Session 504 | “Board Diversity: What We’re Seeing, What We Predict, and How Asians Factor into the Debate”

Session Description:
The rising focus on board diversity can no longer be ignored. Companies are facing pressure from multiple constituencies—investors, proxy advisory firms, policy-makers, and their own employees—to diversify their boards and address racial injustice. Activist shareholders have increased pressure on companies to diversify, submitted diversity-related shareholder proposals, launched proxy fights, and filed derivative suits alleging lack of board diversity. On August 6, 2021, the SEC approved a Nasdaq proposal to amend its listing standards to require board diversity disclosures. Several states have also passed (or are considering passing) legislation to encourage board diversity. For example, California enacted SB 826 in September 2018, mandating diversity of women on boards of public companies headquartered in the state, and AB 979 in September 2022, which was a similar law but for underrepresented minorities. Both laws were subsequently challenged in court and struck down, the decisions of which have since been appealed.

These developments place a clear responsibility on companies to factor diversity into their governance and decision-making. However, some have criticized these developments, publicly challenging them as racist and unconstitutional and filing lawsuits arguing the same. Regardless of one’s views, it is undeniable that these developments are of growing importance and that companies must monitor them and take action accordingly.

Our panelists will offer their perspectives and predictions, and debate what board diversity means and whether and why it matters. Discussion topics will include public disclosures on diversity; regulatory actions and state legislation on board diversity; and shareholder actions to address diversity, including derivative lawsuits and shareholder proposals.

Moderator:
Tansy Woan, Litigation Counsel, Skadden, Arps, Slate, Meagher & Flom LLP

Speakers:
Douglas K. Chia, President, Soundboard Governance LLC
Don H. Liu, Executive Vice President and Chief Legal & Risk Officer, Target
Fuad Rana, Assistant Director, SEC, Division of Enforcement
Nate Saint Victor, General Counsel & Chief Compliance Officer, Engine No. 1
Statement on Elimination of Bias Credit

Our session is designed to educate lawyers about the elimination of bias and prejudice in the legal profession as well as the role in which the legal profession has played with respect to diversity on public company boards. We address, among other things: (1) studies and reports addressing issues of diversity on public company boards; (2) ways in which state legislatures have sought to increase diversity on public company boards and how those efforts have been challenged in the judicial system; (3) regulatory efforts by the SEC to increase diversity on public company boards and how those efforts have also been challenged in the judicial system; (4) shareholder derivative suits that have been filed alleging lack of board diversity; (5) shareholder proposals seeking to increase diversity on public boards; and (6) policy considerations that come up in how we as lawyers can assist with these efforts in eliminating bias and prejudice.
Board Diversity
What We’re Seeing, What We Predict, and How Asians Factor Into That Debate

November 5, 2022
Presented by Douglas K. Chia, Don H. Liu, Fuad Rana, Nate Saint Victor, and Tansy Woan
Panelists

Moderator

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1 Background
Board Diversity

- The composition of boards at the Fortune 500 and 100 levels has not changed materially in the last several years.

  - Women and minorities combined occupy just 38% of Fortune 500 board seats and 42% of Fortune 100 seats.

  - Minority women represent the smallest percentage of boardroom seats.

  - More than 36% of diverse board seats overlap.

Board Diversity (cont’d)

Number of Diverse Directors, Fortune 1000

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Figures from:
- Asian Representation on Fortune 1000 Boards, 2022 edition; KPMG and Ascend Pinnacle
- Latino Representation on Fortune 1000 Boards, 2022 edition; KPMG and Latino Corporate Directors Association
- African American Representation on Fortune 1000 Boards, 2022 edition; KPMG and African American Directors Forum
Board Diversity (cont’d)

Number of Asian Directors on Fortune 1000 Boards

- 71.60% No Asian directors
- 22.20% One Asian director
- 22.20% Two Asian directors
- 2.40% Three or more Asian directors

Figures from Asian Representation on Fortune 1000 Boards, 2022 edition; KPMG and Ascend Pinnacle
2 Legislative Efforts
Board Diversity

• To address this lack of diversity, some states have passed, or are currently considering, laws that aim to effect change in one of three ways:

1. Mandating board diversity

2. Encouraging board diversity

3. Requiring disclosure of board diversity information
### Overview of Enacted Board Diversity Statutes

| Mandatory Diversity / Disclosure: Public companies headquartered in the state | California, Illinois, Washington  
|                                                                         | Also being considered by  
|                                                                         | - Connecticut, Hawaii, Massachusetts, Michigan, New Jersey, Oregon  
| Non-Binding Diversity: Public companies headquartered in the state         | Colorado, Pennsylvania  
|                                                                         | Also being considered by Ohio  
| Mandatory Disclosure: Business entities (profit or nonprofit) with corporate headquarters in the state | Maryland  
| Mandatory Disclosure: Public and private for-profit business corporations authorized to do business in the state | New York  

