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Thomas Lee Hazen

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# DIVERSITY ON CORPORATE BOARDS: LIMITS OF THE BUSINESS CASE AND THE CONNECTION BETWEEN SUPPORTING RATIONALES AND THE APPROPRIATE RESPONSE OF THE LAW\*

THOMAS LEE HAZEN\*\*

Some observers suggest that diversity on corporate boards of directors will lead to new perspectives and hence better decision making by the board. It would seem to follow that improved decision making will lead to better corporate performance and thus presents a “business case” for increasing diversity on corporate boards. This Commentary explores the limits of the business case, some of the alternative rationales for increasing diversity on corporate boards, and the extent to which those rationales provide a basis for the law mandating or encouraging increased diversity. This Commentary concludes that the recently adopted SEC rule mandating disclosure of any policies relating to the role of diversity in board selection is a measured response to the current rationales, although it could have gone a bit further. Although the current rationales for increased diversity do not provide a clear mandate for more proactive government intervention, these rationales clearly support some form of regulatory intervention.

For a considerable period of time, the primary argument in favor of increasing the diversity of corporate boards was that it would result in more successful companies.<sup>1</sup> As noted above, this is referred to as the business case. In her most recent article, Professor Lisa Fairfax aptly points out that the business case for diversity on corporate

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\*\* Cary C. Boshamer Distinguished Professor of Law, University of North Carolina at Chapel Hill.

1. See Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 795; see also David B. Wilkins, *From “Separate Is Inherently Unequal” to “Diversity Is Good for Business”*: *The Rise of Market-Based Diversity Arguments and the Fate of the Black Corporate Bar*, 117 HARV. L. REV. 1548, 1553–55 (2004) (“Diversity, in other words, is not only ‘good for business,’ it is essential to prosperity in the global economy.”).

boards of directors has had limited success.<sup>2</sup> As Professor Fairfax explains, the success of the business case in demonstrating a positive correlation between board diversity and corporate performance is limited in at least two respects. First, the existing studies are equivocal at best.<sup>3</sup> Second, notwithstanding the studies tending to show a correlation, the business case has not been successful in increasing board diversity in recent years.<sup>4</sup> Professor Fairfax concludes that the business case should not crowd out the moral rationale.<sup>5</sup> Professor Fairfax undoubtedly is correct that the business case has not been as robust a foundation of increased board diversity as proponents of an increase would prefer. There are a number of rationales to support board diversity, and rather than simply question the strength of the business case rationale, the question that should be asked is whether these other rationales, when combined with the business case, support legal rules and regulations that encourage increased board diversity.<sup>6</sup>

Many of the existing empirical studies show a correlation between increased board diversity and successful businesses, but a correlation does not necessarily establish a causal relationship.<sup>7</sup> Even beyond the problems with the existing studies that Professor Fairfax analyzes, how do we truly judge business success? Is a company's stock price or market capitalization the best measure? Or should researchers be looking at profitability to measure business success? Is success better determined by looking to a company's relative ranking with respect to its business peers? If diverse boards are in fact better decision makers, should that fact be empirically provable within the first year after diversity is achieved, or is a longer view a better measure of business success?

To date, the business case has not convinced most corporate boards to expand their diversity significantly.<sup>8</sup> It has been suggested that only when corporate boards become more diverse will it be possible to study the impact of board diversity, but it seems

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2. Lisa M. Fairfax, *Board Diversity Revisited: New Rationale, Same Old Story?*, 89 N.C. L. REV. 855, 858 (2011).

3. *Id.* at 860–64.

4. Fairfax, *supra* note 1, at 800–03.

5. *Id.* at 853–54.

6. I believe that increased diversity on corporate boards should be encouraged. I also believe that there is some merit to the business case and that corporations will be better off with more diverse boards. A distinct question is the extent to which the law should be proactive in encouraging increased board diversity.

