9 Pathways to Diversity Innovation and Better Strategic Risk Governance

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In observance of Women's History Month and International Women's Day, Governance Clearinghouse is publishing a series of articles focused on gender balance on corporate boards. The series will highlight several facets of this complex issue, including pathways to board diversity, best practices of companies that have achieved gender parity in the boardroom, and the steps aspiring women directors can take to become "board ready."

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The imperative to equip the governance bodies of companies with diverse directors has never been higher – how the U.S. gets there is up for grabs. The EU has already made up its mind that this will be achieved through quotas. Other regions and countries like Canada require explanations of why diversity is low or does not exist. In the U.S., we have the first instance of a state establishing quotas – California – and where California leads other states often follow.

Regardless of external regulatory or market pressures to move the needle on board diversity and inclusion, people see through half-hearted, check-the-box efforts. Rather, companies and their boards, must view their closer approximation to the diversity in society as a net gain for their own resilience, decision making and competitive advantage. More women on boards and at the head of the table or head of countries, just like more diversity of experience and backgrounds, will make for more fulsome decision making. Diversity and inclusion should not be call-out efforts, but rather deliberate initiatives that become ingrained in the DNA of well-run companies.

Diversity improves returns – not only financial but reputational and stakeholder returns as well. Just like demographics, diversity is destiny and for boards that aim to capture this dividend, diversity and inclusion need to be incorporated into broad governance.

How do companies do this? We believe there are nine key pathways to board diversity.

1. Establish a percentage target for diversity (gender, race, ethnicity, national origin, age) that is customized to your business needs.

Many (especially those already ensconced in board seats) abhor government regulations and mandates when it comes to board design. But when nothing changes, or change is glacial, others have come to accept that some government requirements for greater board diversity may not be so bad after all. Witness the recent California law mandating minimum gender diversity for California based companies.

What can companies do to either prevent or end new "onerous" governance laws? There is always the option to be proactive and look at your board, and look at your employee and customer base, and ask yourself the question: does our board reflect the stakeholder populations we serve? There is nothing like a voluntary corporate program to instigate positive change, reputational opportunity and value creation. Indeed, the more companies—and their boards—become a closer reflection of the diversity in society and markets, the less they will fear a reputational backlash for issues like the gender pay gap, the #MeToo movement or other "externalities".

2. Broaden the talent pool with individuals skilled in the areas of risk, technology, sustainability, ethics and compliance.

Many boards do not include a broad enough pool of skillsets on the slate of possible board candidates. The vast majority of corporate board members are CEOs and CFOs, who on the one hand have clear skills in leading organizations and in financial accountability, but may lack refinement in wielding, responding to and appreciating the effects of "soft power" and intangible, unmeasurable threats – especially those that do not conform to quarterly reporting cycles. People (experienced and business-savvy of course) who hold expertise in areas other than the traditional silos of top financial and operational expertise, are seldom considered for board positions.

What about the treasure trove of highly experienced chief risk officers, chief ethics and compliance officers, heads of investor relations and corporate responsibility, audit, environmental, health and safety, chief information security or technology officers that are everywhere? Not all may be qualified to sit on a board, but undoubtedly the top 10% of these populations would make for an extraordinary addition to any board. Broadening the diversity of skills tapped for boards is as critical as broadening the depth and breadth of diverse talent across all lines.

3. Reshuffle committees to represent current market realities and operating norms.

Most boards have the traditional 3-4 committees: audit, finance, nominating/governance and maybe one more; but rarely one that covers risk, sustainability, compliance and similar "intangibles" separately. Indeed, many boards' audit committees are so oversaturated with responsibilities that anything that comes up that is seen as "extra" – whether ethics and compliance, risk, ESG, health and safety and recently cyber risk – gets thrown into the already overburdened audit committee.

We advocate that each company board look at the mission, vision and strategy of their company and decide what additional committee they might need to tackle their most important environmental, social, sustainability, ethics, technology issues, risks and opportunities. And, of course, in the process, review who on the current board is qualified and capable of being the chair or a member of such a committee. If there is no one present, maybe the time has come to search for a couple of non-traditional and diverse board members with relevant ESG and/or technology expertise? Indeed, a novel concept to stay ahead of a growing market backlash or compliance-driven pressure to improve diversity and inclusion would be to establish a board-level committee to advance and defend these issues across the enterprise. The UK's laws on corporate reporting on gender pay are a good example of the growing pressure and the negative backlash faced by firms that were underperforming on the gender pay gap. Pay parity, like diversity and inclusion, is not only the right thing to do it is a source of resilience, employee motivation and recruitment, as well as competitive advantage.

4. Separate risk and opportunity oversight from audit, perhaps by creating a specialized strategic risk and opportunity committee.

Very much along the lines expressed in point three above, and depending heavily on the industry, footprint and or sector involved, boards should be proactive in looking at their strategy from beyond the traditional mindset. Strategy is not just about growth, revenue and the search for profit, innovation and long term market gains. It is also about looking at strategic risk governance through the lens of the board, which includes considering risk as opportunity.