**California**: Cal. Corp. Code § 301.3; Cal. Corp. Code § 301.4  
**Washington**: Wash. Rev. Code § 23B.08.120  
**Hawaii**: S. 193, 31st Leg., Reg. Sess. (Haw. 2021)  
**New York**: N.Y. Bus. Corp. Law § 408
California Legislature Takes Action

- **September 30, 2018**: California enacts law, **SB 826**, mandating diversity of **women** on boards of public companies headquartered in the state.
  - In doing so, California became the first state to enact a board diversity statute.
  - Companies must appoint a minimum number of women based on board size.

- **September 30, 2020**: California enacts similar law, **AB 979**, for **underrepresented minorities**.
  - Companies must have at least one board director from an underrepresented community by the end of 2021, and two or three directors (depending on size) by the end of 2022.
  - Initially did not include Asians as one of the groups selected for preference.
California: Challenges

- Both laws were subsequently challenged and recently struck down.
- **April 1, 2022**: The court struck down AB 979, stating that the legislature “skipp[ed] directly to mandating heterogenous [sic] boards” without first attempting “to create neutral conditions under which qualified individuals from *any* group may succeed.
- **May 13, 2022**: The court struck down SB 826, holding that the state had failed to offer a compelling interest for the law, rendering it unconstitutional under the Equal Protection Clause of the California Constitution.
- Appeals in both cases are pending.
AB 979 (Minorities)

  - The court rejected the State’s claim that it had a compelling interest in regulating diversity on public company boards, concluding that:
    » (i) corporate boards are not an arena in which past discrimination has occurred;
    » (ii) the State failed to submit sufficient evidence to show the law would remediate past discrimination; and
    » (iii) the State’s generic interest in healthy businesses and good business practices was not sufficiently specific or immediate to permit the use of suspect classifications.
  - The court found that Section 301.4 failed to pass constitutional muster because it was not the “least restrictive means” of achieving the state’s goal of promoting diversity on public company boards.
SB 926 (Gender)

  - The court was unpersuaded by the State’s assertions that the statute was necessary and appropriately tailored to
    » (1) eliminate and remedy discrimination in the director selection process;
    » (2) increase gender diversity on the boards to benefit the public and state economy; and
    » (3) increase gender diversity to benefit and protect taxpayers, public employees, and retirees.
  - Applying strict scrutiny to SB 826, the court concluded that the statutory goal was to achieve “gender equity or parity” but “not to boost California’s economy, not to improve opportunities for women in the workplace nor not to protect California’s taxpayers, public employees, pensions and retirees.”
  - The court considered testimony that women are “consensus builders” and offer “less risky behavior in investments,” but it concluded that “this offer of stereotypes” was not a justification for SB 826.
3 Regulatory Efforts
The SEC Approves NASDAQ’s Board Diversity Proposal

- **August 6, 2021:** SEC approves NASDAQ’s proposal to amend its listing standards to encourage greater board diversity and to require board diversity disclosures for NASDAQ-related companies.

- **NASDAQ Rule 5606(f):** Requires companies to have at least two diverse board members or to explain the company’s reasons for not meeting this diversity objective
  - **U.S. issuers:** One diverse director must self-identify as female and the other director must self-identify as either a racial or ethnic minority or a member of the LGBTQ+ community
  - **Foreign issuers:** May satisfy this requirement by appointing a director who self-identifies as an underrepresented individual based on national, racial, ethnic, indigenous, cultural, religious or linguistic identity in the company’s home county jurisdiction
NASDAQ Rule 5606(f) – Legal Challenges

- **August 2021**: The National Center for Public Policy Research and the Alliance for Fair Board Recruitment challenged this rule as unconstitutional and discriminatory. The Fifth Circuit heard the case in August 2022.
  - This non-profit also sued over CA’s requirement for corporate board diversity.

