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TRANSCRIPT

Will Nasdaq's Diversity Rule Be Effective?

Featuring:

Harlan Tufford, *ESG Researcher*

Carrie Wang, *ESG Researcher*

Catherine McCall, *Executive Director, Canadian Coalition for Good Governance*

Adam Bass:
This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass. And today is August 11th, 2022.

Adam Bass:
While there was no three-day weekend, no patio furniture sales, and Hallmark did not produce a special line of cards, this past Monday, August 8th, was no ordinary Monday. For NASDAQ listed firms, it marked the first deadline for annual disclosure about their board's gender, racial and ethnic and sexual orientation diversity numbers. While seemingly a narrow corporate governance issue that comes from one exchange in one country, the implications for companies and investors are quite notable.

Adam Bass:
More data, more standardized data means more informed comparisons as investors evaluate the companies that make up their portfolios. And as we'll hear from our guests today, shareholders around the world are looking for this data not only for board diversity, but for diversity at all levels of a firm.

Catherine McCall:
If investors are going to make knowledgeable voting and investment decisions, they need to be informed. And the way they get their information primarily is through public disclosure.

Adam Bass:
That's today's first guest.

Catherine McCall:
My name is Catherine McCall. I am the executive director of the Canadian Coalition for Good Governance, which is an organization representing institutional shareholders that manage approximately $6 trillion in assets. There is a risk involve in investing, but you minimize that risk by having enough information about what's relevant and can impact the investment.

Catherine McCall:
And so essentially it gives them the tools. If they have this disclosure, it gives them the tools to engage with issuers and boards and to have a meaningful assessment and make decisions meaningfully in their voting and investment decisions.

Adam Bass:
Our second guest today could not agree more.

Harlan Tufford:
My name is Harlan Tufford. I'm in MSCI's Toronto office, and I work on the ESG research team focusing on corporate governance practices in the Americas. If you want to compare the financial performance of two companies, that's easy to do because you have consistent disclosure about financial performance. You can look at the revenue figures of company A and company B and understand the assumptions and how that number was determined.

Harlan Tufford:
But if you want to look at performance on diversity today, you don't have that same apples to apples consistent disclosure. And what the NASDAQ diversity disclosure rule gives investors is that kind of consistent comparable disclosure. And it's going to allow investors to look at two NASDAQ listed companies and understand in a consistent apples-to-apples way, which one might be a leader and which one might be a laggard in terms of building a diverse board across a number of factors.

Harlan Tufford:
And this is data that right now investors can't really deduce for themselves. If you can't understand how an individual director identifies when it comes to something like sexual orientation and looking at things like visible minority status. It's also problematic unless you have the director's own self-assessment of how they fit in to that disclosure framework.

Adam Bass:
Okay. I realize I started us down this path, but it does feel like we're getting just a little ahead of ourselves. What exactly is the NASDAQ rule, Harlan?

Harlan Tufford:
So in a nutshell, there's three things that companies are going to be asked to do. And the first one starts this year and that's to disclose details about the diversity of the board of directors. And what we mean by diversity, the framework here is really modeled after the EEO-1 disclosure rules in the United States.

Adam Bass:
For those of you keeping score at home, that's acronym number one for today. Well, number two if we count NASDAQ. But in any case, the EEO is the US Equal Employment Opportunity Commission, also referred to at times as the EEOC.

Harlan Tufford:
So these are disclosure rules that all companies have to produce and companies will now have to disclose how their board of directors stacks up relative to those categories. So directors will be asked to self-identify as whether or not they're a visible minority, also whether or not they're male or female, and whether or not they're LGBTQ plus.

Harlan Tufford:
And then one year later, a comply or explain quota kicks in and companies will have to have at least one diverse director on their board. And a year after that, the quota goes up to two diverse directors, including one director who is either a visible minority or LGBTQ plus, and one director who is a woman.

Adam Bass:
The fact that the NASDAQ rule builds on the EEO framework, now that's important because reporting within that framework is far from new for most US companies, as our third guest for this episode explains.