7. Fairfax, *supra* note 1, at 810; Fairfax, *supra* note 2, at 862.

8. Fairfax, *supra* note 2, at 867.

premature to do so now given the current levels of board diversity.<sup>9</sup> This creates an unfortunate conundrum since it may not be possible to engage in meaningful empirical studies until board diversity increases and this increase may not take place in the absence of stronger evidence of the business case.

This Commentary addresses the extent to which the business case is important given corporate norms and the laws regulating corporations. The Commentary concludes that the business case need not be a driving force for those observers urging laws to promote board diversity. Rather, if increased diversity on corporate boards can be justified in other ways, the burden should then shift to the objectors to show that increased diversity on boards would in fact be inconsistent with corporate success, however that might be measured.

There may also be demonstrably negative effects of increased board diversity,<sup>10</sup> but that need not sound the death knell for increased diversity. Even without strong empirical evidence, a strong positive link between board diversity and good decision making can be hypothesized.<sup>11</sup>

The use of the business case as an exclusive basis for justifying corporate conduct is premised on the late Professor Milton Friedman's belief that corporations have no social responsibility beyond making money for their shareholders.<sup>12</sup> The necessity of justifying board diversity exclusively or primarily on the business case is premised not only on the for-profit nature of corporations, but also on the common perception that corporate law is purely a matter of private law and of contractual relationships within the corporate

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9. See generally Deborah A. DeMott, *The Milieu of the Boardroom and the Precinct of Employment*, 89 N.C. L. REV. 749 (2011) (arguing that research techniques applied to diversity among employees are likely useful when applied to diversity among boards of directors).

10. See, e.g., Frank Dobbin & Jiwook Jung, *Corporate Board Gender Diversity and Stock Performance: The Competence Gap or Institutional Investor Bias?*, 89 N.C. L. REV. 809, 837 (2011) ("We offer another theory of the effect of board gender diversity on corporate performance. We suggest that gender diversity may be influencing corporate performance not by shaping the efficacy or monitoring capabilities of boards themselves, but by activating bias on the part of the institutional investors who now control eighty percent of the shares of America's leading companies. We suggest that if institutional fund managers are indeed acting on gender biases and reducing the value of firms that increase female directorships, we should see negative effects of female directors on stock value. We suggest that if female directors are influencing stock price by altering board efficacy, we should see effects on both profits and stock value.").

11. James A. Fanto, Lawrence M. Solan & John M. Darley, *Justifying Board Diversity*, 89 N.C. L. REV. 901, 904 (2011).

12. See Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32.

community and constituency.<sup>13</sup> The corporate persona, however, is not so monolithic as to preclude consideration of factors besides the business case and profit motive.<sup>14</sup>

Corporate law most often is considered private law rather than public law. However, there is clearly a public law aspect since the laws that regulate corporate conduct have as much or more impact on society outside of the corporate arena as do many public law concerns.<sup>15</sup> The corporate social responsibility movement<sup>16</sup> recognizes

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13. For a discussion of the contractarian approach to corporations, see R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 390–91 (1937) (describing the firm as an organized way of minimizing the transaction costs of contracting and pricing); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777, 794–95 (1972) (introducing the contractarian view of the corporation and highlighting the efficiency of a central firm engaging in a number of bilateral contracts). See also Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 *BROOK. L. REV.* 767, 770–77 (1989) (discussing the debate over contractarianism and competing theories of the nature of a corporation).

14. See William W. Bratton, *Confronting the Ethical Case Against the Ethical Case for Constituency Rights*, 50 *WASH. & LEE L. REV.* 1449, 1461–63 (1993) (showing the fallacies of a pure contractarian approach). See generally Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 *N.C. L. REV.* 273 (1991) (discussing the multifaceted nature of the corporate persona).

