

# Promoting Corporate Diversity: The Uncertain Role of Institutional Investors

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April 2023

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I am grateful for the helpful comments from participants in the Berle XIII symposium at McGill University Law School and the inaugural Women in Law and Finance conference at the Wharton School. I especially appreciate the thoughtful conversations with Darren Rosenblum, without whose help I could not have ventured into this area. <sup>1</sup> See Angela Cai, U.S. Public Pension Fund Diversity Initiatives: Practices, Rationales, and Constitutionality, 13 DEPAUL BUS. & COMM. L.J. 107, 113–115 (2014) (describing efforts by CalSTRS, the Connecticut State Treasurer and the New York City Comptroller).

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## Abstract

Two developments are having an impact on corporate decisions. One is the increased engagement by institutional intermediaries, and a shift in the focus of that engagement from corporate governance to environmental and social issues. The other is a heightened societal awareness of diversity, equity and inclusion (DEI) issues, particularly the importance of diversity in corporate leadership. This Article considers the intersection between the two. It describes how institutional investors have focused their attention on increasing diversity in corporate leadership, the potential motivations for that focus, and the impact of that focus, to date. It highlights the tensions that result from relying on institutional intermediaries to promote diversity. Institutional involvement in environmental, social, and governance (ESG) issues as a general matter raises a host of questions including the extent to which a fiduciary may appropriately trade off economic and non-economic considerations in its investment and engagement strategies. Diversity, however, raises distinctive concerns because the justifications for DEI initiatives are multifaceted and extend beyond firm-specific economic considerations to a broad range of societal objectives. This range of objectives creates challenges both in structuring diversity efforts and evaluating their success. While there is little doubt that the societal case for greater diversity in corporate leadership is compelling, to the extent that the rationale for diversity extends beyond demonstrable effects on firm-specific economic value, it is unclear that institutional intermediaries and their agents—those who make engagement and voting decisions on behalf of such institutions—are well-positioned to address those issues in terms of both accountability and institutional competence. The Article highlights the potential costs of existing institutional efforts and concludes by considering the effectiveness of existing tools of corporate governance in addressing those concerns.

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*This Article considers the intersection between the two. It describes how institutional investors have focused their attention on increasing diversity in corporate leadership, the potential motivations for that focus, and the impact of that focus, to date. It highlights the tensions that result from relying on institutional intermediaries to promote diversity. Institutional involvement in environmental, social, and governance (ESG) issues as a general matter raises a host of questions including the extent to which a fiduciary may appropriately trade off economic and non-economic considerations in its investment and engagement strategies. Diversity, however, raises distinctive concerns because the justifications for DEI initiatives are multifaceted and extend beyond firm-specific economic considerations to a broad range of societal objectives. This range of objectives creates challenges both in structuring diversity efforts and evaluating their success.*

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## **I. Introduction**

Institutional investors are paying increasing attention to ESG issues at their portfolio companies. One area in which they have been particularly influential is increasing the diversity of corporate leadership. Major public pension funds spearheaded the initial effort to increase board diversity.<sup>1</sup> That effort gained traction when the Big Three mutual fund companies—State

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\* Saul A. Fox Distinguished Professor of Business Law, University of Pennsylvania Carey Law School. I am grateful for the helpful comments from participants in the Berle XIII symposium at McGill University Law School and the inaugural Women in Law and Finance conference at the Wharton School. I especially appreciate the thoughtful conversations with Darren Rosenblum, without whose help I could not have ventured into this area.

<sup>1</sup> See Angela Cai, *U.S. Public Pension Fund Diversity Initiatives: Practices, Rationales, and Constitutionality*, 13 DEPAUL BUS. & COMM. L.J. 107, 113–115 (2014) (describing efforts by CalSTRS, the Connecticut State Treasurer and the New York City Comptroller).

Street, BlackRock and Vanguard—began to demand greater female corporate leadership and incorporated board diversity standards into their proxy voting guidelines. The diversity initiative has had a dramatic impact on the overall number of women serving on corporate boards as well as the number of corporate boards that have at least one female director.<sup>2</sup>

Institutional efforts to promote diversity have expanded beyond advocating for boardroom gender diversity. In addition to seeking more diverse and representative boards across a range of dimensions, institutions are asking corporations to conduct racial audits, to report on the demographics of their workforces, and to provide greater inclusion for members of the LGBTQ+ community.<sup>3</sup> Investor initiatives have been complemented by other developments, such as California’s adoption of board diversity legislation and the Nasdaq’s inclusion of diversity disclosure requirements in its listing standards.<sup>4</sup>

Institutions also taking stronger measures against companies that fail to meet their demands for diversity. In 2021, both BlackRock and Vanguard announced their intention to vote against directors “who fail to act on diversifying their boards and workforces.”<sup>5</sup> Institutional Shareholder Services announced that, starting in 2022, it would incorporate a lack of board diversity into its proxy recommendations.<sup>6</sup> Similarly, in 2022, CalSTRS pledged to vote against the director candidates of companies with too few women on their boards.<sup>7</sup>

While it is tempting simply to applaud institutional investors for their success in promoting more diverse corporate leadership, there are reasons for caution rather than unconstrained celebration. Although the normative case for greater corporate diversity is powerful, it stems from a range of distinct justifications. These justifications include economic arguments about the relationship of diversity to firm value, as well as noneconomic arguments about representation, justice and equal opportunity. The rationale for promoting greater diversity has important implications for the form that diversity should take, as well as what types of diversity to prioritize.

Efforts to promote greater diversity can also pit the interests of one identity group against another, particularly when, as with board composition, claims for diversity compete for a limited number of positions or opportunities. Such competition is at the heart of pending litigation over

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<sup>2</sup> See Todd A. Gormley, Vishal K. Gupta, David A. Matsa, Sandra C. Mortal & Lukai Yang, *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Voice* (Eur. Corp. Gov. Inst., Fin. Working Paper No. 714/2020, 2021), <https://ssrn.com/abstract=3724653> [<https://perma.cc/VV2B-J6ML>].

<sup>3</sup> See, e.g., Saijel Kishan, *BlackRock to Push Companies on Racial Diversity in 2021*, BLOOMBERG, Dec. 10, 2020, <https://www.bloomberg.com/news/articles/2020-12-10/blackrock-plans-to-push-companies-on-racial-diversity-in-2021> [<https://perma.cc/FX8X-FT5D>].

<sup>4</sup> Courts invalidated California’s board diversity statutes. See *Crest v. Padilla*, No. 20-STCV-37513, 2022 WL 1073294 (Cal. Super. April 1, 2022) (invalidating AB 979); *Crest v. Padilla*, No. 19STCV27561, 2022 WL 1565613 (Cal. Super. May 13, 2022) (invalidating SB 826). A non-profit organization has filed litigation challenging the Nasdaq rule. See Kevin M. LaCroix, *Court Challenge to Nasdaq Board Diversity Rules Filed*, THE D & O DIARY, Aug. 22, 2021, <https://www.dandodiary.com/2021/08/articles/corporate-governance/court-challenge-to-nasdaq-board-diversity-rules-filed/> (describing litigation) [<https://perma.cc/F4ZF-WTAK>].

<sup>5</sup> Saijel Kishan, *Investors Pressure Corporate America with Record Diversity Push*, BLOOMBERG (Apr. 22, 2021), <https://www.bloomberg.com/news/articles/2021-04-22/investors-pressure-corporate-america-with-record-diversity-push> [<https://perma.cc/5TYF-AMVD>].

<sup>6</sup> *Id.*

<sup>7</sup> Alex Wittenberg, *Calstrs to Vote Against Boards of Companies Failing on Diversity*, BLOOMBERG, 1(Mar. 30, 2022), <https://www.bloomberg.com/news/articles/2022-03-30/calstrs-to-vote-against-boards-of-companies-failing-on-diversity> [<https://perma.cc/M9QN-PS6V>].

the role of diversity in college admissions.<sup>8</sup> Broad-based diversity initiatives in the selection of directors may also compete with other economic and societal priorities.

In this debate, the role of institutional investors is complicated by their status as intermediaries who manage other people's money. While one may plausibly argue that asset managers act pursuant to delegated authority when they engage with portfolio companies to pursue economic objectives, the claim that beneficiaries delegate to managers the authority to pursue ethical or social objectives is less clear.<sup>9</sup> The growth and concentration in the asset management industry have produced a small number of institutions that exercise substantial power over social policy, raising questions about whether their exercise of that power is legitimate.<sup>10</sup> At the same time, both institutional investors and the individual fund managers who act on their behalf face political and social pressures that influence their engagement choices and create agency problems.<sup>11</sup>

Although these concerns present challenges for institutional engagement across a wide range of social and political issues, diversity is distinctive. Simply put, diversity is a big topic. The case for diversity has its roots in both business and societal rationales, and there is at least a plausible argument that the societal benefits of diversity are a more important driver of DEI than firm-specific economic justifications. Moreover, supporters of greater diversity as a priority differ in the reasons for their support and, as a result, in their preferences for the form that such diversity should take. In that context, intermediation poses particular challenges for shareholder engagement.

The Article begins in Part II by briefly summarizing the involvement of institutional investors in promoting diverse corporate leadership. Part III considers the rationale for diverse corporate leadership and highlights the range of economic and non-economic arguments that have been advanced in support of greater diversity. Part IV considers institutional investors' limitations in confronting complex social issues in general, and diverse leadership in particular. Part V briefly evaluates the potential of existing governance mechanisms to enhance accountability and legitimacy of institutional engagement.

## II. Institutional Investor Efforts to Promote Diverse Leadership

On March 7, 2017, the eve of International Women's Day, State Street Global Advisors initiated its "Fearless Girl" campaign, an effort to increase the number of female directors on the

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<sup>8</sup> See Adam Liptak & Anemona Hartocollis, *Supreme Court Will Hear Challenge to Affirmative Action at Harvard and U.N.C.*, N.Y. TIMES (Jan. 24, 2022), <https://www.nytimes.com/2022/01/24/us/politics/supreme-court-affirmative-action-harvard-unc.html> (describing litigation in which the Supreme Court will hear claims in the University of North Carolina case that "the university discriminated against white and Asian applicants by giving preference to Black, Hispanic and Native American ones.") [<https://perma.cc/YTC2-ZV6K>].

<sup>9</sup> See, e.g., Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983 (2020) (explaining that investors rationally delegate to asset managers when the managers possess an informational advantage and when the managers share the investors' purpose or objective. Griffith does not emphasize other rationales for delegation including improved efficiency).

<sup>10</sup> See, e.g., John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (Sept. 20, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3247337](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337).

