Securities Regulation Daily Wrap Up, CORPORATE GOVERNANCE—Garrett Institute disclosure panel reviews SEC diversity C&DIs and related state law developments, (Apr. 11, 2019)

Securities Regulation Daily Wrap Up

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Disclosure of diversity characteristics is not automatic under the SEC's updated C&DIs. Proposed federal legislation emphasizes disclosure over enforcement, which is the focus of related state legislation.

The public company disclosure panel at the 39th Annual Ray Garrett Jr. Corporate & Securities Law Institute held at Northwestern University's Pritzker School of Law discussed the SEC's recently issued Compliance and Disclosure Interpretations on board diversity and the key differences between proposed federal board diversity legislation and the approach taken by California. The panel discussion is summarized below and then followed by a sampling of state and federal legislation plus additional information about the SEC's updated C&DIs on board diversity disclosures.

Privacy interests. Panelist Patrick Daugherty of Foley & Lardner, LLP cited data indicating that most S&P 500 companies have at least one female director (many of these companies have two female directors). But he also noted that other data from a PwC survey found disagreement between men and women about whether political correctness underlies board room diversity efforts: overall, 52 percent said yes, but men (58 percent) were more likely than women (26 percent) to answer yes. He further noted that demands from both institutional investors and proxy advisers can influence board diversity.

Daugherty then summarized the several components of the SEC's new C&DIs updating board diversity disclosures under Regulation S-K Items 401 and 407. Before a disclosure could be made under the C&DIs, the board nominee or board member must first self-identify as having a diversity characteristic, that person must then consent to disclosure, the board's nominating committee must then consider the disclosure, and finally, disclosure can be made.

Daugherty asked Michele Anderson, Associate Director for Disclosure Operations within the SEC's Corporation Finance Division, why the agency did not go further with its C&DI update. Anderson offered two reasons: (1) C&DIs are merely guidance; and (2) the updated C&DIs reflect companies' concerns about the privacy interests of their board members.

With respect to legislation, Daugherty noted the varied approaches under proposed federal legislation and California's law. A bill introduced in Congress would focus on disclosure by companies of the extent to which their officers and directors self-identify as having a diversity characteristic. By contrast, California's approach is less about disclosure and more about enforcement for a company's failure to meet statutory diversity requirements. Daugherty observed that California's law, if challenged, could rise or fall on Equal Protection grounds.

California's law. In 2018, California enacted a law (SB 826) that requires a public company with its principal executive offices located in California (as determined by the company's Form 10-K) to have at least one female director on its board of directors by the close of 2019. A company can increase the size of its board in order to comply. A further requirement states that, by the close of 2021, such companies must have a minimum number of female directors based on the size of the company's board:

- Six or more directors: at least three female directors.
- Five or more directors: at least two female directors.

- Four or fewer directors: at least one female director.

The California law also authorizes the Secretary of State to implement it via regulations and to impose penalties for violations. For example, the penalty for the failure to file required information with the Secretary of State would be $100,000. Moreover, the penalty for a first violation also would be $100,000, while a second or subsequent violation would be $300,000. However, no violation would occur if a female director held a board seat for at least part of the year.

"Female" is defined to be inclusive and would appear to include to transgender persons. Thus, "female" means "an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth." The law also defines "publicly held corporation" as a company whose shares are listed on a major U.S. stock exchange.

California's board diversity law has generated much interest and concern regarding how companies will comply with it and whether it can withstand potential legal challenges. California's Secretary of State is due to publish its first report on the number of companies located in California with at least one female director in July 2019. At least one proxy advisory firm, ISS, has predicted that the law will result in a significant increase in women directors at California-based companies.

Illinois bill. Illinois lawmakers are likewise considering a bill to address concerns about diversity on public company boards. However, unlike California's law, the Illinois bill (HB 3394), which passed the House 61-27, would require public companies located in Illinois to have on their board of directors at least one female director *and* one African American director by the close of 2020. The Illinois bill makes no provision for the size of a company's board as does California's law.

The definition of "female" would track the California law. The bill would define "African American" to mean "a citizen with at least partial Sub-Saharan African ancestry and who self-identifies as being African American."

Penalties under the Illinois bill would be identical in amount to those imposed under the California law. For purposes of determining the principal executive office, reference would be made to a company's Form 10-K. A public company would be a company whose shares are listed on a major U.S. stock exchange. During consideration of the bill in the Illinois House, lawmakers made one amendment (HB 3394 as introduced) to eliminate the penalty for the Illinois Secretary of State's failure to publish a required report.