15. See, e.g., Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 *HARV. L. & POL'Y REV.* 1, 2–5, 10–16 (2008) (discussing the potential for using corporate law to address economic ills); Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 *HARV. L. REV.* 1197, 1203–05, 1273–96 (1999) (discussing the use of SEC regulations to facilitate social responsibility of corporations). Since the inception of the private corporation and the advent of the general chartering statutes, there has been a great debate among scholars as to whether the regulation of corporations is, and should be, a matter of public law or private law. See generally Adolph Berle, *Modern Functions of the Corporate System*, 62 *COLUM. L. REV.* 433 (1962) (critiquing Professor Henry Manne's theory of a corporation in terms of laissez-faire economic principles); William C. Cary, *Corporate Standards and Legal Rules*, 50 *CALIF. L. REV.* 408 (1962) (advocating adoption of internally imposed ethical restraints in addition to government-mandated disclosure); Alfred F. Conard, *Reflections on Public Interest Directors*, 75 *MICH. L. REV.* 941 (1977) (discussing the possible role of public interest directors in changing the corporate governance structure); Henry Manne, *The "Higher Criticism" of the Modern Corporation*, 62 *COLUM. L. REV.* 399 (1962) (providing an overview of the theories of the nature of a corporation from corporate democracy to corporate constitutionalism); Bayless Manning, *Corporate Power and Individual Freedom: Some General Analysis and Particular Reservations*, 55 *NW. U. L. REV.* 38 (1960) (grappling with the conflict between a corporation's power as an individual entity and individual freedom); Thomas J. Schoenbaum, *The Relationship Between Corporate Disclosure and Corporate Responsibility*, 40 *FORDHAM L. REV.* 565 (1972) (advocating new society-oriented disclosure requirements for corporations).

16. Michael E. Porter & Mark R. Kramer, *Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, *HARV. BUS. REV.*, Dec. 2006, at 78, 83 ("Successful corporations need a healthy society. . . . Ultimately, a healthy society creates expanding demand for business, as more human needs are met and aspirations grow."); Kent Greenfield, *Proposition: Saving the World with Corporate Law?*, 57 *EMORY*

that it is appropriate for corporations to be responsible citizens, and as such, law may legitimately reach beyond the traditional mission of the chartering statutes.<sup>17</sup> In these instances, the business case is not the primary justification for regulatory provisions imposed on corporations.

A classic example of the law's concern for matters beyond the business case can be found in the law relating to corporate charitable contributions. The landmark decision discussing corporate gift giving is found in Justice Jacobs's opinion for a unanimous New Jersey Supreme Court in *A.P. Smith Manufacturing Co. v. Barlow*.<sup>18</sup> In this case, a shareholder had challenged the use of corporate funds for a \$1,500 charitable gift to Princeton University.<sup>19</sup> The court's analysis traced the history of the corporation, concluding that the corporate entity always has had a role as a responsible societal member.<sup>20</sup> State corporate statutes uniformly recognize that unless restricted by the corporate charter, it is proper for a corporation to make charitable donations.<sup>21</sup> The foregoing shows that corporate gift giving is widely embraced by courts and legislatures irrespective of any demonstrable

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L.J. 948, 953–58 (2008) (discussing the success of corporations as instruments of social change).

17. See, e.g., Thomas Lee Hazen, *Corporate Chartering and the Securities Markets: Shareholder Suffrage, Corporate Responsibility and Managerial Accountability*, 1978 WIS. L. REV. 391, 394–95, 398–400, 409–10 (discussing various corporate law and securities law provisions that go beyond the profit motive).

18. 98 A.2d 581 (N.J. 1953); see also, e.g., *Kelly v. Bell*, 266 A.2d 878, 879 (Del. 1970) (upholding corporation's decision to make voluntary payment to county); *Theodora Holding Co. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969) (upholding charitable gift under Delaware law).

19. The plaintiff in *A.P. Smith* challenged the gift as a waste of corporate assets since it resulted in no direct economic benefit to the corporation. 98 A.2d at 581–82.

