REPORT
Futures & Derivatives Law
The Journal on the Law of Investment & Risk Management Products
May 2021 · Volume 41 · Issue 5

BOOSTING FINANCIAL SERVICES C-SUITE AND BOARD DIVERSITY IS A BUSINESS AND REGULATORY IMPERATIVE

By Douglas E. Harris

Douglas E. Harris *is a former Managing Director of Promontory Financial Group, an IBM Company. Prior to joining Promontory, he was the General Counsel and Chief Operating Officer of BrokerTec Futures Exchange, LLC. and BrokerTec Clearing Company, LLC. From 1993 to 1996, he held the position of Senior Deputy Comptroller for Capital Markets at the Office of the Comptroller of the Currency. Previously, Mr. Harris served as Assistant General Counsel of JPMorgan and General Counsel of JPMorgan Futures, Inc. Mr. Harris is a public director of National Futures Association, the self-regulatory organization of the U.S. derivatives industry, where he serves on the Executive Committee, the Audit Committee and the Compliance & Risk Committee. Mr. Harris earned a J.D. from Harvard Law School in 1975 and an A.B. (with honors) from Harvard College in 1972.*

Diversity, Equity and Inclusion (DEI) programs, in one form or another, have existed for many years at large U.S. companies, including those providing financial services. Unfortunately, other than with respect to gender, their success has generally been limited to increasing the number of individuals from underrepresented groups (Blacks, indigenous and people of color, or BIPOC, and LGBTQ) in junior level positions or positions with limited upward mobility. There has been little change in the racial or sexual orientation diversity of senior management and even less in the diversity of corporate boards. This is no longer acceptable: Increasing the diversity of senior management and corporate boards is now a business and regulatory imperative. Financial services firms that fail to do so risk underperformance relative to those that do. They also face increased public and regulatory scrutiny and the potential loss of customers and market share due to the failure to manage their reputation risk. Their inaction or indifference will contribute to the ongoing inequity in the delivery and provision of services and products to minority communities and minority-owned businesses.

THE EVOLUTION OF DEI PROGRAMS

Since becoming popular in the 1980s, diversity initiatives have been less than successful in creating a diverse workforce at all levels and in all functions of financial services companies due to a number of factors, among them a lack of organizational commitment to such programs and a primary focus on entry-level hiring. The emphasis on the entry level seemed to make sense as it addressed what was perceived to be a pipeline problem of inadequate numbers of qualified individuals from underrepresented groups to advance to and diversify senior management. Over time, companies have realized that addressing retention, compensation and promotion of underrepresented groups is every bit as important as hiring them in the first place. And establishing a culture of inclusion to create a sense of belonging on the part of employees from underrepresented groups is key to achieving and maintaining a diverse work force over the long run.

The murder of George Floyd and other events of 2020 led to a broader public embrace of the Black Lives Matter movement and a focus on racial inequity with respect to all aspects U.S. life: policing, employment, housing, health care, access to financial services, and the civil and criminal justice systems. As a result, many financial services institutions, financial market infrastructure companies, and the lawyers, consultants and accounting firms that provide services to them began to focus on racial equity in their business operations and with respect to the products and services they provide. Increasingly, these firms have turned to racial equity audits (often in response to shareholder pressure) to identify and remediate those corporate policies, procedures, systems and practices that, often unintentionally, result in inequitable treatment of employees from underrepresented groups. In fact, as with establishing a culture of inclusion, remediating such inequities is key to addressing issues related to the retention, promotion and compensation of junior and mid-level staff from underrepresented groups in order to achieve greater diversity in the ranks of senior management. Unfortunately, years after the implementation of DEI programs, a recent study concludes that racial diversity in senior management of large U.S. financial services companies actually decreased during the 10 years before 2018 from 2.87% to 2.62%.[1]

Recently, the U.S. Congress,[2] state governments,[3] regulatory agencies, business partners[4] and shareholders have focused their attention on the lack of diversity on corporate boards. The increasingly shared view is that a diverse corporate board (i) is more likely to look critically at its current business and operations and appropriately address any identified inequity in policies, procedures, operations, products and services, (ii) is more likely to improve corporate decision-making resulting in a more competitive and successful entity, and (iii) sends the strongest possible message to the firm's stakeholders, specifically including its employees, about its commitment to a diverse, fair and equitable workplace. Accordingly, it is incumbent upon financial services firms to redouble their efforts and employ new tactics and forward-thinking strategies to achieve their diversity goals and, most importantly, to diversify their senior management and boards.

