Should corporate diversity be mandated?

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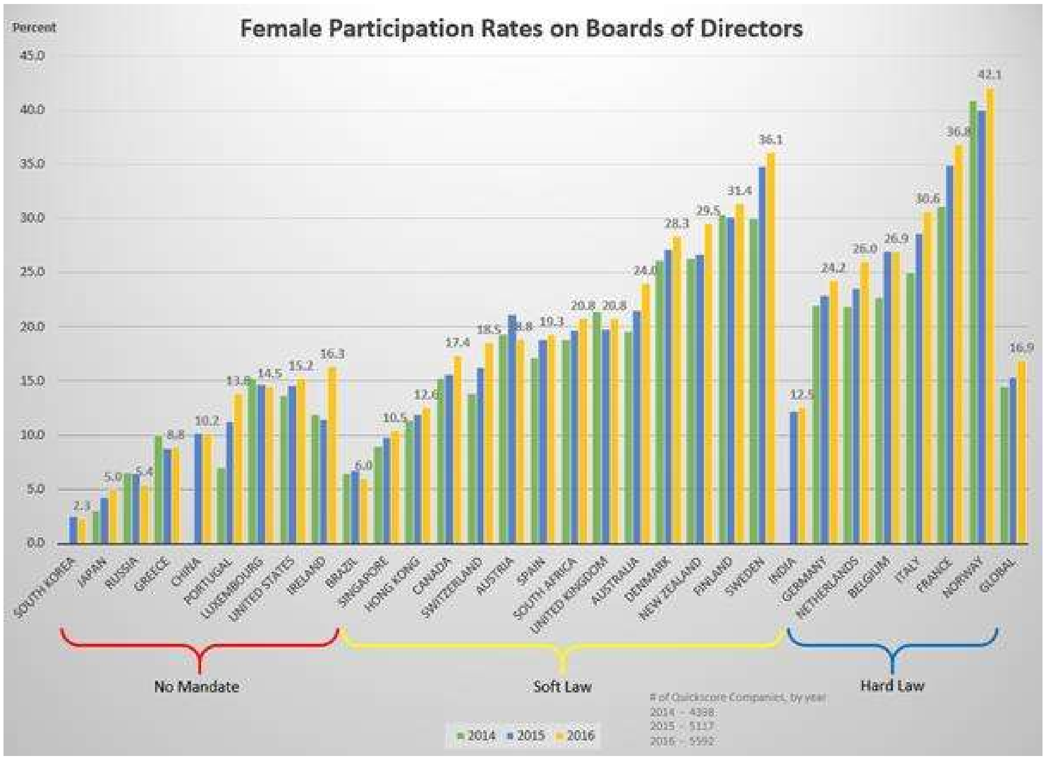
After years of discussing the benefits of diversity in the workplace, we remain perplexed as to why meaningful progress has not been achieved by more companies. After all, companies are keenly aware of the adapt-or-die nature of capitalism. In an effort to understand why decades-long efforts to promote diversity have met with only moderate success we have explored the idea of *mandated diversity* as a possible remedy to inaction.

Can diversity be mandated?

The most obvious example of mandated diversity are the 'hard' and 'soft' laws governing board-level gender representation adopted over the last 10+ years. Norway was the first to enact such laws, followed by France, Germany, Italy, the UK, and many others including notably, California, the first US state to adopt such laws. The 'hard' laws take the form of quotas expressed as a quantity requirement for companies. They typically come with clear penalties for non-compliance that can be severe (e.g. de-listing). Quotas, because of their unambiguous nature, have proven to be a quick and effective way to increase board-level female participation. The 'soft' laws are often in the form of diversity targets set by regulatory bodies. Companies typically must 'comply or explain' by revealing their diversity policies and detailing their progress toward achieving the target. While target-based systems do not have the immediate effect of forcing diversity in the same way as quotas, they have worked to increase board diversity over time by applying a different kind of 'force'. Target-based systems effectively act as a pricing mechanism allowing firms to weigh the costs and benefits so as to choose an optimal gender mix[1]. To date, companies under these systems have clearly viewed the 'benefit' of being aligned with the diversity target as greater than the 'cost' of making changes.

There is demonstrable proof that countries with both the 'hard' and 'soft' approaches to top-down diversity initiatives experienced greater increases in the proportion of female corporate board members relative to countries with no such initiatives. A slightly dated but nonetheless effective exhibit illustrating this point appeared in the Harvard Law School Forum on Corporate Governance a few years ago:

[1] Lu, Shirley, Quota or Disclosure? Evidence from Corporate Board Gender Diversity Policies (November 2019).



Source: Institutional Shareholder Services, January 2017

Has mandated diversity worked? It depends…

The good news is that both the 'hard' and 'soft' diversity laws have worked in the sense that they really have increased the percentage of women in board level positions. We would like to believe that female board representation would have happened naturally, stemming from a management awakening to the economic benefits of diversity even in the absence of such laws, but the United States represents an effective counter-argument to this line of reasoning[2]. Therefore, we do attribute an increase in board diversity to the laws, at least in part.