Carrie Wang:
Hi, my name is Carrie Wang. I'm on the MSCI ESG research team, and I cover financial sector. So actually, US companies with more than a hundred employees have been required to report workforce ratio and ethnic diversity data annually to the US EEOC since the 1960s. But the companies, they have discretion over whether to make this information public and over what format or scope of the disclosures could be.

Carrie Wang:
Under the current EEOC categories, there are seven demographic categories, and each category is divided by male and female members. So what NASDAQ board matrix did was that they added, so that they were based on this rule, these seven demographic categories, and also added LGBTQ, and also it did not disclose category.

Adam Bass:
Did not disclose. So there is still the option for a board member, I guess, to just say, they may not want to disclose that information and that the NASDAQ has allowed for that.

Carrie Wang:
Exactly. So both the EEOC and the NASDAQ board data, they are on a self-reported basis, which means either the board members or the employees, they actually can choose whether to disclose or not to disclose their gender and racial groups.

Harlan Tufford:
So what you might end up seeing for companies where the board doesn't want to participate in the rule or companies where one or more directors have personal reservations about sharing that information is that they'll tick the "I choose not to disclose" box. The whole board might do that. In which case, the company will publish a diversity table that essentially has no diversity data. And that will be in compliance with the rules.

Adam Bass:
And in terms of how often we might see not disclosed selected?

Carrie Wang:
Actually based on the current data we have collected, that not disclosed portion is relatively small. So still most of the employees or board members would choose to disclose. But sometimes we just see maybe very small portion, maybe 1% to 2%, they just chose not to. I would not say that would affect the overall examination of how diverse the board or the workforce is.

Adam Bass:
It feels like the rule is coming into focus a bit. But before we move on, there is one aspect that Harlan alluded to earlier, this idea of comply or explain. I asked him whether he could explain.

Harlan Tufford:
So if you want to make a company do something, if you're a stock exchanger or insurer regulator, you've got two options usually, and this is simplifying. But the first option is to just make them do it, say that if you don't do this, you will be in trouble in some way or another. Or you can give them the comply or explain option.

Harlan Tufford:
And what that means is that you either have to do X, Y or Z, or explain why you didn't. And so it gives the company the option to, in this case, say why they were unable to find diverse directors, or why they chose not to prioritize onboarding diverse directors in making these forms of diversity, why they chose not to consider that as part of their board recruitment strategy.

Adam Bass:
Are there guidelines for these explanations?

Harlan Tufford:
No. NASDAQ has been pretty hands off on the explanations themselves and have said that they don't intend to assess the quality or substantiveness of the explanations. That's going to be left to investors. So you could add up with a situation where a lot of companies are putting out kind of boilerplate statements, that they consider many kinds of diversity in developing their board recruitment strategy and just leave it at that.

Adam Bass:
Fortunately, for the sake of this discussion, we do have a live model for this type of board diversity rule in Canada. And that one has been in effect since 2015. So we have results to look at and hopefully, the US as well as others around the world, can learn from it.

Adam Bass:
We'll get into some more specifics about the Canadian rule later on. But for now, we'll look to Catherine for lesson for the world number one, in this case, as it applies to comply and explain.

Catherine McCall:
One of the interesting things about comply or explain regime is that because it's not prescriptive and because it's not telling issuers what to do, it shifts from the regulator. It shifts the onus onto investors to monitor, police you could say, what companies are doing. So with comply or explain, there's no one but investors to say, "That's not good enough," or "You're doing a great job with this."

Catherine McCall:
So it helps provide investors with a meaningful tool. At CCGG, we engage with independent directors of about 32 companies, 35 companies a year. We know that it gives us a foundation, I guess, to be able to have a meaningful discussion with boards about where they're headed, what their plans are, what their objectives are. Having to say whether you're considering women in your nomination process or promotion process for the executive officers gives investors the ability to get some insight into what they're really doing and whether this is really a serious endeavor or not.