New Jersey. Lawmakers in New Jersey in 2018 introduced a bill (A 4726) on gender diversity on corporate boards. The bill would require a public company with its principal executive office in New Jersey (as determined by reference to its Form 10-K) to have at least one female director. Unlike Illinois, but like California, such companies must further comply with a board size provision:

- Six or more directors: at least three female directors.
- Five or more directors: at least two female directors.
- Four or fewer directors: at least one female director.

The penalty amounts for violations would track both California's law and Illinois's proposed legislation. Both New Jersey and California provide that if a female director holds a board seat for part of the year, that would not be violation (Illinois's bill appears to have no equivalent provision).

The New Jersey definition of "female" would be identical to definitions in California's law and Illinois's proposed legislation. Likewise, New Jersey's definition of a "publicly held" company is a company with shares listed on a major U.S. stock exchange. Moreover, a company could increase its board size to comply with the proposed law.

Pennsylvania resolution. Members of Pennsylvania's House introduced a resolution (House Resolution No. 114) encouraging publicly held companies in the state to have a minimum number of female directors on their boards of directors. The resolution notes California's leadership on the issue of board diversity while also citing research by Credit Suisse Research showing that companies with women holding at least 15 percent of senior manager jobs are 50 percent more profitable than companies with fewer than 10 percent women among their senior managers.

As a result, the Pennsylvania resolution urges that by 2021 public companies in the state add female directors based on board size:

- Nine or more directors: at least three female directors.
- Five to eight directors: at least two female directors.
- Fewer than five directors: at least one female director.

A 2017 Colorado resolution cited similar research and encouraged Colorado public companies to add female directors on the same terms as the more recent Pennsylvania resolution.

CorpFin issues diversity C&DI update. Companies may need to do more to meet their disclosure obligations regarding the self-identified diversity characteristics of director nominees who have agreed that the company can disclose these characteristics about them, according to a pair of new C&DIs issued by the SEC's Division of Corporation Finance. The C&DIs note that self-described diversity characteristics can include "race, gender, ethnicity, religion, nationality, disability, sexual orientation, or cultural background." CorpFin's new mirror image C&DIs (Questions 116.11 and 133.13) were its first issued since the federal government reopened and provide guidance to companies regarding how to apply Items 401 and 407 of Regulation S-K.

Under Item 401 of Regulation S-K, a company must provide a description of director nominees' backgrounds. The C&DIs explain that this description should cover a variety of items, including "specific experience, qualifications, attributes, or skills." Under the new C&DIs, the Item 401 disclosure should, at minimum, identify self-identified diversity characteristics and state how they were considered by the nominating committee or by the board.

Item 407(c)(2)(vi) of Regulation S-K requires a description of a company's process for nominating and evaluating director candidates. As part of that disclosure, a company must explain whether and how it considers diversity in identifying directors. A company must further describe how its diversity policy is implemented and how it judges the policy's effectiveness.

The new C&DIs state that, for purposes of Item 407(c)(2)(vi) of Regulation S-K, a company should explain how it considered self-identified diversity characteristics under its diversity policy. That discussion also should note how the company considered other factors within the scope of its diversity policy, including "diverse work experiences, military service, or socio-economic or demographic characteristics."

Federal legislation. Senator Robert Menendez (D-NJ) and Rep. Gregory Meeks (D-NY) have introduced mirror image bills that would require public companies to disclose data on diversity. The bills are predicated, in part, on a 2017 survey Sen. Menendez conducted in which 61 of the Fortune 100 companies participated and which, in the senator's view, showed a need for greater diversity among corporate leadership teams. The bills also come at a time when the need to address diversity issues has become more imminent, for example, under California's board diversity law. The SEC's updated C&DIs also provide further reason for companies to consider self-identified diversity characteristics.

According to Sen. Menendez, the Improving Corporate Governance Through Diversity Act of 2019 (S. 360) and its House counterpart (H.R. 1018) would address the results of the senator's 2017 Corporate Diversity Survey. That survey, the senator said, indicated a need for greater "representational diversity." This need is underscored by two trends Sen. Menendez said he sees going forward: (1) an increasingly diverse America; and (2) lagging minority representation in fields likely to see the most growth in the coming years, such as technology and professional fields.

The legislation has early backing from several major business groups. The U.S. Chamber of Commerce said the legislation would "organically" increase board diversity without reliance on quotas while also promoting transparency and creating a private sector advisory group. The Council of Institutional Investors said in a letter that the proxy disclosures required by the legislation would align with the CII's own policies on board diversity, which look to a number of factors, including "background, experience, age, race, gender, ethnicity, and culture."

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