<sup>11</sup> See, e.g., Ilene H. Lang & Reggie Van Lee, *Institutional Investors Must Help Close the Race and Gender Gaps in Venture Capital*, HARV. BUS. REV. (Aug. 27, 2020), <https://hbr.org/2020/08/institutional-investors-must-help-close-the-race-and-gender-gaps-in-venture-capital> (calling upon institutional investors to exercise greater influence in holding venture capital funds accountable to DEI objectives) [<https://perma.cc/6E9Q-KRZA>].

boards of its portfolio companies.<sup>12</sup> State Street followed its public announcement by sending letters to 3500 public companies, asking them to increase diversity on their boards of directors.<sup>13</sup> According to State Street, at the time the campaign began, approximately a quarter of those companies lacked even a single woman director.<sup>14</sup> State Street followed through on its announcement by voting against the reelection of companies that failed to make meaningful progress in improving the diversity of their boards.<sup>15</sup>

State Street was not alone in its efforts. BlackRock and Vanguard soon joined State Street in seeking greater female leadership at their portfolio companies.<sup>16</sup> The so-called Big Three promoted diversity through both public statements and engagements with their portfolio companies.<sup>17</sup> Other asset managers took similar action. For example, TIAA's president reported that its asset manager, Nuveen, "encouraged about 325 of the 450 companies in the U.S. that did not have a single woman on their board to add a female director."<sup>18</sup> The Big Three also exercised their voting power in support of several shareholder proposals seeking to promote DEI, such as employee diversity reporting and antidiscrimination proposals. Somewhat puzzlingly, however, and in contrast to their public statements, their support of board diversity shareholder proposals was more limited.<sup>19</sup> Other institutional investors voted more frequently in support of DEI shareholder proposals.<sup>20</sup>

More recent institutional efforts have explicated extended diversity objectives beyond gender. For example, in December 2020, Vanguard announced its intention to vote against directors "who fail to push for greater racial and gender diversity on their boards."<sup>21</sup> Vanguard updated its 2021 proxy voting policies to indicate that it was likely to support shareholder proposals requesting "'reasonable' disclosure on workforce demographics, including gender and racial/ethnic categories."<sup>22</sup> In December 2021, BlackRock announced that it was seeking its portfolio companies to aim for boards that were 30% diverse and included at least one member from an underrepresented group.<sup>23</sup>

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<sup>12</sup> Nel-Olivia Waga, *International Women's Day 2017: Wall Street Meets 'The Fearless Girl'*, FORBES (Mar. 3, 2017), <https://www.forbes.com/sites/neloliviawaga/2017/03/07/international-womens-day-2017-wall-street-meets-the-fearless-girl/?sh=2c1de6235b17> [<https://perma.cc/W4SB-BG25>].

<sup>13</sup> Bethany McLean, *The Backstory Behind That 'Fearless Girl' Statue on Wall Street*, THE ATLANTIC (Mar. 13, 2017), <https://www.theatlantic.com/business/archive/2017/03/fearless-girl-wall-street/519393/> [<https://perma.cc/W5AR-X4T9>].

<sup>14</sup> *Id.*

<sup>15</sup> Gormley, Gupta, Matsa, Mortal & Yang, *supra* note 2, at 8.

<sup>16</sup> *Id.* at 9.

<sup>17</sup> See, e.g., Ning Chiu, *Vanguard's Investor Stewardship*, HARV. L. SCH. FORUM ON CORP. GOV. (Sept. 21, 2017), <https://corpgov.law.harvard.edu/2017/09/21/vanguards-investor-stewardship/> [<https://perma.cc/SQ8B-AZUU>] (citing board diversity as an "important focus" of Vanguard's engagements with its portfolio companies).

<sup>18</sup> Laura H. Posner, *Board Diversity Is Critical to Protect Shareholders, Bottom Line*, BLOOMBERG LAW (Sept. 15, 2021, 1:01 AM), [https://www.bloomberglaw.com/bloomberglawnews/social-justice/X6O9H2U5000000?bna\\_news\\_filter=social-justice#jcite](https://www.bloomberglaw.com/bloomberglawnews/social-justice/X6O9H2U5000000?bna_news_filter=social-justice#jcite) [<https://perma.cc/K67M-85MW>].

<sup>19</sup> Caleb N. Griffin, *Environmental & Social Voting at Index Funds*, 44 DEL. J. CORP. L. 167, 192 tbl.1 (2020).

<sup>20</sup> *Id.*

<sup>21</sup> Saijel Kishan, *Vanguard to Push Companies on Racial Diversity Next Year*, BLOOMBERG (Dec. 15, 2020, 4:47 PM), <https://www.bloomberg.com/news/articles/2020-12-15/vanguard-to-push-companies-on-racial-diversity-next-year> [<https://perma.cc/A22M-TMFZ>].

<sup>22</sup> Rajeev Kumar, *Vanguard's 2021 Voting Policy Updates*, <https://www.georgeson.com/us/insights/corporate-governance-proxy/vanguard-2021-voting-policy-updates> [<https://perma.cc/9MPK-KDEC>].

<sup>23</sup> Ross Kerber & Jessica DiNapoli, *BlackRock Adds Diversity Target for U.S. Boardrooms*, REUTERS (Dec. 18, 2021, 11:05 PM), <https://www.reuters.com/markets/us/blackrock-adds-diversity-target-us-boardrooms-2021-12-14/> [<https://perma.cc/D7A8-UVQ8>].



In addition to asset managers, public pension funds have been outspoken in leading and supporting DEI initiatives.<sup>24</sup> These efforts predated State Street’s Fearless Girl Campaign and have continued. For example, a number of pension funds including CalPERS and the Florida State Board of Administration submitted comment letters in support of the SEC’s 2009 proposed rule requiring greater disclosure of board diversity.<sup>25</sup> CalPERS and CalSTRS, the two large California public pension funds, also introduced shareholder proposals urging their portfolio companies to increase the diversity of their boards.<sup>26</sup> In 2017, California Treasurer John Chiang explicitly called for CalSTRS and CalPERS to pressure the companies in which they invested to meet a 30-30 diversity standard.<sup>27</sup> Additionally, the New York City Employees Retirement System stated that it “will generally vote against members of a nominating or governance committee if the board lacks meaningful gender, racial, and ethnic diversity.”<sup>28</sup>

These efforts have had a dramatic impact in terms of increasing diverse corporate leadership, at least at the board level.<sup>29</sup> One empirical paper reports that engagement by the Big Three asset managers alone “led firms to add 2.5 times as many female directors in 2019 as they had in 2016, accounting for at least three-fourths of the total 2016-to-2019 increase in the net number of females firms add per year . . . .”<sup>30</sup> State Street reports that its Fearless Girl campaign has led to 948 of the companies that it identified as not having a single woman board member

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<sup>24</sup> CalPERS, *CalPERS Expands Engagement for Greater Diversity on Corporate Boards to More than 500 U.S. Companies* (Aug. 22, 2017), <https://www.calpers.ca.gov/page/newsroom/calpers-news/2017/engagement-corporate-board-diversity> [<https://perma.cc/3WU8-VWPM>]; Betty T. Yee, *Opinion: Women on Boards Are Good for California Business – and it’s State Law*, *TIMES OF SAN DIEGO* (Oct. 5, 2021), <https://timesofsandiego.com/opinion/2021/10/05/opinion-women-on-boards-are-good-for-california-business-and-its-state-law/> [<https://perma.cc/A7EL-NMR6>].

<sup>25</sup> Thomas Lee Hazen & Lissa Lamkin Broome, *Board Diversity and Proxy Disclosure*, 37 *U. DAYTON L. REV.* 39, 51 n.82 (2011). The SEC subsequently adopted a rule requiring boards to disclose whether and if so how they considered diversity in identifying nominees for director. *Id.* at 55.

<sup>26</sup> Barbara Black, *Stalled: Gender Diversity on Corporate Boards*, 37 *U. DAYTON L. REV.* 7, 10 (2011); Kristin N. Johnson, *Banking on Diversity: Does Gender Diversity Improve Financial Firms’ Risk Oversight?*, 70 *SMU L. REV.* 327, 365 (2017) (reporting that CalSTRS announced this goal in 2011); (“Over the last several years, California Public Employees’ Retirement System (CalPERS), the largest public teachers’ pension fund in the United States, submitted more than a handful of proposals encouraging nominating and governance committees to introduce board diversity initiatives.”).

<sup>27</sup> *Treasurer Calls on CalPERS, CalSTRS to Adopt Diversity Standards for Corporate Boards*, *PENSIONS & INVESTMENTS* (Nov. 28, 2017, 12:00 AM), <https://www.pionline.com/article/20171128/ONLINE/171129875/treasurer-calls-on-calpers-calstrs-to-adopt-diversity-standards-for-corporate-boards> [<https://perma.cc/C97P-PF8R>].

<sup>28</sup> Posner, *supra* note 18.

<sup>29</sup> The impact on C-suite diversity, particularly positions such as CEO and CFO, has been less significant. Women and racial minorities continue to have very low levels of representation in these positions. David F. Larcker & Brian Tayan, *Diversity in the C-Suite: The Dismal State of Diversity Among Fortune 100 Senior Executives*, *STANFORD CLOSER LOOK SERIES. CORP. GOVERNANCE RES. INITIATIVE*, 3 (Apr. 1, 2020), <https://www.gsb.stanford.edu/faculty-research/publications/diversity-c-suite> [<https://perma.cc/9F4X-HJUC>]. For example, only 4 CEOs in Fortune 500 firms are black, Glassdoor, *Top CEOs 2021: Celebrating Diverse Leaders* (July 8, 2021), <https://www.glassdoor.com/blog/top-ceos-celebrating-diverse-leaders/> [<https://perma.cc/3LCC-ZR3P>] and, in the entire history the Fortune 500 list, out of approximately 1900 CEOs, nineteen have been black. Phil Wahba, *Only 19: The Lack of Black CEOs in the History of the Fortune 500*, *FORTUNE* (Feb. 1, 2021, 12:00 PM), <https://fortune.com/longform/fortune-500-black-ceos-business-history/> [<https://perma.cc/63J3-THDB>].

<sup>30</sup> Gormley, Gupta, Matsa, Mortal & Yang, *supra* note 2 at 3.

adding a woman director.<sup>31</sup> Similarly, the adoption of California’s “Women on Boards” statute (SB 826) was associated with an increase in the number of female directors on boards of California companies from 12.9% in 2016 to 23.2% in 2020.<sup>32</sup>

Although the effort to promote inclusive corporate leadership has, to date, focused primarily on boardroom diversity there are signs that institutional investors are supporting broader efforts to increase diversity. For example, shareholders filed 69 proposals during the 2020-2021 proxy season “asking companies to disclose the diversity of their workforce and information on retention and promotions.”<sup>33</sup> New York City Comptroller Scott Stringer has mounted an effort for corporations to disclose “standardized data on their workplace demographics.”<sup>34</sup> A significant number of issuers have faced shareholder proposals during the 2021-2022 proxy season calling for racial equity audits.<sup>35</sup> Many of these proposals are receiving support by a majority of shareholders, including major institutional investors.<sup>36</sup>

### III. The Complexity of Diversity

What prompts the increasing investor focus on diversity and inclusion? BlackRock explains that its position “is based on our view that diversity of perspective and thought — in the boardroom, in the management team, and throughout the company — leads to better long-term economic outcomes for companies.”<sup>37</sup> State Street’s CEO Cyrus Taraporevala similarly reports that “Research has shown the positive impacts diverse groups can have on improved decision making, risk oversight, and innovation, as well as how management teams with a critical mass of racial, ethnic, and gender diversity are more likely to generate above-average profitability.”<sup>38</sup>

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<sup>31</sup> *Fearless Girl*, STATE STREET GLOBAL INVESTORS, <https://www.ssga.com/us/en/institutional/ic/capabilities/esg/asset-stewardship/fearless-girl> [<https://perma.cc/6TY3-9B34>].

<sup>32</sup> Brett M. Rhyne, *The Impact of California’s Gender Quotas for Corporate Boards*, THE DIGEST (May 2021), <https://www.nber.org/digest-202105/impact-californias-gender-quotas-corporate-boards> [<https://perma.cc/A4LF-BGCC>].

<sup>33</sup> Lorraine Woellert, Catherine Boudreau & Kellie Mejdrieh, *Shareholders Target ‘White Man’s World’ with Record Demands for Diversity Data*, POLITICO (Apr. 6, 2021), <https://www.politico.com/news/2021/04/06/shareholders-diversity-data-479159> [<https://perma.cc/HF4P-CTD4>]. This number reflected a doubling of the prior year’s number. *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> See, e.g., Ron S. Berenblat & Elizabeth R. Gonzalez-Sussman, *Racial Equity Audits: A New ESG Initiative*, HARV. L. SCH. FORUM ON CORP. GOV. (Oct. 30, 2021), <https://corpgov.law.harvard.edu/2021/10/30/racial-equity-audits-a-new-esg-initiative/> [<https://perma.cc/DHT8-WDVA>]. (describing new racial equity audit proposals, and explaining that a racial equity audit is “an independent, objective and holistic analysis of a company’s policies, practices, products, services and efforts to combat systemic racism in order to end discrimination within or exhibited by the company with respect to its customers, suppliers or other stakeholders.”).