  **Challenges:**
  - SEC doesn’t have the authority to approve board diversity requirements for Nasdaq-listed companies. Congress couldn’t constitutionally confer this power on any administrative agency and the government may not collaborate w/ Nasdaq to effectuate something it’s prohibited by the Constitution to do itself.
  - Violates federal securities laws and directors’ and companies’ First Amendment rights
  - **Amicus brief**: 17 states have supported a lawsuit challenging the SEC’s approval of NASDAQ Rule 5606(f), saying the requirement sets quotas that discriminate on the basis of race, ethnicity, and sex

- More litigation could follow as the SEC is contemplating adopting its own board diversity rules for a broader range of companies.
The SEC Names ESG as a Priority

- **March 2021**: SEC announces the creation of a Climate and ESG Task Force in the Division of Enforcement
  - Will develop initiatives to proactively identify ESG-related misconduct
  - Will also coordinate the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential violations
  - Initial focus will be to identify any material gaps or misstatements in issuers’ disclosure of climate risks under existing rules
  - Will also analyze disclosure and compliance issues relating to investment advisers’ and funds’ ESG strategies
  - Will evaluate and pursue tips, referrals, and whistleblower complaints on ESG-related issues

- Division of Examination includes ESG in its 2022 Examination Priorities
4 Shareholder Pressures
Shareholder Derivative Suit: Background

- **Nature of claims:** More than a dozen lawsuits have been filed by shareholders against large, public companies spanning a wide range of industries, from Big Tech to health care and retail, along with their officers and directors, alleging lack of board diversity and other sufficient diversity initiatives.

- **Relief sought:** Plaintiffs have sought wide-ranging corporate reform, including:
  - Resignation and replacement of specific board members
  - Return of all director defendants’ compensation to be donated to an “acceptable charity or organization whose efforts include the advancement of Black people and minorities in corporate America”
  - Publication of annual reports containing detailed information about hiring, advancement, promotion and pay equity of all minorities at the company
  - “Creation of a $1 billion fund to hire Black and minority employees”
  - Filling of “15% of all new positions in the United States with African-Americans”
  - Replacement of the company’s auditor for “failing to point out ... that the company lacks an effective system of internal controls to ensure [it] is not discriminating against minorities”
Shareholder Derivative Suits: Recent Decisions

  - The plaintiffs alleged that Qualcomm defendants violated Section 14(a) by allowing discriminatory practices to proliferate at the company and by failing to include a single Black person either on the board or among the company’s senior officers, thereby exposing the company to significant risk. The court dismissed the Section 14(a) claims:
    - Statements that the “Governance Committee’s goal is to assemble a board of directors that brings to us a diversity of perspectives and skills” was not actionable because it was not material.
    - The statement that the Governance Committee would “include, and instruct any search firm it engages to include, women and racially/ethnically diverse candidates in the pool from which [it] selects director nominees” was not actionable because plaintiffs failed to allege any facts supporting a reasonable inference that this was false or misleading.
    - Statements about a company’s goals are generally found to be non-actionable puffery.

  - The plaintiffs challenged statements regarding Cisco’s diversity aspirations, such as the Cisco “Board believes it is important to consider diversity of race … in evaluating board candidates in order to provide practical insights and diverse perspectives …” The court dismissed the Section 14(a) claims:
    - “Aspirational assertions” about diversity in Cisco’s proxy statements were non-actionable because they were neither misleading nor material; rather, the challenged statements were vague statements of optimism not capable of objective verification.
    - The plaintiff failed to allege that proxy statements were an essential link to a loss-generating corporate action.
Shareholder Derivative Suits: Takeaways and Predictions

- Derivative suits alleging lack of board diversity generally have been unsuccessful, yet plaintiffs have been undeterred. Accordingly, companies should carefully manage their D&I initiatives, performance and disclosures.

- Companies should be prepared for a potential increase in Section 220 demands from shareholders.

- Companies should closely monitor SEC regulations on required ESG disclosures.
  - Prior dismissals were based in part on courts finding that SEC regulations did not specifically require the disclosure of the allegedly omitted information, but as these regulations evolve, this may change.
Shareholder Proposals

- Social proposals have increased 20% since 2021 and constitute the largest category of shareholder proposals submitted in 2022.
  - Among the most popular proposal topics in 2022 were climate change, anti-discrimination, and diversity.

- Shareholder proposals have come in many forms, including requests to:
  - Conduct racial equity audits or reviews
    » JPMorgan Chase, Amazon, Pfizer, Bank of America, Citigroup, JPMorgan Chase, Wells Fargo, Goldman Sachs, Morgan Stanley, Johnson & Johnson
  - Install new diverse board members and/or members focused on ESG
    » Exxon Mobil, Alphabet, Tesla, Home Depot, Wells Fargo
  - Implement ESG resolutions
    » Chevron, Exxon Mobil
  - Disclose “EEO-1” data about race, ethnicity, and gender makeup
    » Nike, Disney, Lowe’s, Union Pacific, Moody’s Investors Service, Walmart.
5 Policy Considerations
Policy Considerations and Discussion

What constitutes “diverse”?

How do we address the criticisms of board diversity?

Where do we go from here?