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A Fact-Based Approach to Boardroom Diversity

The research record shows mixed results from quotas and regulation

THERE IS INTENSE INTEREST AND DEBATE over board diversity, spurred in part by regulatory measures now underway in several countries. Regulators have begun promoting board diversity for societal and good-citizenship reasons (e.g., equal opportunity, equity, inclusiveness and recognition of systemic barriers to designated groups), and in the belief that diverse boards may produce more effective decision-making and mitigate group-think within boardrooms in the aftermath of the global financial crisis.

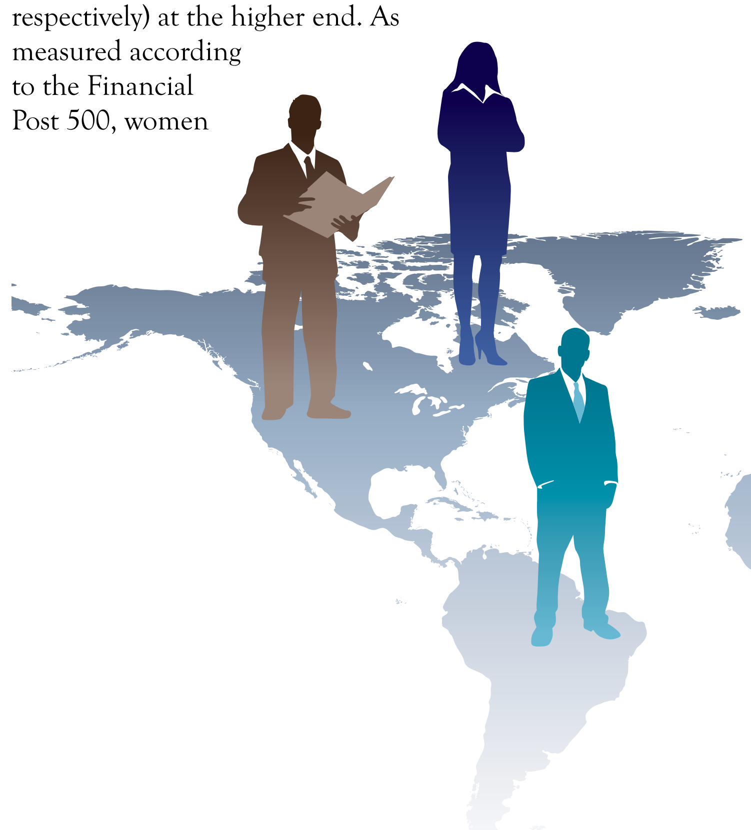
Until very recently, Canada had a bill (Bill S-206) at the Senate committee level requiring 50% women directors on a broad swath of publicly traded, financial institution and Crown boards. (A potential similar quota exists in the UK, but has not reached a regulatory proposal at this stage.) The Senate bill passed second reading last May, went through committee stage, and was in Committee Report stage. On February 3, Liberal Senator Celine Hervieux-Payette, the bill's chief proponent, issued a press release entitled "Conservative senators kill Bill S-206," in which she accused the Conservative government of having "a particularly regressive view of women in our society."

The testimony in the Senate committee hearings focused on regulatory approaches in other jurisdictions and whether the "business case" for board diversity has been properly established. That is to say, do diverse boards result in greater corporate performance? In a statement to the Senate committee, this author reported that the business case has not been sufficiently established, as the academic literature is very much unsettled. However, there are important findings, summarized below.

Regulatory approaches to board diversity range from, on the one hand, rules requiring disclosure of diversity plans by boards, with "diversity" itself undefined by the regulator (as in the United States, established in 2010), to hard quotas on the other hand. Such quotas range from 25% to 50% (in jurisdictions such as Quebec, Norway, France, Spain and Sweden) and apply to organizations ranging from public-sector boards (as in Quebec) to publicly traded corporate boards (e.g., France, Sweden and Norway). Similar laws are under debate in Belgium, Germany and the Netherlands.

In between is an approach where the regulator defines diversity; for example, in Australia, "diversity" includes gender, age, ethnicity and cultural background, and boards themselves are responsible for disclosing diversity objectives and their plans to meet their own targets.