Catherine McCall:
I think we can tell from the quality of our discussions, that if the disclosure is meaningful, it's comprehensive, it's not boilerplate, then it provides a foundation for a much better conversation. And it's also better for the issuers and the boards we deal with because investors are much more likely to be understanding or cut boards some slack if they're not where they think they should be.

Catherine McCall:
If they've got an explanation of what their goals are, how they're making progress towards those goals, what they intend to do.

Adam Bass:
Let's dig deeper. One of the reasons that Joe and I wanted to have Harlan on the show this week was research he had done on the rule back in February. In his assessment from that blog post, Harlan wrote, "One key problem with the rules is that the one woman director quota is a solution to yesterday's problem." I asked Harlan what he meant by that. Here's his answer.

Harlan Tufford:
Yeah. So if this one woman diversity quota had come out even five years ago, it actually would've been quite a substantial shift for the NASDAQ in particular, because five years ago in 2017, a quarter of NASDAQ listed companies in our ESG coverage universe did not have any women directors. But today, that quota affects almost no companies. I think 3% of NASDAQ listed companies at the time that we wrote that blog post had no women directors.

Harlan Tufford:
And you could argue that this new quota will put additional pressure on those few holdout companies, those hardliners, but it is still a comply or explain rule. And these companies have gone this long showing a remarkable degree of intransigence against what is a pretty important investor priority. And I'm not sure that this rule is really going to move the needle on those 3% of companies.

Adam Bass:
So why even do it? I mean, NASDAQ must have known what you know.

Harlan Tufford:
I think that it helps to distinguish NASDAQ as onboarding this important investor priority. The one-woman director quota does reflect I think what a lot of investors see as a market standard, a true bare minimum. A lot of institutional investors, for example, will have policies to vote against, or withhold votes from directors if the board lacks any women directors.

Harlan Tufford:
So I think this kind of enshrines that principle within the regulatory or quasi regulatory framework of the exchange rules and helps to cement it as really and truly the bare minimum a board do.

Adam Bass:
As we talked more about this, however, Harlan pointed to additional research that shed a less cynical light on NASDAQ's motivations.

Harlan Tufford:
In NASDAQ's pitch to the SEC to implement this rule, they actually made a strong argument citing a number of studies showing a relationship between financial performance and greater diversity. And one of the studies they cited was an MSCI study from 2015, which found that boards with at least three women on the board, which typically represents about a third of directors on the average board, directors on the average board. Those boards with three women that were associated with higher ROE, return on equity, and companies with no women directors were associated with lower ROE over the same five-year study period.

Harlan Tufford:
So, there is a financial relationship here. And we've also found that companies with higher levels of board diversity also tend to have higher levels of gender diversity among senior managers. And companies that are able to sustain their board diversity, so that means having three women directors for at least three contiguous years, those companies tend to perform better on environmental practices under our ESG ratings methodology.

Harlan Tufford:
And I think all of this ties into the idea that having more gender diversity on your board gives you more diversity of thought, which allows for better decision making. And that is ultimately what good corporate governance is about.

Adam Bass:
In fact ...

Carrie Wang:
We did a study in 2021, and we found that for companies with sustained board diversity, which means their boards have at least three women for at least three years, they exhibit higher growth in employee productivity. What we found is that for companies that has more diversity on their board, they also tend to have higher or better tendency to have leading talent management practices. And when employees have better profits and better benefits, they tend to generate more revenue on a per employee count.

Adam Bass:
Okay. You've been very patient with me as we discuss the finer points of the NASDAQ rule, what we mean by comply or explain, and some of the very real reasons that board diversity is such a pressing topic for investors. But I did promise you a live example of the rule's big sister from the Great White North, and a live example you shall get.

Catherine McCall:
Most of our governance regulations and rules in Canada are based on a comply or explain regime. What that means with respect to the gender diversity disclosure rules is that issuers are asked to disclose certain elements and there's no penalty if they don't. They simply have to explain why they don't. So the CSA policy ...