<sup>36</sup> See, e.g., Hazel Bradford, *Shareholders Seeing Success with Push for Racial Equity Audits*, PENSION & INVESTMENTS (Mar. 25, 2022, 3:17 PM), <https://www.pionline.com/esg/shareholders-seeing-success-push-racial-equity-audits> [<https://perma.cc/TU68-KQN6>]. (reporting 54% support for a racial equity audit shareholder proposal at Apple, including support from CalSTRS, the New York City Retirement Systems, and the State Board of Administration of Florida).

<sup>37</sup> Ellen Meyers, *Investors Keep up Diversity Pressure After California Law Tossed*, ROLL CALL (Apr. 7, 2022, 7:00 AM), <https://rollcall.com/2022/04/07/investors-keep-up-diversity-pressure-after-california-law-tossed/> [<https://perma.cc/Q5G9-3STW>].

<sup>38</sup> Cyrus Taraporevala, *CEO’s Letter on SSGA 2021 Proxy Voting Agenda*, HARV. L. SCH. FORUM ON CORP. GOV. (Jan. 13, 2021), <https://corpgov.law.harvard.edu/2021/01/13/ceos-letter-on-ssga-2021-proxy-voting-agenda/>

Similarly, in proposing its board diversity requirement, the Nasdaq stated that it had “reviewed dozens of empirical studies and found that an extensive body of academic and empirical research demonstrates that diverse boards are positively associated with improved corporate governance and company performance.”<sup>39</sup>

### A. The Business Case for Diversity

To date, however, evidence that diverse boards improve firm economic value remains inconclusive at best.<sup>40</sup> Media reports have relied extensively on research reported by consultants and advocacy groups, such as a 2018 McKinsey study,<sup>41</sup> but, as Wharton Professor Katherine Klein observes, “research conducted by consulting firms and financial institutions is not as rigorous as peer-reviewed academic research.”<sup>42</sup> Those academic studies report conflicting results.<sup>43</sup> Although the Nasdaq cites multiple studies in support of the proposition that board diversity increases firm economic value, scholars have challenged the claim.<sup>44</sup> Surveying meta studies of the academic research, Klein reports that “Depending on which meta-analysis you read, board gender diversity either has a very weak relationship with board performance or no relationship at all.”<sup>45</sup> Similarly, Jon Klick explains that “When meta-analyses are consulted, the literature as a whole finds little relationship between board diversity and firm value.”<sup>46</sup>

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[<https://perma.cc/9JRW-QN56>]. Notably, Taraporevala cites in support of this proposition a 1972 psychological study of Groupthink and a twelve-country study by McKinsey reporting a correlation, not a causal relationship. See Dame Vivian Hunt, Lareina Yee, Sara Prince & Sundiatu Dixon-Fyle, *Delivering Through Diversity*, McKinsey & Co. (Jan. 18, 2018), <https://www.mckinsey.com/business-functions/people-and-organizational-performance/our-insights/delivering-through-diversity> [<https://perma.cc/F95S-M8FV>].

<sup>39</sup> Arnold Golub, Amendment No. 1 (SR-NASDAQ-2020-082), SEC, 6 (Feb. 26, 2021), <https://www.sec.gov/comments/sr-nasdaq-2020-082/srnasdaq2020082-8425987-229599.pdf> [<https://perma.cc/BA6S-KSTQ>].

<sup>40</sup> See, e.g., Lissa L. Broome, John M. Conley & Kimberly D. Krawiec, *Dangerous Categories: Narratives of Corporate Board Diversity*, 89 N.C.L. REV. 759, 765 (2011) (observing that “the empirical literature on corporate board diversity also yields largely inconclusive results.”).

<sup>41</sup> Hunt, Yee, Prince & Dixon-Fyle, *supra* note 38.

<sup>42</sup> Katherine Klein, *Does Gender Diversity on Boards Really Boost Company Performance?*, KNOWLEDGE AT WHARTON (May 18, 2017), <https://knowledge.wharton.upenn.edu/article/will-gender-diversity-boards-really-boost-company-performance/> [<https://perma.cc/GDW2-R2J3>].

<sup>43</sup> See Chris Brummer & Leo E. Strine, Jr., *Duty and Diversity*, 75 VAND. L. REV. 1, 28–32 (2022) (summarizing the academic and consulting literature).

<sup>44</sup> See, e.g., Jonathan Klick, *Review of the Literature on Diversity on Corporate Boards*, AMERICAN ENTERPRISE INSTITUTE (Apr. 6, 2021), <https://www.aei.org/research-products/report/review-of-the-literature-on-diversity-on-corporate-boards/>; Jesse M. Fried, *Will Nasdaq’s Diversity Rules Harm Investors?*, (Eur. Corp. Gov. Inst., Law Working Paper No. 579/2021, 2021), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3812642](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3812642). See also Rey Dang, L’Hocine Houanti, Krishna Reddy & Michel Simioni, *Does Board Gender Diversity Influence Firm Profitability? A Control Function Approach*, 90 Economic Modeling 168 (2020) (reporting a positive correlation between board gender diversity and price/earnings ratio, but no effect on return on assets); Liliana Nicoleta Simionescu, Stefan Cristian Gherghina, Hiba Tawil & Ziad Sheikha, *Does Board Gender Diversity Affect Firm Performance? Empirical Evidence from Standard & Poor’s 500 Information Technology Sector*, 7 FIN. INNOV. 52 (2021).

<sup>45</sup> Klein, *supra* note.42

<sup>46</sup> Klick, *supra* note 44 at 1.

In contrast, multiple studies found a correlation between board gender diversity and governance attributes such as board attendance,<sup>47</sup> financial reporting quality,<sup>48</sup> and corporate social responsibility.<sup>49</sup> Some studies reported that firms with more women directors take fewer risks.<sup>50</sup> One recent study found that women directors were associated with a reduced likelihood of securities fraud.<sup>51</sup>

When it comes to other categories of diversity, evidence demonstrating a firm-specific impact associated with increased diversity is even more limited.<sup>52</sup> A few studies have attempted to evaluate the effect of racial diversity on firm value,<sup>53</sup> but most of the research is dated, the studies involve a very small number of diverse directors, and the results are inconclusive.<sup>54</sup> With respect to LGBTQ directors, apart from the difficulty in even identifying sexual orientation accurately, the numbers are so small as to make broad-based empirical claims untenable.<sup>55</sup> One recent study used a matching methodology to evaluate the financial performance of firms with a known LGBT executive; the study found that “firms with known LGBT executives outperform their counterparts.”<sup>56</sup> However, the study’s sample consisted of only 100 firms worldwide, and the firms are drawn from a published list of “100 leading LGBT executives published by OUTstanding and The Financial Times (FT).”<sup>57</sup>

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<sup>47</sup> Renee B. Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291 (2009).

<sup>48</sup> Yu Chen, John Daniel Eshleman & Jared S. Soileau, *Board Gender Diversity and Internal Control Weaknesses*, 33 ADVANCES IN ACCT. 11, 12 (2016).

<sup>49</sup> Kris Byron & Corinne Post, *Women on Boards of Directors and Corporate Social Performance: A MetaAnalysis*, 24 CORP. GOV. 428 (2016).

<sup>50</sup> See, e.g., Johnson, *supra* 26, at 361 (surveying empirical literature and concluding that, in financial firms, “a greater number of women on corporate boards may improve risk management oversight”).

<sup>51</sup> Douglas Cumming, T.Y. Leung, & Oliver M. Rui, *Gender Diversity and Securities Fraud*, 58 ACAD. OF MGMT. J. 5 (2015).

<sup>52</sup> See Richard W. Painter, *Board Diversity: A Response to Professor Fried*, 27 STAN. J.L. BUS. & FIN. 174, 184 (2022) (“fewer empirical studies have been conducted on the impact of a racially diverse board”).

<sup>53</sup> For one of the most recent studies, see Rajalakshmi Subramanian, *Lessons from the Pandemic: Board Diversity and Performance*, BoardReady (July 13, 2021), [https://uploads-ssl.webflow.com/61d633fd6b59246c2dc62e98/6271a21dc04d2e13529daa84\\_BoardReady\\_Report\\_Final.pdf](https://uploads-ssl.webflow.com/61d633fd6b59246c2dc62e98/6271a21dc04d2e13529daa84_BoardReady_Report_Final.pdf) [<https://perma.cc/H4DG-XQ8T>].

<sup>54</sup> Painter, *supra* note 52, at 200–201.

<sup>55</sup> As recently as February 2021, Outquorum reported that “only 25 seats among more than 5,600 board roles in the Fortune 500 were held by LGBTQ people, and some of those directors held more than one of those seats.” Jeff Green, *Investors Press for More LGBTQ Members on Bank Boards*, BLOOMBERG TAX (Dec. 21, 2021), <https://news.bloombergtax.com/financial-accounting/busy-burrs-bank-board-role-brings-more-focus-to-lgbtq-gains> [<https://perma.cc/8CCX-CU27>].

<sup>56</sup> Isabel Costa Lourenço, Donatella Di Marco, Manuel Castelo Branco, Ana Isabel Lopes, Raquel Wille Sarquis & Mark T. Soliman, *The Relationship Between LGBT Executives and Firms’ Value and Financial Performance*, J. RISK. & FIN. MANAG. (SPECIAL ISSUE: CORP. FIN., GOVERNANCE, & SOC. RESP.), Dec. 10, 2021, at 1, 14.

<sup>57</sup> *Id.* at 7-8.

The studies also suffer from a variety of methodological challenges.<sup>58</sup> In particular, these studies tend to report correlation rather than causation.<sup>59</sup> Unless greater board diversity causes improved economic performance, pressuring issuers to increase the diversity of their boards is unlikely to have an economic impact. Significantly, commentators generally fail to identify a plausible mechanism by which increased board diversity is likely to improve corporate performance; instead, they simply conclude that “diverse groups make superior decisions.”<sup>60</sup> Conversely, the Nasdaq identified one of the most plausible explanations for why increased diversity might improve performance: greater board diversity reduces a board’s susceptibility to groupthink.<sup>61</sup> The problem with this rationale is that a wide range of directors could bring different types of diversity to the boardroom.<sup>62</sup> Further, even if diverse boards outperform homogenous boards, that conclusion offers no principled basis for requiring the representation of specific identity groups or determining the optimal mix of directors.<sup>63</sup> In striking down California’s board diversity statute, AB 979, the court expressed that concern, and questioned the justification for the statute requiring inclusion of only two specific types of minorities—racial and sexual orientation/gender identity—while excluding other groups.<sup>64</sup>

Notably, the absence of strong empirical evidence supporting a causal relationship between diverse corporate leadership and economic performance does not render illegitimate institutional investors’ consideration of director and officer diversity even within a framework that requires

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<sup>58</sup> Alex Edmans, *Is There Really A Business Case For Diversity?*, MEDIUM (Oct. 30, 2021), <https://medium.com/@alex.edmans/is-there-really-a-business-case-for-diversity-c58ef67ebffa> [<https://perma.cc/X54A-44UZ>] (noting significant flaws in ethnic diversity studies such as lack of replicability and disingenuous reporting of results); Klick, *supra* note 44 (explaining methodological challenges of empirical research on board diversity).

