A New Dimension

Both ethical considerations for boards and the pivotal role of investors is driving change

Deborah Gilshan, FOUNDER OF THE 100% CLUB

In January 2020, I was commissioned by the UK's Institute of Business Ethics (IBE) to research and write a report with them on the ethical implications of diversity. Little did I know what lay ahead in 2020 and that it would bring an urgency to the diversity agenda that I could never have envisaged.

Having been involved in diversity advocacy since 2011, the pace of change in the past year, and the evolving expectations on companies, their investors and society more generally, has been unparalleled. The urgency for this change has been fuelled by COVID-19 and racial injustices that have amplified existing systemic inequalities which were already being exposed through movements such as 'Me Too' prior to the pandemic.

In addition, the increasing recognition of the importance of environmental, social and governance (ESG) considerations by companies and their investors has reinforced the view that the social licence to operate of companies is critical to long term value, especially as the pandemic is testing that social licence to its core. The need to consider stakeholders beyond shareholders should now be self-evident to companies and their boards. Diversity is critical to this: visibility of diverse leaders, the importance of diverse role models and diverse representation are all important for stakeholder relationships. This manifests itself acutely at board level, where the board is taken as the outward face of the organisation.

All of this coincides with the expectation of more assertive and transparent investment stewardship activities expected from all types of investors, from fund managers and pension funds to activist shareholders and bondholders.

Diversity is challenging. This is because it represents complicated issues related to power, status quo, identity, representation, equality, opportunity, fairness, meritocracy and the inherent barriers faced by certain groups within companies and wider society. There are strong ethical dimensions in the framing of the questions asked and the solutions presented.

The IBE report, entitled *The Ethics of Diversity*, seeks to provide boards with a framework for understanding these ethical dimensions and addressing them systematically. The report stands at a point in time, in December 2020, to reflect on what has been achieved, including the ten years of sustained effort in the UK to improve gender diversity, the lessons learned and the challenges ahead. It offers guidance on how boards can get ahead of the curve on all dimensions of diversity to achieve more inclusive corporate cultures.

In my work and research since 2011, there are four key areas which I think are critical to a better understanding of diversity and which are explored in the report.

Gender diversity and board governance dynamics

There is growing evidence that increasing board gender representation can improve board governance, including risk oversight and board effectiveness. The concept of 'substantive gender diversity' was identified by Professor Yaron Nili, a law professor, in his 2018 academic paper *Beyond the Numbers: Substantive Gender Diversity in Boardrooms.* The paper argues that it is not just about having more female directors on boards, it is also about the roles they take and the 'clout' they have. In the UK, we have to ask why female directors tend to be in certain leadership roles but not in others. Data from BoardEx indicates that there is now a majority of female Remuneration Committee Chairs amongst the FTSE 350 index of companies. But women do not seem to be appearing in board chair, other committee chair roles or CEO roles to nearly the same extent. Sir Philip Hampton, chair of the UK's Hampton-Alexander Review, referred to the lack of sufficient female representation amongst board chair roles and committee chair roles as 'a structural subordination of the female role' in a recent discussion at the FutureBoards Cross Border Dialogue.

Diverse teams outperform homogenous teams

Boards that are not diverse are subject to an added layer of governance risk related to homogeneity and groupthink. Diversity is vital to stymie groupthink and to enhance team performance. The work of Professor Scott Page, a social scientist, evidences a 'diversity bonus' where diverse groups almost always outperform homogeneous groups. Page also found that, on complex tasks, the best performing team does not need to consist of the best individuals and a diverse group that displays different perspectives outperforms a group of non-diverse and like-minded experts.

The unethical connotations of 'the business case' for diversity

One of the key proof points sought in justifying pursuit of diversity is the business case, part of which seeks evidence of corporate outperformance when adding female directors, or members of any under-represented group, to boards. From the work of the late Professor Katherine Phillips, a business theorist, it is clear that linking improved diversity to enhancing the bottom line has unethical dimensions to it because it reinforces the idea that some people belong and others have to prove that they do. Phillips argues that the proof points sought have power in them and often serve to reinforce the status quo.

Gender differences in leadership traits

This is an area that I believe we need to understand much more in order to fully harness the differences. Such considerations also switch the narrative to what women bring to organisations rather than what men have to 'give up'.

A Different Approach

The UK has adopted a target driven and multi-stakeholder approach to addressing diversity deficits in companies. This has required input from relevant stakeholders including policy makers, regulators, companies, boards and investors. The UK Corporate Governance Code and the UK Stewardship Code include requirements on diversity for companies and for investors in terms of their engagement with investee companies. Other drivers of change include the Davies Review and the Hampton-Alexander Review for gender diversity and the Parker Review on ethnicity as well as legislation such as the gender pay gap. In my view, no one solution or initiative is as impactful on its own as it is as part of a collective effort.

Progress continues to be made on the target-based approach in terms of female non-executive board representation in the UK's largest 350 companies, although it is important to note that meeting targets represents minimum thresholds, not the end goal. A similar approach is being adopted to increase racial and ethnic diversity at board level.