Adam Bass:
CSA is Canadian Securities Administrators. Unlike the Securities and Exchange Commission in the US, CSA is less federal regulator and more umbrella group that's made up of local regulators in each of Canada's 10 provinces and three territories.

Catherine McCall:
CSA policy requires that issuers disclose whether or not they have a written policy related to the identification and nomination of directors and a summary of the objectives and what the policy consists of and progress against those objectives. Also, whether the issuer considers the level of representation of women on the board in identifying and nominating candidates for election to the board. And if they don't disclose that, why do they not? What are the reasons for not considering the representation of women?

Catherine McCall:
The policy also requires that issuers disclose whether or not they consider the representation of women in senior management as well. And finally, whether the issuer has adopted targets regarding the appointment of women to the board or women in executive officer positions.

Adam Bass:
Well, why don't we go there now? Let's continue with that thought. Why is it important to include one-level down, if you will, from the board which is something that the NASDAQ rule does not do?

Catherine McCall:
Increasing diversity in senior management for one thing seems to be much more of an intractable problem than it is with boards. So there's not been a lot of progress made even in those jurisdictions in the world where they have mandatory quotas for directors for gender. And I think it's kind of a common, sensible explanation when you're looking, when a board is looking for board members, it looks to what it considers to be appropriate skill set expertise, knowledge, that sort of thing. And traditionally on boards, if they have looked to C-suites and given that there are fewer women in the C-suite, especially in certain industries, you're right away reducing the number of women in that pool.

Catherine McCall:
So we think it's incredibly important at the coalition that issuers also focus on increasing the number of women in senior executive positions. And that I think realistically can only be done if they also increase women's gender representation throughout the organization. So starting in the lower bottom levels of the workforce and working all the way through sort of an organic development.

Adam Bass:
That's certainly logical. We asked Carrie if she had looked into this as part of her research and what she'd found when she did.

Carrie Wang:
It's actually hard to find an exact correlation between board diversity and executive diversity. And what we found through data collection process, that the companies also have different definitions of what are executive management and what are leadership. So they can either only include CEO and their direct reports, and they can also include first-level managers. So I would say based on the current data constraint, I'm not able to provide an exact answer at this point.

Adam Bass:
However, what she did find when she looked outside the Americas ...

Carrie Wang:
Based on the data we found in 2021 among the developed markets, European countries had the highest percentage of companies with at least 30% women directors. Well, for emerging markets, they have slightly lower percentage on that, but they have slightly higher percentage of female CEOs. So even though it's a slightly higher, but the percentage of female CEOs among those companies is still at 5.4%, which is really low compared to the total workforce female representation. And the representation even on board for larger companies, they tend to have more board members. And also they tend to have more diverse members, which means either female or minority board members.

Carrie Wang:
The healthcare and financial sector, they had the highest percentage of female CEOs, while for energy and industrial sectors, they had the lowest, which I think would make sense because actually in the sectors such as healthcare and financials, they do have a higher percentage of women representation on their overall workforce. And also another thing I want to mention is that actually there are higher percentage of women on the CFO roles than on the CEO roles.

Adam Bass:
Any thoughts on why that difference might be there? That's clearly a very important position. And stereotypically or historically, finance as you mentioned, not necessarily an area where women would have risen to the top.

Carrie Wang:
I think that has something to do about the current work general responsibilities of CFOs, because they're more responsible for the accounting perspective or the finance management of different companies. And women tend to occupy more accounting or finance-related roles. And I believe that's a major factor that lead to the higher percentage of female CFOs.

Adam Bass:
But the proof, as they say, is in the pudding. Fun fact though, the original version of that saying is the proof of the pudding is in the eating. And while that's longer, of course, you have to admit it makes a lot more sense. Let's listen to that part of my conversation with Catherine while I grab a snack. I'm suddenly very hungry. Simply put, has it worked? Has the makeup of boards changed?