The bad news is that several of the expected knock-on effects of appointing more high-profile women have not materialized. Importantly, studies of the effects of the laws have met with inconclusive results with respect to company financial performance; this flies in the face of the body of research demonstrating improved economic outcomes associated with diverse teams[3].

[2] Further, we cannot ignore the fact that some countries with the largest increases in female board representation have generally stronger gender equality, making the 'cost' of being perceived as 'anti-diversity' particularly steep, so it is possible that greater female board representation may have happened in the absence of any laws. But, again, the paltry growth rate of female board participation experienced by US companies works to undermine this argument.

[3] Catalyst provides a nice summary of just some of that research here: https://www.catalyst.org/research/why-diversity-and-inclusion-matter-financial-performance/

Other anticipated benefits specific to women in the workplace have not come to pass either. For example, more women on a company's board has not necessarily led to greater female representation within the ranks of management. In France, Germany, and the Netherlands (all countries with diversity laws) just 10-20% of senior management jobs were held by women according to data from Korn Ferry reported in 2018[4]. Similarly, based on a recent analysis of the Norwegian quota system, there was no meaningful closing of the wage gap within the management ranks of companies, though the wage gap did narrow for the female board members themselves[5]. The upshot is that the 'hard' and 'soft' laws did meaningfully increase female representation on corporate boards, providing a powerful signaling effect and certainly benefitting the women chosen for board spots, but there is not much evidence of a 'trickle down' effect extending those benefits to others.

Have we been focused on the wrong thing?

Until now, our collective focus has been on increasing diversity at the corporate board level. While we believe it is important to continue to increase female board representation, the real benefits of diversity are yet to be felt by most companies and by the economy more broadly because diversity needs to be increased at every level of a company. Organizational diversity and the policies and practices that make it manifest are associated with greater employee retention, greater productivity, ability to attract new talent, and improved innovation and problem solving (through a reduction in 'group think'). At this juncture, a focus on the organization is arguably as important, if not more, than the focus on the board.

If we are to work to improve organizational diversity we need to start with data. While there are a few data vendors who are offering a much more comprehensive view of company-level diversity than has been available historically, it is still difficult to get a broad set of diversity data for a broad set of companies. While this goes well beyond what is covered by the 'comply or explain' requirements, standardized disclosure of a robust set of diversity measures would be enormously helpful for level-setting and engagement. And, as the saying goes, if you can't measure it you can't manage it.

Next, we need to acknowledge that some diversity initiatives simply work better than others. An HBR study from 2016 of US firms demonstrated that programs that attempt to strong-arm employees to forget their biases through negative incentives like grievance systems were shown to *reduce* diversity over time[6]. In that same study, the authors showed that programs framed around engagement, contact between groups, or people's desire to look good to others work well. Mentoring, college recruitment targeting women, diversity task forces, and other programs anchored on positive reinforcement led to increased female representation. But we know that increasing the diversity numbers is merely the first step-- what needs to happen next is inclusion.

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[4] https://www.economist.com/business/2018/02/17/ten-years-on-from-norways-quota-for-women-on-corporate-boards
[5] Marianne Bertrand, Sandra E Black, Sissel Jensen, Adriana Lleras-Muney, Breaking the Glass Ceiling? The Effect of Board Quotas on Female Labour Market Outcomes in Norway, *The Review of Economic Studies*, Volume 86, Issue 1, January 2019, Pages 191–239, https://doi.org/10.1093/restud/rdy032
[6] https://hbr.org/2016/07/why-diversity-programs-fail)

Without a strong, firm-wide commitment to inclusion, diversity does not yield meaningful benefits and can even result in additional expense to the firm as disillusioned workers leave and must be replaced. Culture – specifically a culture of inclusion – can be the bridge between aspirations and tangible results by working to transform, then maintain, and even accelerate the benefits of diversity. Leadership plays a critical role as inclusive culture cannot be mandated but it can be modeled. Even if organizational diversity could be forced on a company from outside pressures, a culture of inclusion is something that must be endogenous.

***Should* diversity be mandated?**

The 'hard' and 'soft' laws that are in place now exist for a reason – until their enactment there was little progress on improving female representation at the board level. But these laws have not resulted in much meaningful change for companies as a whole or for the economy more broadly. For this reason, it is difficult to be enthusiastic about mandated diversity going forward. More recently, and in step with a greater asset owner focus on diversity, there has been mounting evidence that collaborative investor initiatives like the Thirty Percent Coalition and even large individual investor activism are moving the needle toward greater gender parity at the board level[7]. Unlike the 'hard' and 'soft' laws that are top-down and country/region-specific, these are bottom-up activities that tend to be more company-specific in focus and have the potential to be more nuanced and outcome-oriented. While we acknowledge that these initiatives also represent exogeneous pressure working on companies to elicit change, we believe that they have a better chance of giving rise to more broad-based benefits, especially if there were to be a widening of scope to include other aspects of organizational diversity. Regardless, diversity is hollow and potentially expensive in the absence of inclusion. This, in fact, may be the reason that mandated diversity has not lived up to its potential.

[7] https://www.ai-cio.com/news/corporations-agreeing-calpers-diversity-demands/