BUSINESS CASE

The traumatic events of 2020 led most financial services firms to enhance their DEI programs to address the issues raised by the Black Lives Matter movement and the increased public embrace of diversity as a moral and social imperative. The enhancements were consistent with an evolving view that, in addition to treating employees well, complying with laws and regulations, and returning shareholder value, corporations have a broader social responsibility to their communities and the collective well-being of citizens. But the business case for diversity is now also grounded in the fact that diverse firms make better decisions, make better use of available talent, and better manage their reputational risk—in short, they perform better and are more successful. "There is loads of research that shows the quality of decision-making is better among groups that are diverse in their composition and their experiences than homogeneous groups," Federal Reserve Board Governor Lael Brainard says.[5] And, in recent remarks concerning the need for greater diversity of staff, and particularly economists, at the Federal Reserve Board, Chairman Jerome Powell said "Institutions that focus on diversity and do it well are the successful institutions in our society."[6]

PERFORMANCE AND TALENT

Numerous academic and industry studies demonstrate that more diverse organizations, boards, committees and teams make better decisions by any number of measures.[7] "We're no longer debating the issue of whether or not diversity adds value to a company," says Aisha Mastagni, a portfolio manager at CalSTRS, which manages a $289 billion retirement fund for California state educators, and co-chair of the Human Capital Management Coalition of investors. "There's so much evidence and academic studies that show diversity adds value that we've gotten past that debate and gotten to what companies are trying to do to move the needle."[8]

However, even in the face of overwhelming evidence of the corporate value of diverse decision-making teams and corporate boards, there is opposition from some very powerful voices. Some of this opposition is likely due to unconscious bias—deep-seated prejudices that form outside conscious awareness—training with respect to which is one of the fundamental elements of most DEI programs.

In a January 20, 2021 opinion editorial[9] for *The Wall Street Journal*, Arthur Levitt, a former chairman of the Securities and Exchange Commission, addressed the merits of the Nasdaq rule[10] proposal currently pending approval by the SEC, which would require that listed companies increase the diversity of their boards. The rule proposal is similar to the recently amended California law[11] mandating board diversity with respect to gender, race, ethnicity and sexual orientation. The title of Mr. Levitt's article—"If Diversity Works, Show Me the Money"—provides a clear indication of what his arguments are, to wit:

- Though academic studies appear to show the value of gender diversity, those studies showing better performance by corporate boards that are diverse across other dimensions, specifically including race, than by all-white male boards, are inadequate (a statement he does not substantiate), and

- That corporate value of diverse board members should be determined only by traditional quantifiable financial metrics (notwithstanding that corporations do not routinely assess whether a new white male board prospect will necessarily add quantifiable value in terms of sales, revenues, profit, or market capitalization).

Mr. Levitt also attacked the effectiveness of the Mansfield Rule,[12] which is based on the National Football League's Rooney Rule,[13] pursuant to which law firms commit that a certain percentage of diverse prospects be considered for any senior position. In all, 150 of the largest U.S. law firms have voluntarily committed to the Mansfield Rule and a number of the largest U.S. financial institutions have now adopted variations of the Mansfield Rule, some committing to not just interview a percentage of diverse candidates, but to actually hire a certain percentage of diverse candidates. In Mr. Levitt's view, the results of the Rooney Rule have been mixed in terms of Black coaches in the NFL. Though he is right that the long-term results have been mixed, he doesn't clarify that they have been mixed in terms of the number of Black coaches hired and not in terms of their performance. He also doesn't explain why the rule hasn't resulted in a significant increase in the number of Black coaches or discuss those situations where it has been successful, which is generally when teams consider more than the minimum "required" number of minority candidates.