20. *Id.* at 583–88. Specifically, the court reasoned:

When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens by donating freely for charitable purposes. With the transfer of most of the wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs. They have therefore, with justification, turned to corporations to assume the modern obligations of good citizenship in the same manner as humans do.

*Id.* at 585–86. Justice Jacobs was obviously sympathetic with the views of Professors Berle and Means with regard to the impact of the modern corporation. See ADOLPH BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 352–57 (1932).

21. See, e.g., DEL. CODE ANN. tit. 8, § 122(9) (2001) (“Every corporation created under this chapter shall have power to . . . [m]ake donations for the public welfare or for charitable, scientific or educational purposes . . . .”); MODEL BUS. CORP. ACT § 3.02(13) (2007) (employing similar language to the Delaware Code).

impact on business success. Nevertheless, corporations continue to make considerable charitable donations.<sup>22</sup>

The current acceptance of the value of corporate philanthropy demonstrates that rationales beyond a pure business case could be sufficient to support increased diversity on corporate boards. For example, Professors Fanto, Solan, and Darley suggest that—consistent with other aspects of the corporate social responsibility (“CSR”) movement<sup>23</sup>—increased diversity on corporate boards will foster new positive social agendas for public corporations.<sup>24</sup> Another potential impact of increased board diversity is the possible signaling effect to encourage successful diversity practices throughout all levels of the corporation.<sup>25</sup>

As discussed throughout this conference, there are multifaceted rationales for increased diversity on corporate boards. When viewed in the aggregate, these rationales provide a strong basis for urging increased board diversity. Policy makers’ and decision makers’ evaluations of the various rationales will eventually lead to their answer regarding what approach is preferred or would be optimal in terms of corporate governance. Another question is the extent to which the rationale chosen to support board diversity as a positive value should impact the legal regime and the laws applicable to corporate governance.

Until 2010, there were no laws or regulations directly addressing diversity on corporate boards, but, as discussed below, new SEC rules require disclosure of board diversity policies.<sup>26</sup> At the extremes, if the business case presented a strong case, then one could argue that we

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22. Press Release, GivingUSA Found., U.S. Charitable Giving Falls 3.6 Percent in 2009 to \$303.75 Billion (June 9, 2010), available at [http://www.givingusa.org/press\\_releases/gusa/gusa060910.pdf](http://www.givingusa.org/press_releases/gusa/gusa060910.pdf) (reporting that corporate charitable contributions totaled \$14.1 billion in 2009).

23. See *supra* note 16 and accompanying text.

24. Fanto et al., *supra* note 11, at 935 (“[W]e feel that, if diversity advocates justify board diversity on other grounds and norms, they could promote a transformation in the social identity of boards. Although this transformed identity might have a subsidiary benefit of improving board functioning, it is enough for us that it reflects and promotes antidiscriminatory norms.”).

25. Cf. Patrick S. Shin & Mitu Gulati, *Showcasing Diversity*, 89 N.C. L. REV. 1017, 1027–31 (2011) (criticizing the signaling impact as too shallow a rationale to support something as important as diversity).

26. In 2010 the SEC implemented amendments to its disclosure regulations to require a publicly held company to disclose its policy, if any, on the role of diversity in board selection. See 17 C.F.R. § 229.407(c)(2)(vi) (2010) (amending Regulation S-K to require disclosure of “whether, and if so how, the nominating committee . . . considers diversity in identifying nominees for director”). The SEC disclosure requirement is discussed *infra* notes 40–41 and accompanying text.

should require diversity on boards, just as publicly held corporations must have a significant number of independent directors.<sup>27</sup> Policy makers believe that independence on corporate boards is important to good corporate governance.<sup>28</sup> If empirical studies ever progress to the point where they can provide compelling support for the business case for board diversity, then legislation or regulatory intervention would seem appropriate. In addition, a social justice rationale for board diversity may encourage corporations to increase diversity, but it is not so strong as to have convinced policy makers to apply the antidiscrimination laws to corporate boards.