<sup>59</sup> See, e.g., Naomi Cahn, June Carbone & Nancy Levit, *The Instrumental Case for Corporate Diversity*, 40 MINN. J. L. & INEQ. 117, 143 (2022) (“Some of the most influential studies look at the relationship between diversity and performance without controls that attempt to establish causation.”).

<sup>60</sup> Patricia Lenkov, *Why Diversity in the Boardroom Should Include LGBT*, ELLEVATE, <https://www.ellevatenetwork.com/articles/7063-why-diversity-in-the-boardroom-should-include-lgbt> [<https://perma.cc/7N56-VGYR>].

<sup>61</sup> See John A. Zecca, *Response to Comments and Notice of Filing of Proposed Rule Changes Via Adoption of Rule 5605(f) Relating to Diverse Board Representation*, NASDAQ 1, 123 (Feb. 26, 2021), <https://www.sec.gov/comments/sr-nasdaq-2020-081/srnasdaq2020081-8425992-229601.pdf> (referencing 85 Fed. Reg. 80472 (proposed Dec. 11, 2020) (positing that issuers would benefit from “including diverse directors with a broader range of skills, perspectives and experiences [which] may help detect and prevent fraudulent and manipulative acts and practices by mitigating ‘groupthink’”).

<sup>62</sup> See, e.g., Marko Hakovirta, Navodya Denuwara, Sivashankari Bharathi, Peter Topping & Jorma Eloranta, *The Importance of Diversity on Boards of Directors’ Effectiveness and its Impact on Innovativeness in the Bioeconomy*, 7 HUMANS. & SOC. SCIS. COMM’NS. 116, 3 (2020) (“a board’s composition should reflect diversity in thinking, background, skills, experiences, experti[s]e and a range of tenures that are appropriate given the company’s current and anticipated circumstances.”).

<sup>63</sup> See, e.g., Hester M. Peirce, *Statement on the Commission’s Order Approving Proposed Rule Changes*, U.S. SEC. & EXCH. COMM’N. (Aug. 6, 2021), [https://www.sec.gov/news/public-statement/peirce-nasdaq-diversity-statement-080621#\\_ftnref35](https://www.sec.gov/news/public-statement/peirce-nasdaq-diversity-statement-080621#_ftnref35) [<https://perma.cc/7P5B-LCBB>] (observing that Nasdaq’s definition of diversity “is not reasonably tied (1) to board compositions purportedly shown to increase corporate performance, or (2) to categories that firms already report, or (3) to groups historically protected under federal law, or (4) to conditions necessary to obtain consistent and comparable disclosures, or indeed (5) to ensuring that boards are composed of people with diverse cognitive diversity and backgrounds.”).

<sup>64</sup> *Crest v. Padilla*, No. 20 STCV 37513, 2022 WL 1073294, at \*9 (Cal. Super. Apr. 1, 2022).

institutional investors to focus primarily or exclusively on economic value.<sup>65</sup> One possible reading of the empirical literature is a reverse causation or signaling story. Under that reading, diversity does not cause better firm performance; rather, diverse corporate leadership signals management quality, and it is the higher management quality that increases economic performance.<sup>66</sup> Such a theory would warrant institutional investors seeking greater information on leadership diversity and incorporating that information into their portfolio selection as a screen for management quality.

A 2022 law review article by Naomi Cahn, June Carbone & Nancy Levit provides a new and somewhat more nuanced view of the business case for diversity.<sup>67</sup> The authors offer an instrumental case for the objective behind increased diversity, arguing it improves corporate culture by increasing inclusion, innovation and participation.<sup>68</sup> They identify an association between diverse leadership and those features, and specifically identify how changing leadership characteristics positively affect corporate culture.<sup>69</sup> As a result, they defend diversity as a tool for implementing management reform.<sup>70</sup> Critically, in their view, diversity is not about representation or numbers, but instead its relationship to leadership practices, stating, “diversity is both a result and an architect of change.”<sup>71</sup>

## **B. Other Rationales for Diverse Corporate Leadership**

As a result of limitations in the empirical literature, even those who champion board diversity tend not to rely exclusively on the business case, instead offering other rationales for diverse leadership.<sup>72</sup> In addition, focusing solely on the business case gives short shrift to the societal benefits of diverse corporate leadership. Increasing the number of women, LGBTQ people, and other historically underrepresented minority groups in the boardroom and the C suite serves a variety of objectives that extend beyond firm-specific economic value.<sup>73</sup> These objectives include redressing past discrimination, creating greater opportunities for historically excluded groups to ascend to positions of corporate power, and reducing wealth and income inequality. Increasing the diversity of corporate leadership can also improve the responsiveness of corporations to society as a whole and heighten the attentiveness of corporate boards to the interest of stakeholders such as employees and customers. That these societal objectives motivate institutional efforts to promote diversity is supported by the fact that such efforts are largely

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<sup>65</sup> See Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020) (arguing that their fiduciary duties to their beneficiaries prohibit institutional investors from sacrificing beneficiary value in favor of social objectives).

<sup>66</sup> See, e.g., Cahn, Carbone & Levit, *supra* note 59, at 133–34 (“It may be, for example, that better managed companies are more likely to achieve greater diversity, rather than diversity leading to better company performance.”).

<sup>67</sup> *Id.*

<sup>68</sup> See *id.*

<sup>69</sup> See *id.*

<sup>70</sup> *Id.* at 150–51.

<sup>71</sup> *Id.* at 153.

<sup>72</sup> Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference does Difference Make?*, 39 DEL. J. CORP. L. 377, 379 (2014) (observing that the “‘business case for diversity’ is less compelling than other reasons rooted in social justice, equal opportunity, and corporate reputation.”).

<sup>73</sup> The multiple societal benefits from conclusion may contribute to a willingness to accept the validity of empirical claims in support of the business case for diversity. See, e.g., Edmans, *supra* note 58 (exploring the reasons why commentators frequently overstate empirical support for the business case for diversity).

portfolio-wide initiatives rather than being tailored to specific companies or industries that are particularly susceptible to groupthink.<sup>74</sup>

In defending AB 979, California's Secretary of State argued that a key statutory "purpose was to remedy the effects of past and present discrimination."<sup>75</sup> Statistically, the number of female and minority directors has been dramatically lower than the representation of such groups in the general population.<sup>76</sup> As one Illinois legislator explained, in supporting a similar board diversity statute, "All historically discriminated against communities deserve representation in the business world."<sup>77</sup> Although the Court in *Crest* questioned whether the general population was the right benchmark, there is substantial evidence that director positions have not historically been open even to highly qualified women and minorities.<sup>78</sup> Given that corporate leaders are among the most highly paid, diversity can also serve to reduce wealth and income inequality. Similarly, creating opportunities for qualified women and minorities to achieve meaningful levels of representation is consistent with principles of equality and justice.

Limiting the opportunities for women and minorities to serve on corporate boards reduces their professional opportunities by limiting their visibility and restricting their ability to network.<sup>79</sup> Board experience may facilitate advancing in the C-suite or becoming a candidate for CEO. Moreover, board diversity is correlated with greater diversity in a corporation's executive ranks.<sup>80</sup> As a result, companies with lower levels of board diversity are likely to have few diverse executives. The presence of women and minorities in corporate leadership positions provides role models for future leaders and signals the availability of avenues for professional success. As one commentator explained, "To have an openly gay director is one more way that LGBTQ employees can see someone in power who they can identify with . . ."<sup>81</sup> Similarly, President Biden's appointment of Ketanji Brown Jackson to the U.S. Supreme Court offered many young African-American women encouragement about their ability to aspire to a position of power.<sup>82</sup>

Diverse leadership may also enhance a corporation's reputation. The reputational effects of board diversity stem from several sources. Corporations with diverse leadership may be

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<sup>74</sup> Anna Christie, *The Agency Costs of Sustainable Capitalism*, 55 U.C. DAVIS L. REV. 875, 903 (2021).

<sup>75</sup> Alyesha Dotson, Corinn Jackson, Dionysia Johnson-Massie & Lysette Roman, *Corporate Board Diversity: Next Steps for Employers After Court Strikes Down California Board Diversity Law*, LITTLER (Apr. 18, 2022), <https://www.littler.com/publication-press/publication/corporate-board-diversity-next-steps-employers-after-court-strikes> [<https://perma.cc/9STX-L8MT>]; see also *Crest v. Padilla*, No. 20 STCV 37513, 2022 WL 1073294, at \*11 (Cal. Super. Apr. 1, 2022).

<sup>76</sup> See Brummer & Strine, *supra* note 43, at 10–20 (citing data in support of "representational gap").

<sup>77</sup> *LGBTQ-Inclusive Corporate Board Leadership Bill Passes Illinois General Assembly*, WINDY CITY TIMES (May 20, 2021), <https://www.windycitytimes.com/lgbt/LGBTQ-Inclusive-Corporate-Board-Leadership-Bill-passes-Illinois-General-Assembly/70525.html> [<https://perma.cc/7H2P-9Z97>].

<sup>78</sup> See Michael Hiltzik, *Column: California's Landmark Corporate Diversity Law Was Overturned. What Happens Next?*, L.A. TIMES (Apr. 8, 2022), <https://www.latimes.com/business/story/2022-04-08/californias-corporate-board-diversity-law-unconstitutional> [<https://perma.cc/ZQ5T-RLFS>] (describing California's Women on Boards law as "a response to decades of discrimination against women in corporate board appointments."); *Crest*, 2022 WL 1073294, at \*14.

<sup>79</sup> See *id.*

<sup>80</sup> Jill E. Fisch & Steven Davidoff Solomon, *Centros, California's "Women on Boards" Statute and the Scope of Regulatory Competition*, 20 EUR. BUS. ORG. L. REV. 493, 508 (2019).

<sup>81</sup> Green, *supra* note **Error! Bookmark not defined.**

<sup>82</sup> Emma Henderson, *Cleveland Law Students See Ketanji Brown Jackson Opening Doors for Future*, WKYC STUDIOS (Apr. 8, 2022), <https://www.wkyc.com/article/news/local/cleveland/cleveland-law-students-ketanji-brown-jackson-opening-doors-future/95-7bea76b4-725f-4536-bce3-65167f686145> [<https://perma.cc/N4JD-8VLD>].

perceived as more ethical.<sup>83</sup> Boards with more women are associated with higher levels of corporate social responsibility and charitable donations.<sup>84</sup> Additionally, women on boards appear to promote better corporate cultures and to reduce the incidence of sexual harassment.<sup>85</sup> As one commentator observes, representation of women in leadership “promotes an environment in which gender equality is presumed, harassment is unacceptable, and fair treatment is expected.”<sup>86</sup>

Diverse leadership contributes to more representative corporate decision-making by including different perspectives. As corporations have grown in size and influence, it is valuable for their decisions to reflect a range of viewpoints. The most effective way to accomplish that goal is to give voice to different groups.<sup>87</sup> Indeed, diverse leadership may reduce the “us vs. them” mentality often associated with corporations. Subsequent effects might also change societal attitudes toward corporate regulation and reduce the tendency to blame “giant corporations” for societal problems.<sup>88</sup> In addition, greater representation within the corporate decision-making process may respond to increased demands for corporations to shift from policies of shareholder primacy to a stakeholder approach. Such an approach gives interests of employees, customers, the community, and other interest groups greater weight in operational decisions.<sup>89</sup> Diverse corporate leadership is commonly described as enhancing stakeholder governance.<sup>90</sup>

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<sup>83</sup> Meredith B. Larkin, Richard A. Bernardi & Susan M. Bosco, *Board Gender Diversity, Corporate Reputation and Market Performance*, 9 J. BANKING & FIN. 1, 1 (2012).