What do we know about diversity from the academic evidence? In research presented in Belgium recently, professor Renée Adams of the European Corporate Governance Institute placed Canada midway in gender diversity on boards, between New Zealand, Australia and the UK at the low end (average of 6.2% to 8.8% board seats occupied by women) and the U.S. and South Africa (11.0% and 17.4%, respectively) at the higher end. As measured according to the Financial Post 500, women

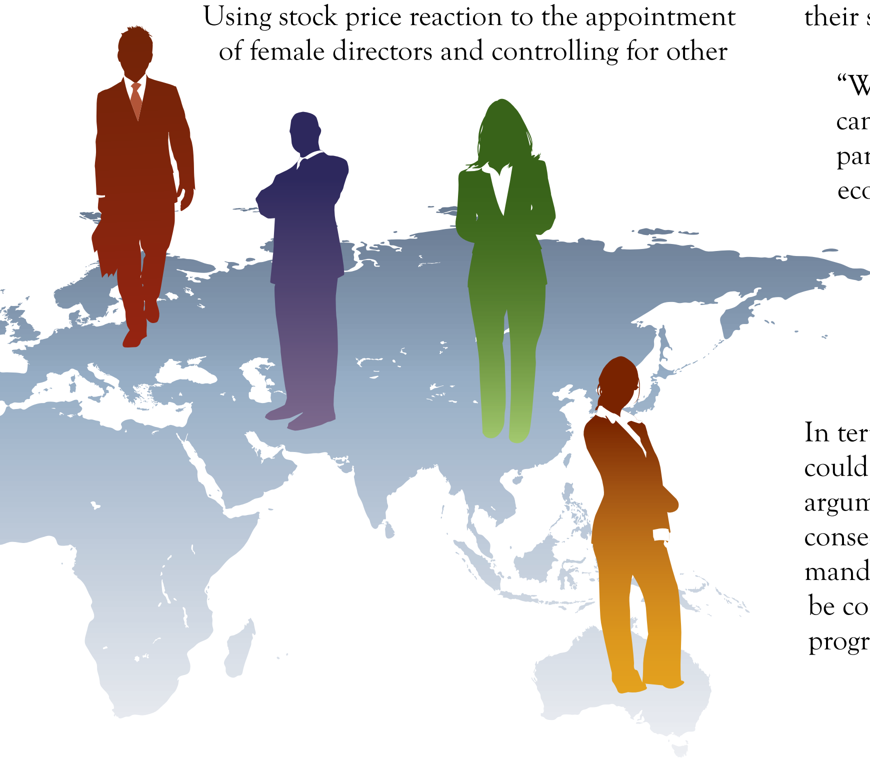


accounted for an average of 10.3% of Canadian board seats in 2009.

In a widely cited 2008 study of the impact of female directors in the boardroom, Adams and ECGI colleague Daniel Ferreira found that women have better attendance records at board meetings than men; in fact, the more women on the board, the more men's attendance records improve. Among their other findings: women are more likely to sit on audit, governance and nominating committees ("monitoring" committees); gender-diverse boards allocate more time and effort to monitoring; and diverse boards are more likely to hold CEOs accountable for poor stock-price performance.

Significantly, however, their research indicated boardroom gender quotas do *not* enhance shareholder value for all firms. The authors found that diversity has a positive impact on performance in firms that otherwise had weak governance, as measured by their abilities to resist takeovers; however, in firms with strong governance, requiring gender quotas in the boardroom may ultimately decrease shareholder value. One possible explanation, the authors state, is that greater gender diversity may lead to over-monitoring in the latter firms.

While there may be other reasons for diversity quotas, the economic case for them (in terms of shareholder value) is weak. Adams draws on other Australian research on the business case for board diversity, indicating that the case is made "sometimes." Using stock price reaction to the appointment of female directors and controlling for other director characteristics, Adams and her colleagues found that the market reaction to female directors is more positive than for male directors, suggesting that tokenism is not the main reason firms appoint female directors. However, the market reaction is also related to industry, firm, and director selection criteria, so some companies benefit more than others.