As a general matter, Title VII of the Civil Rights Act promotes equal opportunity in employment.<sup>29</sup> The Act's coverage depends on the definition of *employee* as interpreted by the courts and the Equal Employment Opportunity Commission ("EEOC"). The interpretation of *employee* under Title VII parallels the definition under the National Labor Relations Act,<sup>30</sup> which focuses, among other things, on whether the alleged employment relationship makes the putative employee "economically dependent for his livelihood on the business to which he renders service."<sup>31</sup> However, it is clear under

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27. For a discussion of the importance of independent directors for public companies, see 2 JAMES D. COX & THOMAS LEE HAZEN, *TREATISE ON THE LAW OF CORPORATIONS* §§ 9.2–9.3 (3d ed. 2010). The SEC did not equate the importance of diversity with the importance of independent directors. See Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,343–44 (Dec. 23, 2009) (adopting the board diversity policy disclosure requirement but not going further).

28. See 15 U.S.C. § 78j-1(m)(3) (2006) (requiring independence for a membership on audit committee); see also 15 U.S.C. § 80a-55 (2006) (requiring that the majority of directors be independent persons). See generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (concluding that the growing emphasis on independent corporate boards has been beneficial).

29. In relevant part, the Act provides that it is unlawful for an employer:

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or

(2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.

42 U.S.C. § 2000e-2(a) (2006).

30. 29 U.S.C. §§ 151–169 (2006).

31. *Hickey v. Arkla Indus., Inc.*, 699 F.2d 748, 751 (5th Cir. 1983) (citing *Usery v. Pilgrim Equip. Co.*, 527 F.2d 1308, 1311 (5th Cir. 1976)); see also, e.g., *Bartels v. Birmingham*, 332 U.S. 126, 130 (1947) ("[I]n the application of social legislation employees

current law that the Act's provisions do not extend to corporate directors.<sup>32</sup>

Since the Civil Rights Act does not extend its protections to corporate boards, an alternative might be to have a direct federal mandate with respect to corporate governance. However, corporate governance has traditionally been left to the states.<sup>33</sup> Substantive corporate law in the United States is based on the state chartering statutes that permit and define corporate existence.<sup>34</sup> State corporate law is largely enabling and thus would likely not be the appropriate venue for addressing board diversity issues absent clear proof that board diversity leads to better corporate governance. In contrast to the chartering and governance approach of state law, which is largely enabling, the federal securities laws focus on investor protection and therefore work to restrict corporations that fall under their jurisdiction.<sup>35</sup> Within that mission the securities laws focus on disclosure and providing information that investors deem significant

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are those who as a matter of economic reality are dependent upon the business to which they render service.”).

32. The EEOC concludes that board members are not employees simply by virtue of their position on the board:

[T]he record reveals that Respondent's Board of Directors are elected by member businesses and that their primary purpose is to set policy. They are not subject to the control of Respondent's officers or administrative staff, nor do they receive any compensation for performing their functions. In light of these facts, we cannot conclude that an employee-employer relationship exists between Respondent and its Board of Directors and that the Board's members may be considered employees.

EEOC Decision No. 75-273, 11 Fair Empl. Prac. Cas. (BNA) 1485, 1486 (1975).

33. See 1 COX & HAZEN, *supra* note 27, §§ 2.4–2.5 (discussing the evolution of modern corporate law).

34. As I have explained elsewhere:

From the earliest conception of the private corporation, the state has created a contractual right of corporate existence in the form of the corporate charter. The process began with the sovereign's case-by-case granting of specific charters and has since evolved into the current scheme of general chartering statutes under which any entity which complies with the statutory norms is entitled to a corporate existence. These statutes, which differ from state to state, not only provide for the necessary formalities, but also form at least a starting point for the substantive norms of intracorporate governance. Of course, common law principles of agency and fiduciary responsibilities also provide a major part of the law regarding the day-to-day functioning of a corporate entity.