<sup>84</sup> See, e.g., Ioanna Boulouta, *Hidden Connections: The Link Between Gender Diversity and Corporate Social Performance*, 113 J. BUS. ETHICS 185, 186 (2013) (evaluating the effect of board diversity on corporate social responsibility).

<sup>85</sup> Aman Kidwai, *3 Factors that are Organically Driving Board Diversity*, FORTUNE (Oct. 1, 2021), <https://fortune.com/2021/10/01/three-factors-that-are-organically-driving-board-diversity/> [<https://perma.cc/W3NF-57SF>] (“diverse leadership can have a positive, cascading effect on inclusion and company culture.”); David A. Katz & Laura A. McIntosh, *Corporate Governance Update: Boards, Sexual Harassment, and Gender Diversity*, HARV. L. SCH. FOR. ON CORP. GOV. (Jan. 26, 2018), <https://corpgov.law.harvard.edu/2018/01/26/corporate-governance-update-boards-sexual-harassment-and-gender-diversity/> [<https://perma.cc/ZT2N-6AJ7>] (“The leadership of women in senior management positions as well as on the board is essential to the establishment of a corporate culture in which sexual misconduct is taboo.”); see also MICHAEL W. FRERICH, ILL. ST. TREASURER, *THE INVESTMENT CASE FOR BOARD DIVERSITY: A REVIEW OF THE ACADEMIC AND PRACTITIONER RESEARCH ON THE VALUE OF GENDER AND RACIAL/ETHNIC BOARD DIVERSITY FOR INVESTORS*, 4–5 (2020).

<sup>86</sup> Katz & McIntosh, *supra* note 85.

<sup>87</sup> Fabrice Houdart, *LGBT Representation on Corporate Boards: Moving from the Menu to the Table*, OUT LEADERSHIP (Mar. 16, 2020), <https://outleadership.com/insights/lgbt-corporate-board-representation/> [<https://perma.cc/D9FC-KWAL>] (“Decisions taken in the boardrooms of Facebook, Apple, 23andme or Amazon are shaping our lives for centuries to come. LGBT+ people have a stake in these decisions and yet have almost no voice in them.”).

<sup>88</sup> See, e.g., Christopher E. Ondeck, John R. Ingrassia & Timothy E. Burroughs, *Price Gouging Updates: Warren Accuses Large Corporations of Price Gouging; Plaintiffs Respond in Amazon Price Gouging Case*, NAT. L. REV. (Feb. 9, 2022), <https://www.natlawreview.com/article/price-gouging-updates-warren-accuses-large-corporations-price-gouging-plaintiffs> [<https://perma.cc/5MFQ-BV3C>] (quoting Senator Elizabeth Warren describing price-gouging by “giant corporations” as “a factor causing the high prices facing U.S. consumers. . .”). See also Kurt Gray, *The Scientific Explanation for Why We Get So Mad at Corporations*, QUARTZ (Mar. 22, 2016), <https://qz.com/644222/the-scientific-explanation-for-why-we-get-so-mad-at-corporations/> [<https://perma.cc/GTH3-KQ2C>] (explaining why people are more willing to view corporations as villains than as victims).

<sup>89</sup> See, e.g., Jill E. Fisch, *Purpose Proposals*, 1 U. CHI. BUS. L. REV. 113 (2022) (explaining stakeholder governance as “enabling corporate decisionmakers to shift their objective from an exclusive focus on shareholder profit toward a broader consideration of stakeholder interests”).

<sup>90</sup> See Hester M. Peirce, *My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance* (Sept. 21, 2018), <https://www.sec.gov/news/speech/speech-peirce-092118>



In sum, commentators unduly limit themselves by focusing on the empirical case that diverse leadership increases firm economic value. Diverse leadership advances a variety of broader societal goals. At the same time, however, the non-economic case for diversity raises challenges for institutional engagement – challenges that this Article will address in the next Part.

## IV. The Limitations of Institutional Investors in Confronting Complex Social Issues

### A. Institutional Investors and Intermediation

The defining characteristics of stock ownership in the United States are that it is both intermediated and highly concentrated. Institutional investors own approximately 80% of the largest public companies in the United States.<sup>91</sup> A small number of institutions, particularly BlackRock, Vanguard and State Street, are often the largest owners of most of these companies.<sup>92</sup> John Coates has described the increasing concentration of ownership as the “Problem of Twelve,” observing that twelve asset managers can, in most cases, exercise the power of control to influence operational business decisions.<sup>93</sup> Anna Christie notes that in the U.S., the Big Three alone “control more than 20% of the shares of the average S&P 500 company, which translates into more than 25% of shares voted in such companies.”<sup>94</sup> A further consideration is that most of the assets controlled by the Big Three are passively managed, meaning that they use an investment strategy that tracks an index rather than engaging in information-based trading.<sup>95</sup> The influence of institutional investors is amplified by the fact that more than 90% of shares held by institutional investors are voted.<sup>96</sup> In contrast, fewer than 30% of the shares held by retail investors are voted.<sup>97</sup>

At the same time, institutional investors—including both the asset managers that run mutual funds and pension funds—are intermediaries. Although the fund is the legal entity that owns the stock and has the authority to exercise the prerogatives of a shareholder—such as

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[<https://perma.cc/3R9A-3AZ7>] (describing SB 826 as embracing a stakeholder approach where “[s]hareholders are mentioned, but the list of beneficiaries features stakeholders prominently.”).

<sup>91</sup> Jacob Greenspon, *How Big a Problem Is It That a Few Shareholders Own Stock in So Many Competing Companies?*, HARV. BUS. REV. (Feb. 19, 2019), <https://hbr.org/2019/02/how-big-a-problem-is-it-that-a-few-shareholders-own-stock-in-so-many-competing-companies> [<https://perma.cc/4MHX-RWG5>] (reporting that, in 2019, institutional investors owned “80% of all stock in the S&P 500.”).

<sup>92</sup> *Id.* As Anna Christie observes: “The ‘Big Three’ asset managers—BlackRock, Vanguard and State Street—are now the largest investors in the vast majority of economically significant companies in the U.S., and to an increasing extent, worldwide.” Christie, *supra* note 74, at 879.

<sup>93</sup> See, e.g., Coates, *supra* note 10. To be fair, this power is constrained by corporate law limits on the scope of shareholder power.

<sup>94</sup> Christie, *supra* note 74, at 890.

<sup>95</sup> See Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019) (describing BlackRock, Vanguard and State Street as the sponsors that operate the largest amount of money invested in index funds).

<sup>96</sup> See, e.g., Kobi Kastiel & Yaron Nili, *In Search of the “Absent” Shareholders: A New Solution to Retail Investors Apathy*, 41 DEL. J. CORP. L. 55, 66 n.25 (2016) (“institutional investors vote in rates of over 90% while retail investors only vote approximately 30%.”).

<sup>97</sup> *Id.*

voting the stock, attending shareholder meetings, and sponsoring shareholder proposals—the economic interest in the shares is held by the fund’s beneficiaries.<sup>98</sup>

One consequence of this intermediation is that fund managers are fiduciaries. They have an obligation to run the funds they manage in the best interests of their beneficiaries.<sup>99</sup> The managers’ fiduciary duties extend to the exercise of the funds’ voting power as well as the funds’ engagement with their portfolio companies.

A second consequence is that the intermediary relationship creates potential agency costs. Fund managers may act selfishly and vote the shares in their portfolio companies for personal gain or in accordance with their personal preferences. Fund managers may seek to further the interests of their employer—the fund sponsor or advisor—rather than the interests of the fund’s beneficiaries. As Dorothy Lund<sup>100</sup> and Jeff Schwartz<sup>101</sup> have separately observed, mutual fund companies are economic and political actors and face a variety of pressures that can cause their voting and engagement behavior to differ from the interests of fund owners.<sup>102</sup> Commentators have expressed concern, for example, about the potential influence of Larry Fink and BlackRock on the policies of the Biden Administration, as well as the impact of those policies on BlackRock’s bottom line.<sup>103</sup>

## B. The Impact of Intermediation on Diversity Initiatives

The intermediated ownership of publicly traded companies means that, in most cases, institutional investors have enough voting power to control outcomes. Moreover, this power enables large investors to influence corporate policies through private engagement as well as formal voting.<sup>104</sup> At the same time, institutional investors are required to vote and engage in the best interests of their beneficiaries. The question is how to determine what that best interest is and how to apply those principles to diversity initiatives.

Importantly, regulators and commentators differ about the extent to which institutional investors must focus exclusively on economic value. For example, Max Schanzenbach and Rob Sitkoff argue that an intermediary’s fiduciary obligations require it to focus exclusively on

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<sup>98</sup> See Jill E. Fisch, *Mutual Fund Stewardship and the Empty Voting Problem*, 16 BROOK. J. OF CORP., FIN. & COM. L. 71 (2021) (describing potential problems with intermediation, including that it separates decision how to vote the shares of a fund’s portfolio companies from the economic interest in those companies, resulting in empty voting).

<sup>99</sup> See Schanzenbach & Sitkoff, *supra* note 65.

<sup>100</sup> See Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. Pa. L. Rev. 77 (2022) (arguing that asset managers adopt policies designed to maximize the inflow of assets from their institutional clients, predominantly assets from pension plans).

<sup>101</sup> See Jeff Schwartz, *‘Public’ Mutual Funds*, Cambridge Handbook on Investor Protection (Arthur Laby ed., 2021) (claiming that large mutual funds adopt policies designed to avoid public retribution in the form of costly regulations).

<sup>102</sup> Significantly, it is the asset managers’ owners who benefit when the asset managers do well, not necessarily the owners of funds managed by the asset managers. The ownership of asset managers varies. See Fisch, Hamdani & Solomon, *supra* note 95, at 22 (contrasting Fidelity, which is privately held, with BlackRock, which is a publicly-traded company).

<sup>103</sup> Charles Gasparino, *Larry Fink Shakes Big Bucks From Lefty Joe’s Environmental Social Governance*, N.Y. POST (Oct. 30, 2021), <https://nypost.com/2021/10/30/larry-fink-shakes-big-bucks-from-lefty-joe-bidens-esg/> [<https://perma.cc/2FZA-W2KR>] (stating that Fink “hasn’t been bashful in deploying BlackRock’s clout to advance Democratic economic causes in ways that happen to support its bottom line.”).

<sup>104</sup> See, e.g., Gaia Balp & Giovanni Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs. Activist Wolf Packs*, 14 OHIO ST. BUS. L.J. 135, 146 (2020) (describing widespread use of collaborative engagement through private discussions between institutional investors and corporate management).

beneficiary value and do not allow it to make decisions that further third-party interests.<sup>105</sup> The Department of Labor under the Trump Administration took a similar position and relied on this position to restrict the extent to which pension fund trustees could consider ESG objectives.<sup>106</sup> Oliver Hart and Luigi Zingales criticize the focus on economic value in the context of corporate decision-making and argue that corporations should maximize shareholder welfare, including non-economic objectives such as providing benefits to society.<sup>107</sup> This argument can logically be extended to an institutional intermediary's decision-making on behalf of its fund owners.

Intermediaries' fiduciary obligations affect their articulated justifications for engagement on diversity initiatives. Both funds themselves and commentators defend diversity initiatives as increasing the economic value of portfolio companies.<sup>108</sup> The concern is that doing otherwise might expose fund managers to legal liability. While funds outside the United States are increasingly allowed or even required to defend their stewardship activities in terms of broad societal objectives,<sup>109</sup> in the United States, the legal authority to do so remains uncertain.<sup>110</sup>

Even if funds were empowered to consider non-economic objectives, however, determining how to engage with respect to diversity would still be problematic. There are a variety of compelling reasons to promote diverse corporate leadership regardless of whether it can be shown to increase firm economic value. The reasons, however, differ. More importantly, the reasons for supporting diversity play a major role in determining what diversity should look like. Put simply, diversity initiatives require investors to make value choices and to identify priorities in ways that differ from the pursuit of other ESG-type goals. As agents seeking to serve the best interests of their beneficiaries, in order to pursue diversity consistent with that responsibility, institutions arguably should determine not only whether their fund owners favor diversity, but also the reasons for that support.