Upon close examination, Mr. Levitt's arguments collapse under their own weight. Maybe most telling is his summation that "Successful companies can't keep secrets quiet for long; if one could reliably increase its market capitalization by, say, 5% through the appointment of a diverse board, every company on Nasdaq would already meet this standard." Why a 5% capitalization standard? He doesn't say. His statement also ignores this country's history and the fact that racism and bigotry have historically trumped what would otherwise be good business decisions. It is likely that in 1947 many whites held the view that there were no Black major league baseball players because they lacked the skills to make their teams better, more competitive and more profitable. And they were just as wrong then, as Mr. Levitt is today.

In writing his op-ed, Mr. Levitt was able to leverage his career and influence as a former regulatory and corporate leader to have his viewpoint shared, amplified and accepted, an option not generally available to those BIPOC and LGBTQ individuals whose value to the corporate world he questions.

REPUTATIONAL RISK; PARTNER AND STRATEGIC RELATIONSHIPS

All firms need to manage their risk, and financial services firms are required by their regulators to manage their risk across multiple dimensions: credit, market, liquidity, operational, strategic and reputational. A recent article in Politico Pro[14] said "U.S. companies are coming under intense pressure to diversify their executive ranks, with shareholders more than doubling their formal demands for audits and increased scrutiny on hiring and promotions." In that same article, Michael Passoff, CEO of Proxy Impact, a shareholder advocacy group that tracks resolutions on environmental, social and governance issues, is quoted as saying that "Companies came out making statements in support of racial justice, and now shareholders are going to hold them to it."

In fact, those firms that don't live up to their public commitments with respect to diversity, equity and racial justice will increasingly face reputational risk, which could be realized by calls for boycotts of their products or services, resulting in declining sales and revenues and loss of market share; by embarrassing shareholder resolutions to hold corporations and their board members accountable; and by the likelihood that certain other companies, including key strategic business partners, will decline to do business with them. In January 2020, Goldman Sachs CEO David Solomon said the bank would no longer work on initial public offerings unless a company had at least one diverse director.[15] Other large U.S. companies, such as Microsoft, U.S. Bancorp, Intel, Uber and Wells Fargo, have stated that they will retain only suppliers that also evidence a commitment to diversity and, in some cases, retain only law firms that commit to fielding diverse teams.[16]

REGULATORY IMPERATIVE

Of course, some influential U.S. business leaders and business associations don't accept the evolving view of corporate social responsibility and aren't convinced that diversity across an organization and business functions can necessarily enhance shareholder value. Nevertheless, these individuals and organizations must understand and accept that an effective DEI program is increasingly a regulatory imperative.

In just the last few years, financial services regulators have included their expectations regarding senior management and board diversity in guidance and examination manuals, notwithstanding weakened regulatory enforcement by the Trump Administration.[17] For example, on February 26, 2021, the Federal Reserve Board released final supervisory guidance setting forth its expectations for boards of directors of large financial institutions.[18] The Fed's guidance applies to boards of domestic bank holding companies and savings and loan holding companies with total consolidated assets of $100 billion or more, as well as nonbank financial companies that may be designated as systemically important by the Financial Stability Oversight Council in the future.

The Fed's guidance details five attributes of an effective board of a large financial institution, which Fed examiners will use to evaluate such boards. Attribute 5 requires that a large financial institution "Maintain a Capable Board Composition and Governance Structure." In explanation of this attribute, the Fed states that "an effective board establishes a process designed to identify and select potential director nominees with a mix of skills, knowledge, experience and perspectives. This process takes into account, for example, a potential nominee's expertise, availability, integrity and potential conflicts of interest and considers a diverse pool of potential nominees, including women and minorities."