Hazen, *supra* note 17, at 392 (footnotes omitted).

35. See generally 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2 (6th ed. 2009) (discussing the origins and scope of securities regulation at the state and federal level).

in making investment decisions.<sup>36</sup> For a long time the SEC has recognized investors' interest in matters beyond a company's bottom line.<sup>37</sup>

When the SEC solicited comments regarding amendments to its rules on proxy solicitations, it received a number of responses urging the Commission to address board diversity.<sup>38</sup> After considering the comments, the SEC amended Regulation S-K<sup>39</sup> to require the management of a publicly held company to disclose in its annual proxy statement—the mechanism used to solicit shareholder votes—the extent to which a nominating committee considers diversity in identifying director nominees.<sup>40</sup> This requirement is relatively modest. It does not require that a company have a policy on the role of diversity in board nominations. Rather, it simply requires disclosure if such a policy exists.<sup>41</sup> The disclosure requirement alerts investors to the policy and allows them to decide how to react (if at all) to the absence of such a policy. This diversity disclosure was a relatively small component of enhanced disclosures relating to corporate governance.<sup>42</sup>

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36. See Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1340–41 (1966); William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171, 173 (1933); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 34–35 (1959).

The federal securities laws' concept of materiality, which draws the dividing line between things that need to be disclosed and those that do not, focuses on what investors deem significant. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (noting that materiality depends on whether there is "a substantial likelihood that a reasonable shareholder would consider it important"); accord *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (applying the *TSC* standard for materiality). "For the securities lawyer 'materiality' is the name of the game." RICHARD W. JENNINGS & HAROLD MARSH, JR., *SECURITIES REGULATION* 1023 (5th ed. 1982).

37. See, e.g., *SEC v. Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 829–30 (E.D. Wis. 1978) (finding that improper sales practices and management integrity are material concerns to investors, even though not directly impacting the bottom line); *Franchard Corp.*, Securities Act Release No. 4,710, 1964 WL 67454, at \*13 (July 31, 1964) (explaining that management integrity is a matter of shareholder concern).

38. See Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,334–44 (Dec. 23, 2009); see also, e.g., Letter from Lissa Lamkin Broome & Thomas Lee Hazen, Professors of Law, Univ. of N.C., to SEC (Sept. 15, 2009), cited in Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,355 n.193.

39. Regulation S-K, 17 C.F.R. pt. 229 (2010), sets forth disclosure requirements for SEC filings and spells out in detail with respect to the narrative portion of SEC filings what must be disclosed and the manner in which it is to be presented.

40. 17 C.F.R. § 229.407(c)(2)(vi) (2010).

41. *Id.*

42. The amendments also require more detailed disclosure of the board's leadership structure, including whether the company has a combined or separate chief executive officer and chairman position, and the board's role in risk oversight. § 229.407(h). In

Although the SEC rules provide a significant first step in recognizing the importance of board diversity and its relevance to many investors, the rule could have done more. For example, the SEC could have given investors even more meaningful information on board diversity had it required disclosure of the ethnicity, race, and gender of existing board members.<sup>43</sup> The existing required disclosures regarding board members and nominees have no such requirement. Often, it is possible to discern gender from a first name, but this is imperfect at best given the number of names that are gender neutral. Race and ethnicity similarly cannot be discerned as a name can be an imperfect indicator. It would be helpful for investors to be able to identify the composition of the board in order to determine whether the board make-up reflects adequate diversity for those investors' interests, regardless of whether the company has a diversity policy. This information would be helpful to investors believing in diversity either as a matter of social justice or because of the business case.<sup>44</sup>