For example, one can support diverse corporate leadership because it increases the range of perspectives for the board and the C-suite, broadens a corporation's information set and reduces the potential for groupthink. However, as commentators have observed, meaningful corporate inclusion requires more than cosmetic compliance through figurehead directors.<sup>111</sup>

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<sup>105</sup> Schanzenbach & Sitkoff, *supra* note 65.

<sup>106</sup> See, e.g., Dep't. of Labor, Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550) ("A fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors . . ."). The Department of Labor explained that it was adopting the rule "to set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends . . ." *Id.* at 72848. See also Schanzenbach & Sitkoff, *supra* note 65, at 388.

<sup>107</sup> Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247 (2017).

<sup>108</sup> See, e.g., Posner, *supra* note 18 ("Studies repeatedly show that increasing board diversity is not only the right thing to do for an organization's culture, but that it leads to better business outcomes, smarter decision-making, and powers innovation, among other benefits.").

<sup>109</sup> For an overview of institutional investor stewardship obligations from a comparative perspective see DIONYSIA KATELOUZOU & DAN W. PUCHNIAK, GLOBAL SHAREHOLDER STEWARDSHIP (2022).

<sup>110</sup> Notably, the DOL has proposed a rule cutting back on the Trump administration rule change. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (proposed Oct. 14, 2021) (to be codified at 29 C.F.R. pt. 2550). This position could, however, be constrained by proposed legislation. See, e.g., Ensuring Sound Guidance Act, H.R. 7151, 117<sup>th</sup> Cong. (2d Sess. 2022), [https://allen.house.gov/uploadedfiles/esg\\_act.pdf](https://allen.house.gov/uploadedfiles/esg_act.pdf). See also Ellen Meyers, *Some states' anti-ESG push garners support in Congress*, ROLL CALL (Apr. 28, 2022, 7:00 AM), <https://rollcall.com/2022/04/28/some-states-anti-esg-push-garners-support-in-congress/> [<https://perma.cc/JB7Q-KSWS>].

<sup>111</sup> See, e.g., Cahn, et al., *supra* note 59 at 152 ("diversity should not just be a matter of adding a few women to corporate boards.").

Directors who have the personality and credentials to bring credibility to their viewpoints are essential. For diverse directors to reduce groupthink on a board, some studies suggest a critical mass of such directors is required.<sup>112</sup>

The extent to which representation of diverse groups has a meaningful effect on corporate decisions also remains unclear. For example, Quaker Oats ended its use of the Aunt Jemima brand name and image in 2020, determining after 130 years that the name and image had a racist history.<sup>113</sup> Notably, however, the board of directors of PepsiCo, Quaker Oats' parent company had what it described as a diverse board that nonetheless had failed to act in the past. PepsiCo reported in its 2019 proxy statement that its board consisted of 46% women and ethnic minorities and included one African American director.<sup>114</sup> Although PepsiCo did not report aggregate diversity statistics in prior years, in 2015 its board was similarly highly diverse in terms of both gender and ethnicity.<sup>115</sup> Although only one case, the PepsiCo example highlights the danger in relying on statistics as evidence of a truly inclusive corporate culture.

At the same time, a variety of perspectives can reduce the prospect of groupthink, and those perspectives need not be from the demographic categories most commonly associated with inclusion initiatives. A substantial percentage of diversity initiatives focus on increasing the representation of women, Blacks and Latinos, but those are not the only groups that can bring diverse perspectives to the table. As one commentator observes, "much genuine diversity gets lost in our current diversity-speak, with its singular focus on Black and Latino diversity."<sup>116</sup> Specifically, commentators have debated the extent to which those with Asian or Middle Eastern backgrounds "count" for purpose of diversity and inclusion.<sup>117</sup> In addition, diverse viewpoints may or may not be correlated with gender or racial diversity.<sup>118</sup> For example, an affluent African American director with a privileged upbringing may bring less viewpoint diversity to the

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<sup>112</sup> See, e.g., Miriam Schwartz-Ziv, *Gender and Board Activeness: The Role of a Critical Mass*, 52 J. FIN & QUANT. ANAL. 751, 754 (2017) (explaining that women directors are most effective when a critical mass of at least three is present).

<sup>113</sup> Ben Kessler, *Aunt Jemima brand to change name, remove image that Quaker says is 'based on a racial stereotype'*, NBC NEWS (June 17, 2020), <https://www.nbcnews.com/news/us-news/aunt-jemima-brand-will-change-name-remove-image-quaker-says-n1231260> [<https://perma.cc/PS6U-H2EA>].

<sup>114</sup> PepsiCo, Inc., Schedule 14A, Mar. 22, 2018, <https://www.sec.gov/Archives/edgar/data/77476/000120677419000992/pep3495251-def14a.htm> [<https://perma.cc/3AZ9-HRK4>].

<sup>115</sup> See PepsiCo, Inc., 10-K for fiscal year ending Dec. 26, 2015, <https://www.sec.gov/Archives/edgar/data/77476/000007747616000066/pepsico201510-k.htm#s7C55195F19F251E78E1F601366543EF0> [<https://perma.cc/Q7LA-89YY>].

<sup>116</sup> Bret Stephens, *The Lessons of Brooklyn Tech*, N.Y. TIMES (Feb. 1, 2022), <https://www.nytimes.com/2022/02/01/opinion/diversity-public-schools.html> [<https://perma.cc/8YSF-63XJ>].

<sup>117</sup> See, e.g., Amy Wu, *Why are Asian-Americans being left out of diversity and equality initiatives?*, SOUTH CHINA MORNING POST (May 13, 2022), <https://www.scmp.com/comment/opinion/article/3177324/why-are-asian-americans-being-left-out-diversity-and-equality> [<https://perma.cc/8P6X-8JUE>] (criticizing exclusion of Asian-Americans from diversity initiatives); Kathryn Lundstrom, *MENA Leaders Push for a More Nuanced View of Diversity*, ADWEEK (Dec. 4, 2020), <https://www.adweek.com/commerce/mena-leaders-more-nuanced-view-diversity-inclusion/> [<https://perma.cc/G6LB-3BXM>] (observing that those of Middle Eastern descent are often categorized as white for demographic purposes despite facing discrimination).

<sup>118</sup> See, e.g., Stephen Castle & Mark Landler, *Truss Forms a Cabinet Diverse in Background but Not in Ideology*, N.Y. TIMES (Sept. 7, 2022), <https://www.nytimes.com/2022/09/07/world/europe/uk-liz-truss-cabinet.html> (citing Professor Kehinde Andrews from Birmingham City University, who stated that by appointing a cabinet that includes no white males but only those who hold traditional conservative views, "Conservatives were practicing a particularly cynical form of identity politics by promoting the diversity among its senior leaders, while also advancing retrograde policies").

boardroom than a white director from an impoverished background. Similarly, as Judge Green noted in *Crest v. Padilla*, it is unclear why an objective of increasing viewpoint diversity should focus exclusively on racial or gender minorities and exclude other groups such as religious minorities.<sup>119</sup> The same arguments have been made in favor of inclusion for categories such as sexual orientation<sup>120</sup> or those with disabilities.<sup>121</sup>

Other diversity advocates take a narrower view and defend diversity initiatives as primarily focused on remedying past discrimination.<sup>122</sup> This motivation suggests a very different set of priorities. Diversity, in this context, requires identifying the groups that have been victims of discrimination and adopting initiatives that focus on increasing the representation of those groups.<sup>123</sup> In contrast to the diversity of perspective rationale, the goal of remedying past discrimination would likely view a narrower set of demographic categories as targets for greater inclusion. As Leo Strine puts it, the progress of women and the LGBTQ community, for example, “did not heal the deeper wounds of our history of racism against black people.”<sup>124</sup> On the other hand, while ethnic groups vary in the extent to which they have faced discrimination in the past or to which they can currently be characterized as disadvantaged, it is difficult to evaluate which groups to privilege among those with competing claims. Indeed, even these two categories point in different directions – some view Asians as victims of discrimination but challenge the claim that they are disadvantaged.<sup>125</sup> Darren Rosenblum and Jeremy McClane observe that the breadth of the LGBTQ+ community makes it hard to answer questions about who should benefit from inclusion efforts.<sup>126</sup>

A somewhat different but related objective might be providing greater access to the executive suite as a tool for remedying wealth and income disparities. Here diversity efforts might focus on groups that face greater levels of poverty than the general population as opposed to groups that, although having historically experienced discrimination, have greater wealth or income.<sup>127</sup> More generally, in contrast to the goal of increasing viewpoint diversity and

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<sup>119</sup> *Crest v. Padilla*, 2022 Cal. Super. LEXIS 5531, at \*24 (Super. Ct. L.A. Cnty. Apr. 1, 2022).

<sup>120</sup> See, e.g., Ashley Williams, Neill Thompson & Binna Kandola, *Sexual Orientation Diversity and Inclusion in the Workplace*, 27 THE QUALITATIVE REPORT 1068, 1068 (2022) (finding experiences of exclusion due to sexual orientation “to be either overlooked due to membership of other minority groups which hold greater significance, or downplayed due to membership of other majority groups.”).

<sup>121</sup> See, e.g., Caroline Casey, *Do Your D&I Efforts Include People with Disabilities?* HARV. BUS. REV. (Mar. 19, 2020) (arguing that including workers with disabilities can “add to the organizational diversity that drives better decision-making and innovation”).

<sup>122</sup> Leo Strine, *Toward Racial Equality: The Most Important Things The Business Community Can Do*, 1-9 ((Oct. 29, 2020), <https://ssrn.com/abstract=3723950> [<https://perma.cc/37WD-532H>] (identifying primary objective of focus on inclusion in corporate governance as to “help black people finally achieve equality after 400 years of systemic racism”).

<sup>123</sup> See *id.* (“hiring Ivy League law, business, and STEM graduates who had not suffered from the African-American experience and putting them – along with a bunch of white women and one black person – on the cover of glossy brochures did not help redress America’s history of racism against black people”).

<sup>124</sup> *Id.* at 3.

<sup>125</sup> See, e.g., Jay Caspian Kang, *Where Does Affirmative Action Leave Asian-Americans?*, N.Y. TIMES MAG. (Aug. 28, 2019), <https://www.nytimes.com/2019/08/28/magazine/where-does-affirmative-action-leave-asian-americans.html> [<https://perma.cc/3SK8-XKFW>] (raising these arguments).

<sup>126</sup> See Jeremy McClane & Darren Rosenblum, *Exploring Rationales for LGBTQ+ Corporate Inclusion*, \_\_ SEATTLE L. REV. \_\_ (2023) (explaining that some categories of LGBTQ+ people have historically experienced greater exclusion and ostracism than others).

<sup>127</sup> See, e.g., Paul Ingram, *The Forgotten Dimension of Diversity*, 99.1 HARV. BUS. REV. 58, 67 (2021) (arguing to expand “D&I efforts to improve the representation in management of workers from lower social-class origins.”).

combatting groupthink, if diversity instead is about targeting the problems experienced by specific identity groups, whether those problems involve historical discrimination, wealth inequality or the absence of visible role models, there are hazards in deciding to lump every preferred minority group into a single, exclusive list.