In "Governance and Politics: Regulating Independence and Diversity in the Board Room," published in the *Journal of Business Finance and Accounting* in November/December 2010, authors Øyvind Bøhren and R. Øystein Strøm found "no relationship between firm performance and board independence." They also reported that "our evidence shows that the firm creates more value for its owners when the board has no employee directors, when its directors have strong links to other boards, and when gender diversity is low." Using a sample of all non-financial firms listed on the Oslo Stock Exchange, and a model investigating the relationship between the value of the firm, board design mechanisms and control variables, the authors' overall robustness tests show "that that alternative ways of operationalizing performance, independence, information network, gender diversity, and board size have no fundamental effect on the relationship between firm value and board characteristics targeted by public policy."

The authors have pretty dramatic statements critiquing the focus of governance policy-making, and conclude their study by stating:

> "We find that the current politics of board design cannot be justified by valuation arguments. In particular, our data provides no convincing economic reason for requiring by law or code that a minimum fraction of the firm's directors be employees, be independent, be of a certain gender, or only hold a few directorships. ... If anything, the regulatory implications of these findings are the opposite of the current regime."

In terms of board diversity, the authors state that "one could argue that for gender mix in particular, political arguments should not be based on beneficial economic consequences for the firm's stockholders. Rather, mandating gender diversity in the boardroom should be considered an inherent part of a broader political program to ensure equal opportunities. Implementing such a program seems costly for stockholders, but may still be beneficial for society at large."

In a September 2010 working paper from Stanford University's Rock Center for Corporate Governance entitled "Diversity on Corporate Boards: How Much Difference Does Difference Make?," Professors Deborah Rhode and Amanda K. Packel state the following:

> "After exploring the strengths and limitations of various methodological approaches and survey findings, the article concludes that the relationship between diversity and financial performance has not been convincingly established. The review does, however, find some theoretical and empirical basis for believing that when diversity is well managed, it can improve decision-making and can enhance a corporation's public image by conveying commitments to equal opportunity and inclusion. To achieve such benefits, however, diversity must extend beyond tokenism and corporations must be held more accountable for their progress."

These three studies, as a whole, seem to suggest that while there are benefits to gender-diverse boards, including higher attendance, enhanced monitoring roles, and a greater propensity to replace poorly performing CEOs, the overall impact (which would include the strategic and resource role of the board) of diversity on corporate performance has yet to be established.

Second, managing diverse boards may pose challenges, but improvements to board decision-making may offset these challenges. In other words, the leadership skills of the board chair may become very important in managing a diverse team to achieve its full benefits.

In addition, it is important to define diversity beyond gender and in ways appropriate to the organization. Additional Canadian diversity categories (which could include designated groups) may include, for example, Aboriginal peoples, age, diversity of skills and experiences, geographical, gender, linguistic, persons with disabilities and visible minorities. All these diversity categories have been used in companies and boards with which the author has worked, in various combinations and in ways appropriate to each organization.

As interest grows in the subject of board diversity, these are some of the steps that corporate boards might consider taking to pursue diversity and improved performance:

- Identifying exemplars (e.g., people and processes) and peer-sharing of knowledge and practices;
- Consideration of appropriate broadening of director qualifications and selection criteria (e.g., enterprise leadership, market knowledge and functional capabilities);
- Developing the pipeline to increase the pool of qualified applicants;
- Overcoming potential bias (e.g., in-group favoritism, stereotypes) or unintended consequences of policies or preferences;
- Considering the adverse effects of tokenism vs. the critical mass necessary to fully realize the benefits of diversity;
- Recommending candidates for directorship not previously known to the board;
- Instituting term limits or other policies to open up seats for women and minorities;
- Reducing the influence of management on director nomination, and increasing the influence of shareholders;
- Accepting the importance of board leadership in leading and managing board diversity; and
- Disclosure of diversity initiatives.

As this review makes clear, there needs to be more and better research conducted on board diversity, including qualitative research to address methodological limitations. Extant research suggests that financial benefits of diversity should not be over-stated. Nor, however, should a financial case be required to address diversity. There are non-financial benefits to addressing board diversity, including forestalling regulation, reputation, in-boardroom decision-making, role modeling, making full use of available talent, and important signaling to stakeholders.

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Editor's Note: The Institute of Corporate Directors will host Board Diversity Town Halls across Canada in the month of April. For more details, please visit www.icd.ca/events.