Although it requires disclosure of diversity policies, the SEC did not precisely define *diversity*. There is some concern that the SEC's failure to define *diversity* is problematic.<sup>45</sup> In adopting its board diversity policy disclosure requirement, the SEC left to companies making the disclosure "to define diversity in ways that they consider appropriate."<sup>46</sup> Professor Fairfax decries the failure to define *diversity* as "perhaps most devastating to the rule's potential effectiveness."<sup>47</sup> Reasonable people can differ as to what type of diversity is beneficial to corporate governance. Limiting the concept of diversity would seem to be at odds with the purpose of the rule. The required disclosures are designed to inform investors as to what diversity policies are in place. A definition of diversity might result in unduly limiting what investors can learn from the disclosures. The SEC noted that diversity may include "concepts such as race, gender and national

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addition, management must disclose fees paid to compensation consultants and their affiliates in certain circumstances. § 229.407(e)(3)(iii).

43. See Letter from Lissa Lamkin Broome & Thomas Lee Hazen to SEC, *supra* note 38, at 2 (urging such a disclosure requirement).

44. The SEC received a number of comment letters that indicated this is the case. See Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,343 nn.116–18 (Dec. 23, 2009).

45. See Fairfax, *supra* note 2, at 874–75.

46. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,344 ("We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate. As a result we have not defined diversity in the amendments.").

47. Fairfax, *supra* note 2, at 874.

origin.”<sup>48</sup> However, the SEC observed that a company’s concept of diversity may also “include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes.”<sup>49</sup> The absence of a definition in the SEC rules may actually help inform investors. For example, they can determine which companies expressly include gender, race, and ethnicity in their diversity policies and which do not.

The SEC rulemaking on director diversity responds to various concerns. The SEC’s adoption of the board diversity policy disclosure requirement can be seen as an acceptance of at least the “appearance” of the business case’s validity.<sup>50</sup> However, its basis is not limited to the business case. The fact that shareholders and potential investors may be interested in board diversity is itself a sufficient justification for disclosure.

For a long time, the SEC, in its shareholder proposal rule, has recognized the importance of shareholder views on corporate governance.<sup>51</sup> The shareholder proposal rule embodies the SEC’s long-established belief that investors have a legitimate interest in the ways in which a company’s activities impact issues of major social concern.<sup>52</sup> The director diversity policy disclosure requirement can be seen as consistent with investors’ social responsibility concerns. Professor Fairfax acknowledges that these diversity factors may be significant for corporate governance, but she is concerned that what she considers to be an inadequate definition dilutes the concept.<sup>53</sup> Her main concern is that this in turn takes away from companies’ incentives to increase diversity.<sup>54</sup>

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48. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,344.

49. *Id.*

50. Fairfax, *supra* note 2, at 866 (“[T]he SEC referenced, among other things, the fact that commentators noted the appearance of a ‘meaningful relationship between diverse boards and improved corporate financial performance.’” (quoting Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,344)).

51. SEC Rule 14a-8 gives shareholders access to management’s proxy statements with respect to shareholder proposals for consideration at shareholder meetings. 17 C.F.R. § 240.14a-8 (2010).

52. In interpreting the shareholder proposal rule, the SEC consistently concludes that management may not exclude from its proxy statement matters of significant social concern. *See* 3 HAZEN, *supra* note 35, § 10.8[8] (discussing the “ordinary business” exception to the shareholder proposal rule).

53. Fairfax, *supra* note 2, at 874–75.

54. *Id.* at 875 (“The failure to define *diversity* could limit significantly the ability of the SEC’s new rule to alter the status quo with respect to racial and gender diversity on boards.”).