By separating strategic risk and opportunity evaluation from the audit committee, the board liberates itself from lumping risk into the audit committee's core mission – financial auditing oversight – and allows other considerations to enter the board's field of vision.

Strategic risk oversight is all too often a compliance-driven, check the box activity on most boards, which is why they often find themselves flat-footed and tone-deaf when "surprise" events and crises occur. By liberating important strategic issues – such as technology and digital transformation, climate change risk and opportunity, and leadership and culture as a competitive advantage – from the audit committee, companies and boards will breathe new life into their strategy formulation as they consider risk as part of opportunity creation.

5. Bring in third-party specialists to conduct scenario-based long-range analysis and cross-industry benchmarking.

Another step that can add to board diversity, at least to the diversity of views, is to consider introducing more innovative educational opportunities to the board. This can be achieved through outside and inside experts that will help sensitize the board. For example, experts can offer perspective on the potential crises that the augmented global risk landscape presents to every type of business today, such as culture shifts, cyber threats or climate change.

By dint of the kind of topic that can become a crisis, there is a diversity of experts available both inside the company and outside advisers who are not subject to "paycheck persuasion" to tell the board what they want to hear; these individuals can educate the board and perhaps become a member of the board over time.

6. Separate the CEO from the chair and strategic risk management oversight.

We believe this is a pro-diversity strategy by definition because many CEOs and board chairs suffer from deep diversity challenges. By having the amount of power that they do in a combined role, very little change is possible unless the person himself is in favor of improving governance diversity. The operational benefits from this separation of powers have long been chronicled in the breakdown of decision making, risk management and the types of moral hazards that are bred when power remains unchecked.

In a recent piece we co-wrote for Risk Management Magazine, we detailed and made the case that if the boards of companies that had suffered recent serious crises and scandals had been more diverse leading up to their crisis, it would have helped prevent the crisis in the first place or enabled a more agile response and recovery. And in each of the cases mentioned, the CEO was also the Chairman of the board before and leading up to the crisis event.

7. Enforce term limits and cap the total number of concurrent board seats.

Again, this step is pro-diversity by definition because with more turnover and less entrenchment the opportunity for new and diverse members of a board grow substantially.

Leading good governance advocates including some of the biggest asset managers such as Blackrock, State Street and some of the big state pension funds, have been on the record about preferring term limits for board members. Indeed, in this Harvard Law School Forum on Corporate Governance and Financial Regulation piece written by Jon Lukomnik, he reports on a study of major institutional investors responding to an ISS 2016-2017 Global Policy Survey in which:

> "Among the 120 institutional investors (one-third of whom each own or manage assets in excess of $100 billion) who responded, 68 percent pointed to a high proportion of directors with long tenure as cause for concern…Just 11 percent of the investor respondents said that tenure is not a concern."

What this means in plain English is that boards that have tenures that are too long, or allow for repeated terms over time for the same person without limits, may not be serving the best interests of their shareholders or other key stakeholders – like customers and employees.

8. Create advisory committees of key outside experts to provide new perspectives.

While unusual and uncommon, such advisory committees can include less experienced but highly specialized, more diverse and helpful people who may not be ready for prime-time board seats but are promising candidates to be both listened to and mentored.

One area in which this practice can be specifically helpful is in the technology, cyber-security and digital transformation area, not to mention the clear generational shifts in populations. Most traditional board members are still current or retired CEOs and CFOs who did not grow up during the technological revolution. While it may be wise to have one or more board members with actual technology experience on your board, you might not be able to find the properly seasoned person to perform that role yet. Why not create a feeder advisory board to the corporate board that includes younger, more technologically savvy members who may one day make it to boards as well?

9. Bring in independent, qualified directors and wean CEOs from the habit of appointing "friends and family" to the board.

The "friends and family" approach to board packing can be harmful to shareholders and other key stakeholders in the long run (and maybe even in the short run). By definition these kinds of boards are very un-diverse – mainly created by founders who are typically white men (although many can be fairly young as founders of tech start-ups).

We think that the long-term profitability and resilience of companies - and the acceptance and support of key stakeholders - is served well by the introduction of talented, meritorious board members who may not be friends and family to the founder or a powerfully entrenched CEO (who so often is also the chairman).

We also believe that the best governance solutions come from voluntary board self-evaluation with the help of the right experts to refresh your board. Boards should break out of the cycle of the self-fulfilling prophecies that most traditional board searches continue to do– with the same recycled profiles of people who are already on boards and have been vetted by the same handful of search firms. Such an approach will assure the continued un-diverse nature of many boards. Breaking that cycle will do the reverse - unearth the many non-traditional and highly qualified talents that are out there in search of board service.

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Diversity is resilience, innovation and competitive advantage because diversity is destiny - both at the macrocosmic level of national demographics and at the microcosmic level of every company.

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