But to achieve cognitive diversity, there needs to be a move beyond meeting targets to a focus on the qualitative aspects in addressing imbalances in identity diversity, be that gender, race, ethnicity, disability or sexuality, by engaging a diversity of lived experiences. Diversity has to permeate at a strategic level and across the entire operations of the board, the Executive Committee and the company as a whole. A good first step would be reporting on how diversity links to strategy, a key requirement of the UK Corporate Governance Code.

Recent research from the Financial Reporting Council on reporting by UK companies on the Code highlighted that many companies were still approaching it as a 'box-ticking exercise'. On diversity, many companies stated its importance and the importance of diverse boards but offered little explanation in the way of evidence to support their assertions, including: a lack of targets to improve diversity at the board and executive committee levels; little or no discussion of succession planning; and minimal reporting on how board evaluations are leading to the development of diverse talent pools. A compliance approach to diversity is one of the key risks highlighted in the IBE report.

The report ends with a Call to Action and a series of ten practical recommendations as to how a board of directors can achieve cognitive diversity.

Recommendation One: Understand and explore the diversity of thought and experience on the board.

Recommendation 2: Ensure that the company's push for diversity and inclusion is a strategic and commercial imperative for the organisation.

Recommendation 3: Look critically at the culture in the boardroom.

Recommendation 4: Review nomination and succession planning processes for all board and executive committee appointments.

Recommendation 5: Look critically at the individual roles assigned to board members.

Recommendation 6: Learn from the experience of improving gender balance and learn from the experience of other sectors.

Recommendation 7: Understand the company's stakeholders. Actively listen and respond to them.

Recommendation 8: Communicate aims and milestones internally and externally.

Recommendation 9: Learn from a more challenging board evaluation.

Recommendation 10: Recognise inequalities and racism as systemic risks to the economy and see diversity and inclusion as an opportunity for long-term change.

These recommendations also present a framework for engagement by investors with board members and senior executives of their investee companies. They support an understanding as to how diversity is leveraged as a strategic imperative for companies and how the risk of groupthink is managed, and the benefits of diversity are harnessed, in the boardroom and throughout the company. It is important that investors hold companies to account.

Investor Stewardship and Diversity

I believe the role of investors, and the collective investor voice, is a game-changer when it comes to diversity. As noted earlier, I have been involved in diversity advocacy since 2011. In that year, RPMI Railpen, the pension fund for the railway industry which I worked for at the time, became an inaugural member of the 30% Club's UK Investor Group.

From the extensive company engagement I have undertaken during my time within institutional investment, including leading collaborative efforts with the 30% Club Investor Group, I believe the power of investor capital is transformational in promoting and driving change. The growth of the 30% Club Investor Group is testament to that. From seven members with £1.6 trillion in assets under management in 2011, the Group now has 39 members from across the investment chain with £11 trillion in assets under management. There are now parallel investor groups in France, Australia, Canada and Japan too.

One of the most effective features of the 30% Club's UK Investor Group is its Statement of Intent, issued in October 2016. This is a public commitment by the Group's investor members to "signal the collective voice ... to companies and the wider marketplace, and to demonstrate the ways in which their members will use their ownership rights and undertake stewardship to encourage progress on gender diversity". In addition, the Statement indicates that investors will applaud examples of best practice and pressure laggards.

Since 2011, it has been interesting to observe the increasing number of investors stating that diversity is now a key priority for their investment stewardship activities, or that it continues to be. I predict that this will only continue, especially as the updated 2020 UK Stewardship Code encourages investors to focus on 'activities and outcomes' and to address market-wide and systemic risks.

There is a particular role for investors to play in their stewardship work on diversity in terms of voting and engagement but also in how they escalate their stewardship activities, which is also a key expectation of the updated Code. All of this should produce a more assertive form of stewardship, especially given the recommendations from the HM Treasury-led Asset Management Taskforce, issued in November 2020, one of which is that 'shareholders should use requisitioned resolutions more proactively as an escalation tool and develop model resolutions to escalate a range of critical concerns with investee companies'.

The increasing role of activist shareholders on all types of issues, including diversity, is also fundamental to an understanding of the market dynamics that are driving change. Activist shareholders are using diversity data when engaging with under-performing companies, as they realise that poor diversity at board level can be a signifier of deeper board governance issues.

More Action

All of this leads me to believe that companies should anticipate more shareholder activism on diversity, especially as shareholders seek to address systemic risks more effectively. This is already happening on climate change, for example shareholder resolutions co-ordinated by ShareAction on the financing of fossil fuel companies by banks and the initiative by The Children's Investment Fund Management (TCI), which has filed resolutions requesting an annual vote on climate transition action plans.

It is quite conceivable that shareholder resolutions on diversity at UK companies will soon begin to be filed, in addition to more targeted voting strategies by investors on the election of board members. Companies and their boards would do well to consider an annual vote on diversity action plans before shareholder resolutions and activism requires them to do so. Systemic change requires the entire ecosystem around boards and companies to act, individually and collectively. The opportunity is enormous. There is still much to do.

The Ethics of Diversity by Deborah Gilshan with Mark Chambers from the Institute of Business Ethics can be found at: ibe.org.uk/resource/ethicsofdiversity.html

A recording of the discussion on the launch of the report is available here: ibe.org.uk/resource/the-ethics-of-diversity-moving-beyond-targets.html n