Another objective of diversity is to increase representation to promote role models.<sup>128</sup> Here, in addition to the foregoing choices, one might reasonably consider the visibility of corporate leaders, prioritizing representation in large or public-facing companies. A related objective might be improving workplace conditions. Some studies suggest, for example, that the inclusion of women on the board or the C-suite improves corporate culture and reduces the incidence of sexual harassment.<sup>129</sup>

The foregoing list of objectives is not comprehensive. It illustrates, however, that, within the universe of investors who value diversity, the diversity can be implemented in different ways, and these differences are consequential. Investors might reasonably disagree both on the rationales for increasing diversity and on the categories of candidates to include within a particular objective.

Yet a further complication is that investors may disagree on implementation priorities. It is unrealistic to expect even large institutional investors to engage with every one of their portfolio companies on diversity; to prioritize diversity, in every case, over the range of other compelling issues; and to vote against every director candidate who does not fall within some targeted demographic category. In addition, there are practical limits to incorporating diversity. Every group added to the list of viewpoints that must be represented reduces the opportunity to include other groups. If a corporation need fill only a certain small number of seats with members of these communities, it must necessarily pick and choose, or prioritize among competing minority interests. The societal justifications for diversity do not provide guidance about how to create categories and navigate trade-offs. Simply increasing the board size is not a desirable solution either; research indicates that increasing board size is likely to reduce its effectiveness.<sup>130</sup>

Adriana Robertson and Sarath Sanga demonstrate that the foregoing differences in perspectives are likely to result in meaningfully different investor preferences that cannot readily be aggregated.<sup>131</sup> An investor focused on remedying discrimination or increasing opportunity, for example, might prioritize increasing the total number of diverse corporate directors. An investor whose goal is to reduce groupthink may focus instead on bringing some level of diversity to the boards of all companies. Yet another investor who is concerned about workplace culture might place particular weight on diversity in industries that have traditionally been dominated by white men. Given a choice of where to focus their efforts, these investors are going to make very different choices.<sup>132</sup> These differences represent a particular problem for institutional intermediaries who are charged with acting in accordance with their investors' interests.

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<sup>128</sup> Castle & Landler, *supra* note 118 (explaining that diversity in political leadership “can shift attitudes by providing role models”).

<sup>129</sup> See Cahn et al., *supra* note 59, at 151 (citing examples).

<sup>130</sup> The definitive article is David Yermack, *Higher Market Valuation of Firms with a Small Board of Directors* 40 J. FIN. ECON. 185 (1996). Other studies have found similar results. See, e.g., Theodore Eisenberg, Stefan Sundgren & Martin T. Wells, *Larger Board Size and Decreasing Firm Value in Small Firms*. 48 J. FIN. ECON. 35 (1998).

<sup>131</sup> See Adriana Z. Robertson & Sarath Sanga, *Portfolio ESG and the Problem of Aggregation*, working paper.

<sup>132</sup> Robertson and Sanga explain, in the context of pursuing gender diversity on corporate boards, that it is perfectly rationale for one investor to focus on total representation, another to focus on average representation and a third to

The difficulty in identifying and aggregating fund owner preferences and priorities reflects one concern about institutional efforts to promote diverse corporate leadership: accountability. Today's institutions are promoting their vision of diversity, but there is no evidence that this vision corresponds to the preferences of the fund beneficiaries whose economic stake is being harnessed in support of these objectives.<sup>133</sup>

Beyond the issue of accountability, institutional investors' pursuit of corporate diversity raises a question of legitimacy. DEI issues highlight the challenges in using investor initiatives to address societal issues.<sup>134</sup> Here there are two distinct considerations.

The first is the extent to which DEI properly falls within the province of shareholder authority. Traditional corporate law operates according to principles of board or director primacy.<sup>135</sup> Historically courts and regulators have frowned on shareholder efforts to micromanage the corporation, concluding that the legal authority to make operational decisions is relegated to the corporation's officers and directors.<sup>136</sup> Shareholders play only a limited role in corporate operations by exercising their power to sue, sell and vote, and the shareholders' recourse against officers and directors who fail to act in accordance with shareholder preferences is to exercise those limited powers.<sup>137</sup>

Concededly, election of a corporation's directors is a core shareholder function.<sup>138</sup> As such, it is clearly within the shareholders' province to choose which people to elect to the board and to choose to elect them according to principles that include diversity however rationalized. But, in pursuing their power to vote, shareholders also have the right to act selfishly.<sup>139</sup> They are not required to take corporate or societal interests into account. In addition, although shareholders elect directors, they lack agenda control.<sup>140</sup> In the vast majority of cases, shareholders vote for or against a slate of directors chosen by the board's nominating

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focus on the marginal value of adding another female director. These differences, however, create challenges in seeking to aggregate investor preferences. *Id.*

<sup>133</sup> I describe this problem as "empty voting." Fisch, *supra* note 98.

<sup>134</sup> Significantly, the SEC long took the position that the shareholder proposal rule was not an appropriate mechanism for pursuing broad societal change. See Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 87, 910 (1994) (describing the SEC's codification, in 1952 that management could exclude proposals made "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes."). The SEC retreated from this position in 1972. *Id.* In 2021, the SEC staff went further in affirming the propriety of shareholder proposals on matters of societal impact. See Shareholder Proposals, Staff Legal Bulletin No. 14L (CF) (Nov. 3, 2021) (explaining that the SEC would no longer approve the exclusion of shareholder proposals raising "issues of broad social or ethical concern").

<sup>135</sup> See, e.g., Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

<sup>136</sup> See *id.* at 569 (explaining that a variety of rules "prevent shareholders from exercising significant influence over corporate decision-making").

<sup>137</sup> See, e.g., Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005) ("The only way in which shareholders can attempt to introduce a new corporate decision is by replacing incumbent directors with a new team that is expected to make such a change").

<sup>138</sup> Robert B. Thompson, *Defining the Shareholder's Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771, 778 (2008) ("The corporate franchise is the ideological underpinning on which the core premise of Delaware law rests as the justification for permitting directors such broad control over other people's money.").

<sup>139</sup> Paula J. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 Hous. BUS. & TAX L.J. 301, 326 (2008) ("under current law shareholders are permitted to act completely selfishly when voting, even in the presence of conflicts of interest.").

<sup>140</sup> John C. Coffee, *Reform of the Proxy Process*, Corporate Governance Institute, 5 (2003) ("even motivated shareholders do not currently enjoy the ability to participate in the nomination of directors without running a proxy contest, a cost-prohibitive exercise absent a battle for corporate control.").

committee.<sup>141</sup> Diversity standards, whether imposed through shareholder proposals, legislation or listing requirements, simply leave to the nominating committee the discretion about how to satisfy those standards and, as a result, how to navigate the tradeoffs described above. Accordingly, it is problematic to view the shareholder vote on directors as a referendum on diverse leadership.

The second consideration is that this entire enterprise involves investors making societal decisions – determining how much diversity is necessary or appropriate for corporate America and what kind of diversity should be pursued. This is a particular concern when the justification for investor action is what is good for society rather than what is good for the corporation. Shareholders, after all, reflect only a portion of society. They are disproportionately old, rich, white and male.<sup>142</sup> Shareholder voting is based on economic ownership, meaning that the shareholders with larger investments have greater say. As a result, shareholder voting seems like an odd way to determine issues of societal importance. The problem is exacerbated when it is not shareholders who are making the decisions, but their unelected asset managers.<sup>143</sup> If the goal of corporate diversity is to benefit society, it would seem like the traditional democratic process would be a more appropriate way of setting standards and determining priorities.

Moreover, there is a societal cost to delegating to investors the responsibility for addressing moral or ethical issues. Giving investors the authority to determine what inclusion means in corporate leadership takes these deliberations outside the political process, reduces the input of other members of society and, to a degree, may relieve pressure on courts and legislatures.

## V. The Role of Corporate Governance

The foregoing discussion highlights two different problems with the current institutional efforts to promote diverse corporate leadership: accountability and legitimacy. These problems raise a variety of complex considerations about the role of ESG issues in corporate governance, agency problems both within corporations and in institutional shareholder intermediaries, and the extent to which it is desirable to implement a corporate purpose that focuses more on broad societal concerns to redress shortcomings in the political process. These considerations are largely beyond the scope of this Article. Instead, this Part briefly identifies two possible corporate governance approaches that offer a partial response to the concerns identified in Part IV. The first is to reduce or limit the authority of institutional intermediaries to engage with

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<sup>141</sup> The adoption of proxy access bylaws has, as a theoretical matter, increased shareholder control over the vote on corporate directors but, in practice, such bylaws have rarely been used. See Holly J. Gregory, Rebecca Grapsas & Claire Holland, *The Latest on Proxy Access*, HARV. L. SCH. FORUM ON CORP. GOV. (Feb. 1, 2019), <https://corpgov.law.harvard.edu/2019/02/01/the-latest-on-proxy-access/> [<https://perma.cc/L8CZ-96GR>] (detailing the adoption and use of proxy access bylaws through early 2019).

<sup>142</sup> See, e.g., William W. Bratton & Michael L. Wachter, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489, 491 (2013) (“The modal shareholder in the data is rich, old, and white. It follows that there is nothing inherently democratic or progressive about the shareholder interest in corporate politics.”); Sarah C. Haan, *Voter Primacy*, 83 FORDHAM L. REV. 2655, 2700 (2015) (“Stockholding Americans are more likely to be white, male, and older than non-stockholding Americans, and more likely to identify as Republican.”).

<sup>143</sup> See Andrew Puzder, *Larry Fink’s Crusade Runs Into Resistance*, THE HERITAGE FOUNDATION (Feb. 7, 2022), <https://www.heritage.org/progressivism/commentary/larry-finks-crusade-runs-resistance> [<https://perma.cc/F85T-Y9Q6>] (“State officials, in particular, have started resisting the notion that unelected and unaccountable functionaries such as [Larry] Fink . . . can legitimately substitute their progressive beliefs and fixations for the will of the American people.”).



respect to diversity initiatives. The second is to require them to take affirmative steps to inform themselves of the preferences of their fund owners.

### A. Limiting Institutional Engagement on Diversity

The first possible approach is to reduce the role of institutional investors in addressing corporate diversity. Sean Griffith, for example, has argued that institutional intermediaries should not vote (or should vote in accordance with management's recommendation), at least as a default matter, on environmental and social issues.<sup>144</sup> The position of the Trump Administration Department of Labor can be understood as a partial attempt to implement this approach by cautioning pension funds against voting or engagement efforts aimed at promoting objectives other than increasing firm-specific economic value.<sup>145</sup> Senators Pat Toomey & Ron Johnson took a similar position, criticizing the companies that manage the federal government's Thrift Savings Plan, specifically BlackRock and State Street, for pursuing ESG initiatives including racial and gender diversity without showing that those initiatives are expected to increase financial returns.<sup>146</sup> Significantly, reducing the role of institutional investors in promoting diversity initiatives would address both the concerns about accountability and legitimacy identified in the preceding Part.

There are two problems, however, with this approach. First, unlike some ESG issues like decarbonization or greenhouse gas reporting, diversity initiatives are a component of a key shareholder role – election of the board of directors. It is difficult to imagine a legitimate election process in which institutional investors are precluded from voting in director elections. At the same time, it would be almost impossible to envision a mechanism in which such shareholders were precluded from including diversity considerations into their evaluation of board candidates.

The second and more significant problem is that, as Gormley et al. have demonstrated, institutional engagement on diversity and inclusion has been highly effective in increasing the representation of women and minorities on corporate boards.<sup>147</sup> Notably, with diversity mandates such as California's laws facing legal challenges, private ordering through institutional

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<sup>144</sup> Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983 (2020).