In addition, banking and market regulators require that firms manage reputational risk, just as they do credit, market, operational and liquidity risk, because the failure to do so exposes an institution to potential financial loss as result of loss of business from state and local governments who will refuse to do business with them (see California law referenced above), inability to access certain critical markets (see Nasdaq rule proposal), and the loss of market share as a result of organized consumer boycotts or general aversion to their product and services.

CONCLUSION

Predictably, some companies are now failing to follow through on the commitments they made following the racial unrest of 2020; they are resisting the racial equity audits necessary to identify corporate practices that unnecessarily disadvantage BIPOC and that are impeding the effectiveness of their DEI programs.[19] And, they have, for the most part, withheld their support for the proposed Nasdaq rule. This quiet opposition on the part of corporations has received less notice than it should. (The public's attention has been captured by op-eds by corporate legends like Arthur Levitt[20] and Warren Buffet[21],[22] and campaigns by the Republican Party[23] that express doubt about the benefits of diverse boards.) This is most unfortunate—these large corporations risk failing to meet their social responsibilities to the communities they serve, negatively impacting their businesses by failing to tap into underutilized pools of talent, hindering their boards' ability to make the best strategic decisions for their companies, and also exposing themselves to regulatory and reputational risk.

Fortunately, some financial services firms are stepping up and enhancing their DEI programs by implementing aggressive and innovative initiatives and relationships, as are the Futures Industry Association, the Securities Industry and Financial Markets Association, and National Futures Association, which are leading the derivatives and securities market participants they represent and regulate by example. These initiatives and relationships include:

- Partnering with Historically Black Colleges and Universities and community-based organizations to ensure a pipeline of diverse talent

- Committing to adherence to the Mansfield Rule or some variation of it

- Committing to hiring a certain percentage of individuals from underrepresented groups over a specified time or by a certain date

- Implementing mentorship programs for employees from underrepresented groups that will hopefully develop into the types of sponsorship relationships that many senior Black financial services officers have indicated were crucial to their success[24]

- Making better use of data to identify issues and track progress in hiring, promotion, compensation and retention, and employing racial equity audits to identify the unintended discriminatory impacts of policies, procedures, systems, technology and business practices

- Ensuring diverse representation on hiring, compensation, and promotion committees

- Including an assessment of senior managers' diversity efforts as a metric in their annual performance evaluations and compensation decisions

- Ensuring that panels and speakers at conferences and seminars include diverse voices

- Including panels on diversity at industry-wide conferences

- Developing affinity groups within trade associations to provide greater visibility and networking opportunities for individuals from underrepresented groups

Hopefully, the effective implementation of these initiatives and their broader acceptance by U.S. financial services firms, and the market infrastructure, lawyers, consultants, accountants and rating agencies that support our financial markets will help reverse the recent trend and result in significant increases in the number of Blacks and other underrepresented groups on corporate boards and in senior management. Following a decade of little progress with respect to the diversification of corporate boards and a retreat with respect to the diversification of senior management, it is time for real commitment and significant change.

ENDNOTES:

[1]"*Share of Black employees in senior US finance roles falls despite diversity efforts" by Laura Noonan and Taylor Nicole Rogers*, Financial Times, March 30, 2021.

[2]Congressman Gregory W. Meeks (D-NY) recently introduced in Congress the "Enhancing Corporate Governance through Diversity Act of 2021," which would require public companies to disclose the race, ethnicity, gender, and veteran status of their board members, nominees and executive officers.

[3]On September 20, 2020, California Gov. Gavin Newsom signed into law a bill that requires publicly held companies headquartered in the state to include board members from underrepresented communities, including racial and ethnic minorities and the LGBTQ community. The action follows passage of a similar law in 2018, SB 826, mandating that public companies headquartered in the state have at least one woman on their boards of directors by the end of 2019, with further future increases required depending on board size.

[4]At the end of last year, both Vanguard Group Inc. and BlackRock said they planned to vote against company directors who fail to push for greater racial and gender diversity on their boards. (See "*Vanguard to Push Companies on Racial Diversity Next Year*" by Saijel Kishan, Bloomberg News, December 20, 2020, and "*BlackRock to Push Companies on Racial Diversity in 2021*" by Saijel Kishan, Bloomberg News, December 10, 2020.)