Catherine McCall:
Yes, they have. I think there's disagreement or different views about whether the progress has been fast enough or developed quickly enough, essentially because we have seen increases. I think when the regulation was adopted, the policy was adopted back in 2015, women comprised about 10% of the board seats on the TSX, which is our major stock exchange. Now, I guess this is seven years later, eight years later, on the TSX listed companies so that's about 1,500 companies, 23% were held by women in last October.

Catherine McCall:
In the TSX 60, which are the 60 largest companies which tend to have better governance in our experience in Canada, the number was 33%. And for the TSX Composite, which is about 230 companies and still larger companies than perhaps than most of the companies on the TSX, it's 31%. What's very interesting, I think, is the fact that last year, the number of women filling empty board seats was occurred at a rate of 39%. And that's key because if you replace women at a 1% per year, 2%, 10%, you're never going to get to gender parity on the boards.

Catherine McCall:
So I think that we have seen progress. Whether it's enough, as I said, is a matter of your perspective. The CSA, which they actually have put out for consultation and are considering right now whether to move beyond just the comply and explain, because there is a sense that the progress hasn't been fast enough. So they're looking at, okay, maybe we should require or mandate that a target be set, perhaps without prescribing what that target would be. And perhaps having term limits on a board should be mandated as well.

Adam Bass:
Definitely as you mentioned, significant increase. But have those been attributed directly to the rule or other factors? Has there been any research around that?

Catherine McCall:
Actually, yeah. It's a good question. The Conference Board of Canada put out a report, I think, in April '21 where their view was that there was no compelling evidence that the disclosure requirement had accelerated women on boards. They were suggesting that it could be put to alternate catalysts such as general social change, investors being more aggressive about it being an important issue. And so they said that you could not conclude that.

Catherine McCall:
But however, there's a study out of the US that was from last year as well and just updated as of July '22. So it's very recent, which seems to be very clear that the number of women on boards increased compared to controlled companies because of the disclosure. And that's a very interesting study. They also saw an increase in the gender diversity considered in board nominations. And there's more likelihood of adopting a target if you have to disclose whether or not you have one.

Catherine McCall:
So personally, I think that it's safe to say that it has had an impact. So hopefully, the NASDAQ rules will as well. But they're very interesting in comparison because they're not as expansive as our rules as I've just described them. So it'll be interesting to see whether that in itself has the kind of effect, because I think under the Canadian rules, there has been this encouragement to consider the issue and focus on ways of getting it to be something that is more acceptable within the boardroom.

Catherine McCall:
So, look at the pool, consider women when you're nominating. Do you have a term limit? Is a board refreshment going on? So it might make an interesting point of study further down the road about whether we think there's any differences between those two approaches.

Adam Bass:
Harlan concurred.

Harlan Tufford:
So I think it'll be really interesting. I think I speak for pretty much everyone, all of my colleagues who make a living staring at proxy circulars. We're going to be really interested to see how disclosure around this changes board composition, and if indeed it does change board composition. So looking at how NASDAQ boards looked in 2020 and 2021, and seeing how that changes through to say 2025 and whether or not this can be a catalyst for companies to maybe have more than one woman director. Maybe it will have a broader effect.

Adam Bass:
We're just getting started on the journey of the NASDAQ rule, even as Canada's continues to evolve and new ones emerge. This year alone, we've seen new rules in the UK and Germany. And just this past June, Japan announced their framework of policies that would require large companies to publicly disclose on gender gaps. Though we focused mainly on gender diversity here, many of these rules including NASDAQ, they also account for racial diversity as well as representation from the LGBTQ plus community.

Adam Bass:
One thing that does seem certain is that shareholders, regulators, and organizations around the world, they've all recognized the importance of diversity at the board level, at every level really, and have put companies on notice. And to a large and growing extent to their credit, companies have heard them.

Adam Bass:
That's all for this week. A big thank you from Joe and me to Catherine, Harlan and Carrie, and as always to all of you for listening. Next up on the podcast, depending where you live, the debate over hybrid working either never went away or just feels like yesterday's news. But the impact on commercial real estate investments particularly offices, that remains an open question. We'll look for answers with two industry experts.

Adam Bass:
Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe.

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