous independent studies have concluded that publicly held companies perform better when women serve on their boards of directors, including:

"(1) A 2017 study by MSCI found that United States' companies that began the five-year period from 2011 to 2016 with three or more female directors reported earnings per share that were 45 percent higher than those companies with no female directors at the beginning of the period.

"(2) In 2014, Credit Suisse found that companies with at least one woman on the board had an average return on equity (ROE) of 12.2 percent, compared to 10.1 percent for companies with no female directors. Additionally, the price-to-book value of these firms was greater for those with women on their boards: 2.4 times the value in comparison to 1.8 times the value for zero-women boards.

"(3) A 2012 University of California, Berkeley study called 'Women Create a Sustainable Future' found that companies with more women on their boards are more likely to 'create a sustainable future' by, among other things, instituting strong governance structures with a high level of transparency.

"(4) Credit Suisse conducted a six-year global research study from 2006 to 2012, with more than 2,000 companies worldwide, showing that women on boards improve business performance for key metrics, including stock performance. For companies with a market capitalization of more than $10 billion, those with women directors on boards outperformed shares of comparable businesses with all-male boards by 26 percent."

Mandating board minimums for gender diversity is an approach that has been adopted in a number of other countries to increase the proportion of women directors. According to the legislation, "Germany is the largest economy to mandate a quota requiring that 30 percent of public company board seats be held by women; in 2003, Norway was the first country to legislate a mandatory 40 percent quota for female representation on corporate boards. Since then, other European nations that have legislated similar quotas include France, Spain, Iceland, and the Netherlands."

The Wall Street Journal reports that "the number of women on big-company boards in Italy, Germany and several other European nations has tripled and, in some cases, quadrupled in recent years as mandates have forced corporations to boost the share of female directors to as much as 40 percent."

Several other states—Illinois, Massachusetts, Pennsylvania, Ohio and Colorado—have adopted non-binding resolutions setting voluntary goals for board gender diversity, and a bill that largely mirrors the California law has been introduced in New Jersey. Whether these or other states will ultimately follow California's mandatory model is an open question.

Some suggest that the risk of negative publicity could make companies reluctant to associate themselves with litigation aiming to invalidate the law.

☐ ***Opposition to SB826.*** Over two dozen organizations, including many Chambers of Commerce, opposed the bill in a coalition letter, stating that it prioritized a single element of diversity and violated both the California Constitution and the equal protection clause of the U.S. Constitution. Opponents have also criticized the law for imposing one-size-fits-all quotas and applying the new mandate to "foreign" corporations (*i.e.,* those not incorporated in California). Accordingly, it would not be surprising to see a legal challenge to the legislation.

Because the law states that it "shall apply to a foreign corporation...to the exclusion of the law of the jurisdiction in which the foreign corporation is incorporated," it arguably violates the "internal affairs doctrine," which provides that the law of the state of incorporation governs matters that pertain to the relationships among or between the corporation and its officers, directors and shareholders. The vast majority of companies to which the legislation is intended to apply are incorporated outside of California, and thus are subject to the corporate laws of other states.

As a result, the new legislation raises the issue of whether it could legitimately be applied or enforced against companies incorporated outside of California. It remains to be seen whether courts will view the location of a company's principal executive office as sufficient to confirm California's interest in the composition of a foreign corporation's board, or otherwise to establish the nexus necessary to overcome the internal affairs doctrine.

Although much ink has been spilled on the law's potential fatal flaws (including, as noted, by former Governor Brown himself), some have suggested that the risk of negative publicity could make companies reluctant to associate themselves with litigation aiming to invalidate the law. In any event, legal challenges are unlikely to be resolved swiftly.

☐ ***Institutional investor perspective.*** Even if the legislation is ultimately struck down or limited to companies incorporated in California, public opinion and pressure from institutional investors and proxy advisory firms—many of which, as discussed below, have raised the stakes on board gender diversity—suggest that public companies, and those private companies proposing to go public, would be well advised to consider the compositions of their boards and whether any further action is appropriate.

For example, State Street Global Advisors, which initiated its "Fearless Girl" campaign in 2017, announced that, in the first half of 2018, it voted against reelection of board members at 581 companies worldwide for failing to take action regarding their board gender diversity. Starting in 2020, State Street will vote against the entire slate of board members on the nominating committee if a company does not have at least one woman on its board, and has not engaged in "successful dialogue" on board gender diversity for three consecutive years.

State Street is not the only asset manager to try to tackle the issue. In 2018, BlackRock (reportedly the largest asset management firm) stated in its voting guidelines, "In addition to other elements of diversity, we encourage companies to have at least two women directors on their board."

In addition, in its survey of over 60 institutional investors with an aggregate of $32 trillion under management, the EY Center for Board Matters reported that, among investors' top priorities for companies in 2018, board composition, particularly gender diversity, was a top priority for 82 percent. About half of respondents reported that they consider board diversity in voting for directors, while a quarter do so in the context of certain events, such as proxy contests and shareholder proposals. The driver appeared to be "interest in effective board composition, given the wide range of studies demonstrating the benefits of diversity, including how diverse perspectives enhance issue identification and problem-solving ability and impede 'group think.'"