[5]"*Analysis: U.S. central bankers are mostly white men. The Fed wants to change that*" by Ann Saphir, Reuters, March 6, 2021.

[6]"*Jerome Powell Advocates Greater Diversity at the Federal Reserve*" by Jeanna Smialek, New York Times, March 25, 2001.

[7]On October 26, 2020, Willis Towers Watson issued "*White Paper: Diversity in the asset management industry,*" which concluded that gender and racially diverse investment teams generate better excess returns for their investors. A 2018 study by McKinsey, "*Delivering through Diversity,*" found that "companies in the top quartile for gender diversity on their executive teams were 21% more likely to experience above-average profitability than companies in the fourth quartile." As for ethnic and cultural diversity, "the finding was a 33% likelihood of outperformance on EBIT margin."

[8]"*Shareholders target 'white man's world' with record demands for diversity data*" by Lorraine Woellert, Catherine Boudreau and Kellie Mejdrich, Political Pro, April 6, 2021.

[9]"*If Corporate Diversity Works, Show Me the Money,*" by Arthur Levitt Jr., January 20, 2021.

[10]On December 20, 2020, Nasdaq filed a proposed rule 4505(f) with the SEC to adopt new listing rules related to board diversity and disclosure. If approved by the SEC, the new listing rules would require all companies listed on Nasdaq's U.S. exchange to publicly disclose consistent, transparent diversity statistics regarding their board of directors. Additionally, the rules would require most Nasdaq-listed companies to have, or explain why they do not have, at least two diverse directors, including one who self-identifies as female and one who self-identifies as either an underrepresented minority or LGBTQ+. Foreign companies and smaller reporting companies would have additional flexibility in satisfying this requirement with two female directors.

[11]See endnote 3.

[12]The Mansfield Rule is named for Arabella Mansfield, the first woman admitted to practice law in the U.S. The current version of the Mansfield Rule, Mansfield 4.0, requires that for leadership and governance roles, equity partner promotions, formal client pitch opportunities, and senior lateral positions, 30% of the pool of candidates considered for the position must be women, people of color, individuals living with a disability, or individuals that identify as LGBTQ.

[13]The National Football League's Rooney Rule, which was created by the late Pittsburg Steeler's President Dan Rooney in 2003, requires that an NFL team must consider at least one minority candidate for any vacant head coaching position.

[14]See endnote 7. See also "*BlackRock Breaks Wall Street Ranks with Planned Racial Audit*" by Saijel Kishan, Bloomberg News, April 5, 2021.

[15]See endnote 7.

[16]See "*Law-Firm Clients Demand More Black Attorneys*" by Susan Randazzo, The Wall Street Journal, November 2, 2020. See also https://www.wellsfargo.com/about/diversity/supplier-diversity.

[17]"How the White House Rolled Back Financial Regulations," by Emily Flitter, Jeanna Smialek and Stacy Cowley, the Wall Street Journal, November 6, 2020.

[18]SR Letter 21-3 "Supervisory Guidance on Board of Directors' Effectiveness."

[19]See endnote 14.

[20]See endnote 9.

[21]Letter to Shareholders, Warren Buffett, February 28, 2006, p. 18

[22]"Buffett rejects diversity measure for Berkshire, but throws support behind its goal," by Ethan Wolff-Mann, Yahoo News, May 3, 2020.

[23]"Senate Republicans Attack NASDAQ's Board Diversity Rule," by Joseph S. Hartunian, National Law Review, April 22, 2021.

[24]A 2019 survey by Korn-Ferry of Black executives who oversaw major lines of business at Fortune 500 companies—"*The Black P&L Leader*"—found that 86% of the individuals surveyed said that having a sponsor (i.e., a senior manager who opened doors, provided exposure or advocated for promoting them) was indispensable to their career progression.