Professor Fairfax's concern is misplaced. The SEC disclosure requirement is not designed to shape conduct.<sup>55</sup> Rather, it is designed to inform investors how a company views the role of diversity in the nomination of directors.<sup>56</sup> If investors are dissatisfied with a company's policy or lack thereof, they can become more proactive. In the past, investors have taken action by making shareholder proposals to increase board diversity.<sup>57</sup> If nothing else, the SEC's new disclosure requirement will keep diversity in people's minds. Even a company without a board diversity policy will be reminded of that fact each year when it makes its proxy disclosures and has nothing to disclose. In addition, the new requirement may trigger a resurgence in shareholder proposals calling for consideration of diversity in companies' board nomination policies.<sup>58</sup> In any event, a disclosure approach seems commensurate with the current rationales and evidence favoring board diversity.

More compelling data supporting the business case for increasing diversity on corporate boards could justify statutory or regulatory intervention. As explained above, typically the state of incorporation sets the rules for corporate governance, so there would be an appropriate forum for corrective legislation if warranted by the business case. Only in extreme cases has federal legislation ventured into corporate governance.<sup>59</sup> The current state of the business case for board diversity is at best equivocal, based on the current empirical evidence. Accordingly, there does not appear to be sufficient justification at this time for a federally mandated corporate governance structure that would include board diversity. Alternatively, federal civil rights legislation could provide an appropriate forum for addressing board diversity through inclusion in Title VII protections. While this may be warranted at some point in the future, it seems premature at this juncture, given the inconclusive

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55. See Hazen, *supra* note 17, at 409–12.

56. See *id.*

57. See, e.g., Cypress Semiconductor Corp., SEC No-Action Letter, 1998 WL 113674, at \*1 (Mar. 11, 1998) (stating that management could not exclude from its proxy statement a shareholder proposal requesting “that the Company: (1) make a greater effort to find qualified women and minority candidates for nomination to its board of directors; (2) issue a public statement committing the Company to a policy of board inclusiveness with a program to further these goals; and (3) issue a report describing its efforts to encourage diversified representation on the board, its criteria for board qualification and the process of selecting board candidates and committee members”).

58. See, e.g., Smithfield Foods, Inc., SEC No-Action Letter, 2010 WL 1974680, at \*7 (June 24, 2010) (discussing a proposal relating to mutual funds' voting practices and urging that diversity in board nomination be a factor).

59. See 1 COX & HAZEN, *supra* note 27, § 2.5 (discussing modern corporation laws).

empirical support of the business case. Neither the business case nor other rationales present a strong enough case to warrant laws compelling increased board diversity. Better empirical data could help bring us to this point.

Given the current state of the data, a disclosure approach seems best. As mentioned earlier, however, the SEC should go further than it has and require more than disclosure of board nomination criteria. The interests of investors (especially those committed to CSR) would be even better served by disclosure of the race, gender, and ethnicity of both sitting board members and also of nominees for the board of directors. Such an approach, however, could have a backlash among those interested in perpetuating boards dominated by white males.<sup>60</sup> Nevertheless, the rationales supporting increased diversity and the apparent concerns of investors, including institutional investors such as CalPERS,<sup>61</sup> suggest that increased disclosure would not have such deleterious effects.

The SEC took a significant step with its board diversity policy disclosure requirement. This will provide investors with information regarding the extent to which corporate boards value diversity. In furtherance of this goal, the SEC should consider expanding the rule to require disclosure of the race, gender, and ethnicity of current board members. Over time, there may be a more robust business case that would justify even more proactive government intervention. However, until that occurs, the SEC's current disclosure approach is a well-measured, albeit not perfect, regulatory response.

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60. Cf. Dobbin & Jung, *supra* note 10, at 812, 821–22 (suggesting that such a bias might exist).

61. CalPERS is the California Public Employees' Retirement System and has been a very proactive shareholder in terms of corporate governance. See CAL. PUB. EMPLOYEES' RET. SYS., GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE 7, 9 (2010), available at <http://www.calpers-governance.org/docs-sof/principles/2010-5-2-global-principles-of-accountable-corp-gov.pdf> (advancing a series of principles for accountable corporate governance, including board diversity, that it believes will lead to "sustainable investment returns").