Although most investors and other interested groups have not set "quotas" for board gender diversity, many are seeking a demonstrated commitment to diversity, including through the implementation of processes designed to increase diversity. A number of different advocacy groups, such as the Thirty Percent Coalition, a coalition of companies, professional service firms, institutional investors, government officials and major advocacy groups, founded in 2011, as well as public pension fund managers such as CalSTRS and the NYC retirement programs, have reached out to public companies directly on the issue of board gender diversity. These groups have contacted hundreds of companies that do not have gender diverse boards, requesting engagement, offering resources and urging that boards and nominating committees demonstrate their commitment by taking action to address the issue.

Moreover, proxy advisory firm ISS has announced a new policy on diversity, effective for meetings on or after February 1, 2020, applicable to companies in either the Russell 3000 or S&P 1500 indices. ISS may issue adverse voting recommendations against nominating committee chairs of boards with no gender diversity (and possibly other responsible directors). Glass Lewis has a similar policy that will apply to all companies beginning in 2019. Both firms will consider exceptions to the policy if companies provide adequate explanations for the absence of board gender diversity.

In light of the new law and intense institutional investor interest, boards should consider that failure to address the issue of board gender diversity may leave their companies vulnerable to votes against directors, negative publicity, shareholder proposals, shareholder scrutiny of board refreshment practices, and potentially even proxy fights.

Failure to take action now on board gender diversity could have adverse consequences for companies.

☐ ***What should boards be doing now?*** Regardless of whether the law withstands any legal challenge, private-ordering efforts to increase board diversity are likely to continue, and failure to take action on board gender diversity could, as discussed above, have adverse consequences. With that in mind, boards should proactively discuss a strategy for addressing board diversity, taking into account the 2019 and 2021 deadlines and related penalties for noncompliance, any specific requests or guidance from investors and the timing of upcoming board and shareholder meetings (especially if an increase in the size of the board is necessary and shareholder approval would be required for that purpose).

It may be a hard truth, but for companies with no or a minimal number of women on their boards, achieving board gender diversity will be a significant challenge unless those companies "deliberately do something different," as the chair of the National Association of Corporate Directors phrased it. To that end, boards and companies may want to consider casting a "wider net" when searching for board nominees. For example:

▫ *Utilize databases,* in particular those designed to identify diverse board candidates based on industry and other relevant experience. One such database is the Equilar Diversity Network. Through its partnerships with various institutional investors and diversity organizations, Equilar offers the network with the goal of building a consortium that advances diverse boardrooms around the world. Equilar refers to the network as the "registry of registries of board-ready executives from leading ethnic and gender diversity organizations."

□ *Consider candidates outside the C-suite* and candidates who have not previously served on public company boards, including those from government, academic and nonprofit backgrounds, a practice advocated by institutional investors and governance commentators alike as a way to include additional diverse talent in the pool of potential candidates.

□ *Engage a search firm* to identify director candidates. These firms could be instructed to include diverse candidates with appropriate experience in any search for new directors.

□ *Adopt a version of the "Rooney Rule,"* a commitment to include women and minority candidates in every pool from which board nominees are chosen, another strategy promoted by institutional investors, such as CalSTRS, and groups that advocate for board diversity, such as the Thirty Percent Coalition. The "Rooney Rule" was originally created by the National Football League to increase the number of minority candidates considered for head coaching and general manager positions.

In addition, boards should consider that failing to respond to institutional investor requests may invite more aggressive tactics, including votes against directors and submission of shareholder proposals regarding board diversity. As a result, boards may want to consider affirmatively demonstrating that they have undertaken processes designed to increase diversity, including:

□ *Respond to institutional investors and advocacy groups* that contact them, conveying the board's perspective and taking advantage of resources offered. Although some institutional investors will be satisfied with the nomination and election of a single diverse director, most seek direct engagement and implementation of policies prioritizing diversity.

□ *Affirm in the company's governance documents,* such as the nominating and governance committee charter or corporate governance guidelines, that the board will consider specific diversity characteristics in the board nomination process. A rigorous version of this approach would be to codify the Rooney Rule in these documents.

□ *Use board self-evaluations* and evaluations conducted by outside consultants to identify desired board skills and attributes (including diversity). Apply the results in upcoming board recruitment opportunities and individual director evaluations in connection with the board's nomination and refreshment practice.

□ *Expand proxy disclosure* regarding the company's efforts to increase diversity, including:

–Provide enhanced disclosure of specific efforts by the board to increase the number of diverse directors. Explain how the board considers gender and racial/ethnic diversity when nominating directors, and expand the discussion regarding how current board composition aligns with the company's long-term strategy. Public companies subject to SB 826 will also need to factor in the impact of the law in their required board diversity proxy disclosures.

–Specifically discuss the company's board refreshment practices (covering board evaluations, mandatory retirement ages or tenure guidelines or limitations). These practices are often viewed as predicates to enhancing board diversity.

–Include a "board matrix" providing a visual representation of the mix of skills, qualifications and expertise of the board, specifically addressing the board's composition in terms of diversity of age, gender and race/ethnicity. These disclosures can be presented by director, or aggregated across the entire board for anonymity. ■

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