<sup>145</sup> Financial Factors in Selecting Plan Investments, 85 FED. REG. 72,846, 72,884 (Nov. 13, 2020) (to be codified at 29 C.F.R. pt. 2509, 2550) (“A fiduciary’s evaluation of an investment or investment course of action must be based only on pecuniary factors”). Although the rule did not explicitly reference ESG investing, the DOL explained that its purpose was “to set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends.” *Id.* at 72,848. Although the Biden administration reversed the DOL policy, several Republican-sponsored bills would implement similar restrictions through legislation. See Ellen Meyers, *Retirement funds are ground zero in Senate GOP opposition to ESG*, ROLL CALL (July 28, 2022), <https://rollcall.com/2022/07/28/retirement-funds-are-ground-zero-in-senate-gop-opposition-to-esg/> [<https://perma.cc/GE8E-R4UN>] (describing Republican legislative proposals).

<sup>146</sup> Letter from Senators Pat Toomey & Ron Johnson to David A. Jones, Acting Chairman Federal Retirement Thrift Investment Board, dated June 30, 2021, [https://www.banking.senate.gov/imo/media/doc/toomey\\_johnson\\_letter\\_to\\_frtib.pdf](https://www.banking.senate.gov/imo/media/doc/toomey_johnson_letter_to_frtib.pdf) [<https://perma.cc/E9FL-G8V9>].

<sup>147</sup> Gormley, Gupta, Matsa, Mortal & Yang, *supra* note 2. See also Sara Savat, *WashU Expert: Shareholder influence more effective than mandates in diversifying boards*, NEWSROOM (Dec. 4, 2020), <https://source.wustl.edu/2020/12/washu-expert-shareholder-influence-more-effective-than-mandates-in-diversifying-boards/> [<https://perma.cc/GR65-WKS2>] (quoting Todd Gormley expressing concern that the Nasdaq approach may only result in “tokenism”).

engagement is critical for board diversification.<sup>148</sup> Despite concerns about the ability of institutional intermediaries to get diversity “right,” it does not seem desirable to dismiss the substantial impact of their diversity initiatives.

## B. Informed Intermediation

An alternative approach is informed intermediation. In other work, Jeff Schwartz and I argue that institutional intermediaries should be required to ascertain the preferences of fund owners and to take those preferences into account in formulating their voting and engagement policies.<sup>149</sup> We defend informed intermediation as superior to solutions to the accountability problem posited by other commentators such as pass-through voting<sup>150</sup> or market segmentation.<sup>151</sup>

Pass-through voting suffers from two key problems. First, pass-through voting reduces the heft of the large asset managers thereby sacrificing their ability to influence management decisions.<sup>152</sup> Second, because voting turnout by mutual fund owners is likely to be extremely low, pass-through voting will leave the vast majority of intermediated shares unvoted.<sup>153</sup> This will interfere with traditional governance mechanisms such as an issuer’s ability to get a quorum at a shareholder meeting, as well as impeding certain corporate actions that require minimum voting thresholds such as amending a corporate charter.

Market segmentation offers a market-based alternative and, in some cases, can be highly effective. State Street’s Fearless Girl campaign is an example of market segmentation that worked well – investors who prioritized board diversity invested in State Street mutual funds and, through so doing, demonstrated their support for State Street’s campaign. Market segmentation works best when there is a single message, and it is simple. In State Street’s case, the objective was increased gender diversity on corporate boards. It is also effective at a moment in time when its message, as State Street’s campaign was in 2017 – is highly salient

As the preceding discussion indicates, however, the long-term debate over how corporate inclusion should develop is more complex. In this environment, market segmentation is an imperfect tool. The mutual fund marketplace is dominated by investors with both limited financial literacy and limited bandwidth for obtaining and evaluating detailed information on

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<sup>148</sup> David A. Bell, Dawn Belt & Ron Llewellyn, *Meeting Expectations for Board Diversity*, HARV. L. SCH. FORUM ON CORP. GOV. (June 22, 2022), <https://corpgov.law.harvard.edu/2022/06/22/meeting-expectations-for-board-diversity/> [<https://perma.cc/49M2-E3HU>] (“Because attempts to mandate board diversity or its disclosure have faced legal challenges, private ordering may ultimately prove to be more effective in achieving diversity.”).

<sup>149</sup> See Jill E. Fisch & Jeff Schwartz, *Corporate Democracy and the Intermediary Voting Dilemma*, TEX. L. REV. (forthcoming 2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4360428](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4360428).

<sup>150</sup> See, e.g., Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders’ Rights*, 34 IOWA J. CORP. L. 843, 889 (2009) (advocating “optional pass-through voting, where advisers would have to take proxy assignments from retail fund shareholders who wish to vote from time to time on contentious matters at portfolio companies.”).

<sup>151</sup> See, e.g., Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 U. CHI. BUS. L. REV. 195 (2022) (discussing pass-through voting, aggregation of fund owner preferences and market segmentation).

<sup>152</sup> See Jill E. Fisch, *The Uncertain Stewardship Potential of Index Funds*, in GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES, (Dionysia Katelouzou & Dan W. Puchniak eds., Cambridge Univ. Press 2022) (observing that “to the extent a mutual fund adviser votes in accordance with the preferences of its beneficiaries, it loses its power to negotiate with issuers for change”).

<sup>153</sup> Fisch & Schwartz, *supra* note 149 at 29 (“Direct retail investors only vote 29% of their shares, and mutual fund investors show even less interest in voting”).

fund characteristics.<sup>154</sup> The evidence suggests, for example, that a substantial number of investors choose funds largely on the basis of their name.<sup>155</sup> One recent article revealed that BlackRock changed the name of an ESG fund three times, and that the name changes correlated with substantial inflows of assets.<sup>156</sup> Indeed, the concern that investors are easily misled has led the SEC to propose complex rules regulating the use of fund names and the information fund advisors are required to disclose.<sup>157</sup>

Market segmentation is also limited by the extent to which retail investment decisions themselves are intermediated. Most retail investors participate in the capital markets largely if not exclusively through employer-sponsored 401(k) plans.<sup>158</sup> Those plans have a limited number of menu options, and the options are chosen by the employer.<sup>159</sup> Indeed, many employees do not even make an affirmative choice among those menu options but are instead defaulted into a fund chosen by the employer.<sup>160</sup> When the default fund is a target date fund, the employee cannot be understood to have made a meaningful choice about that fund's engagement in DEI initiatives, even if the fund's engagement in such initiatives is fully disclosed.<sup>161</sup>

Instead of these approaches, we argue for a requirement that institutional intermediaries be required to take reasonable steps to ascertain the preferences of their fund owners and to consider those preferences in formulating their voting and engagement policies.<sup>162</sup> Critically, the informed intermediation that we advocate is qualitatively different from requiring mutual fund managers simply to collect and aggregate investor preferences.<sup>163</sup> Aggregating investor preferences raises similar challenges to pass-through voting and creates additional complexities.

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<sup>154</sup> Indeed, there are reasons to question whether mutual fund investors are even capable of understanding and evaluating the fees charged by their funds. *See generally* James Kwak, *Improving Retirement Savings Options for Employees*, 15 U. PA. J. BUS. L. 483, 496–97 (2013) (explaining that retail investors pay too much in fees, invest too heavily in actively-managed funds and trade at the wrong time).

<sup>155</sup> SEC Commissioner Allison Herren Lee, *What's in a Name? Aligning Fund Names with Investor Expectations* (May 25, 2022), <https://www.sec.gov/news/statement/lee-names-rule-statement-052522> [<https://perma.cc/CQE2-NCWY>] (“investors may often rely on fund names in deciding where to invest their savings”); Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825, 2826 (2005).

<sup>156</sup> Silla Brush, *One Fund, Three Names and Lots of Questions for 'ESG'*, BLOOMBERG (July 25, 2022), <https://financialpost.com/pmn/business-pmn/one-fund-three-names-and-lots-of-questions-for-esg> [<https://perma.cc/LHN8-GVN2>].

<sup>157</sup> Investment Company Names, Rel. No. IC-34593, May 25, 2022, <https://www.sec.gov/rules/proposed/2022/ic-34593.pdf> [<https://perma.cc/XJC6-84MV>]; SEC Press Release, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices, May 25, 2022, <https://www.sec.gov/news/press-release/2022-92> [<https://perma.cc/7WGL-L62D>].

<sup>158</sup> Anne Tucker, *The Citizen Shareholder: Modernizing the Agency Paradigm to Reflect How and Why a Majority of Americans Invest in the Market*, 35 SEATTLE U. L. REV. 1299, 1353 (2012) (“a majority of modern investors enter the market and purchase mutual funds through employer-sponsored defined contribution plans, such as 401(k) plans.”).

<sup>159</sup> Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans*, 124 YALE L. J. 1476, 1485 (2015) (“The menu of mutual funds from which employees choose is ultimately constructed by the employer.”).

<sup>160</sup> *See, e.g., id.* at 1515 (“The Pension Protection Act of 2006 permits employers to enroll employees in 401(k) plans as a default, and to invest their funds by default into the plan's QDIA.”).

<sup>161</sup> A target date fund offers participants a blend of debt and equity that becomes more conservative as the target date, which typically corresponds with the participant's likely retirement age, approaches. *See* Dana M. Muir, *How Behavioral Science Ultimately Fails Retirement Savers: A Noble Experiment*, 56 AM. BUS. L.J. 707, 718 (2019) (“The vast majority of 401(k) plans with a default investment have adopted a target date fund (TDF) as the QDIA.”).

<sup>162</sup> Fisch & Schwartz, *supra* note 149.

<sup>163</sup> *See id.*

How should managers vote when they have received input from a limited number of shareholders? Should a small group of vocal shareholders control a fund's entire voting power? Are decisions made by majority vote, such that BlackRock votes its entire portfolio in the same way regardless of whether a proposal is supported by 51% of fund owners or 99%?

Whether our proposal will result in institutions continuing their existing efforts on corporate diversity or shifting their approach remains to be seen. There is limited evidence suggesting that, at least on some issues, retail investors' views differ from those of institutional intermediaries,<sup>164</sup> and there are plausible reasons to suspect that large asset managers might be either more or less aggressive in supporting diversity.<sup>165</sup> In addition, informed intermediation does not address the serious legitimacy concern. In the spirit of not allowing the perfect to be the enemy of the good, however, informed intermediation is likely to both improve the quality of the information asset managers are using to formulate their policies and to encourage fund owners that their preferences matter. With respect to an important and potentially controversial issue such as diversity, that is at least a good start.

## VI. Conclusion

Institutional investors have been a powerful and effective force for diversifying corporate leadership. Today's corporate boards rarely consist exclusively of old white men. Although progress has been slower in the C-suite, there are signs that institutional investors have had an influence in encouraging a more diverse executive team as well. Institutional engagement offers the potential to promote equality and opportunity further down the employment ladder.

As diversity efforts increase, however, corporations are increasingly facing the questions about who to include and why. Quotas and checklists mask difficult questions about the objectives behind greater inclusion and which goals and identity groups to prioritize. These questions highlight the challenges presented by institutional intermediation and, in particular, the effectiveness of investor intermediaries in navigating complex social issues. This Article does not attempt to address all these challenges, but it suggests that informed intermediation can be a valuable tool in improving the quality of institutional investor engagement.

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<sup>164</sup> See, e.g., Alon Brav, Matthew D. Cain & Jonathon Zytnick, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, 144 J. FIN. ECON. 492, 493 (2022) (documenting "substantial differences in voting between retail and institutional shareholders"). See also Jill. E. Fisch, *Standing Voting Instruction: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 15 (2017) ("there are reasons to believe that retail investor voting preferences differ systemically from those of institutional investors.").

<sup>165</sup> See, e.g., Lund, *supra* note 100, at 23–24 (observing that "the Big Three did not adopt bold policies such as mandating that half the board be composed of female directors (which would better approximate the workforce); instead, they offered tepid policies with fewer requirements than the quota eventually adopted by the state of California.").

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