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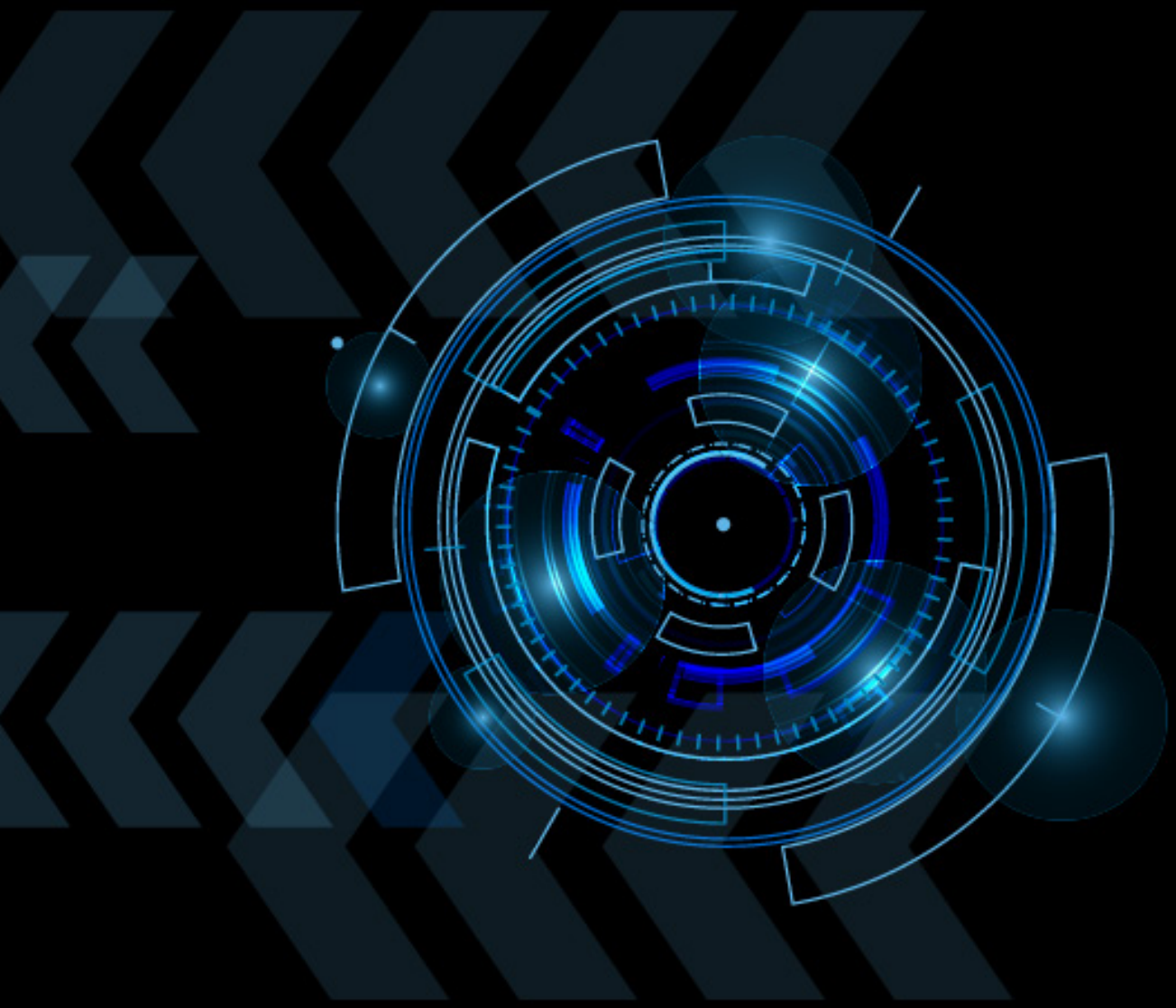


Expanding and Diversifying Director Candidate Pools through Subsidiary Board Service

The business case for board diversity is not new and may no longer be forward-thinking.[1] While organizations – and other parties – have introduced initiatives to encourage boardroom diversity, developing the next generation of board members is a persistent challenge for many business leaders.

Beyond current initiatives to increase boardroom diversity, organizations with subsidiaries are uniquely positioned to further diversify the board candidate pool.

As an example, organizations can place diverse executives onto their subsidiary boards. By providing this opportunity to their executives through a formalized policy, organizations can fill subsidiary boards with those that are interested in board service, and the executives can gain valuable experience of serving on a board that can be used as a steppingstone for longer-term board service aspirations should they wish. Putting such a policy in place also sets the stage to infuse diverse candidates into future parent board refreshment initiatives. However, this approach may not be as simple for listed subsidiaries that will have their own requirements for outside, independent directors.

Developing Diversified Director Candidate Pools:

Subsidiary Boards as a Steppingstone

Consider this: Although women represent nearly half the world's population (49.5% as of 2020), they hold only 19.7% of boards of directors' seats, according to the seventh edition of the Deloitte report *Women in the Boardroom: A Global Perspective*.[2] Even fewer board chairs – just 6.7% – are women. The current pace of change, hovering around 2.8% growth every two years, suggests that women may not hit parity in board representation until around 2045. While that represents an acceleration of change (the prior report suggested parity may not occur until 2052), the pace remains remarkably slow.

The numbers are even more concerning for minority board members, who currently hold 17.5% of Fortune 500 board seats.

Deloitte's latest *Missing Pieces Report: The Board Diversity Census of Women and Minorities on Fortune 500 Boards*,[3] shows that board representation of minority men has stagnated since 2010, growing no more than 0.5% per year.

Government regulation, legislative action, and social pressure are combining to bring a greater sense of urgency to the issue, and many companies are taking steps to improve representation on their boards. But the needle must move more quickly – not just for the sake of appearances, but for companies' financial health and longevity.

While gender and racial/ethnic diversity are critical to creating a broad perspective, other qualifications such as cultural and educational background and career experience are also important. Companies with more diversity at the top – whether that diversity is cultural, background, or perspective – are often better-positioned to deliver financial results that outpace more homogenous organizations. According to BoardReady's 2021 Report "Lessons from the Pandemic: Board Diversity and Performance, boards rated *"best-in-class in terms of multi-dimensional board diversity experienced revenue growth of 0.9%" throughout the pandemic, compared to negative growth of 3.4% for companies in BoardReady's "Needs Improvement" group*.[4]

Large organizations are seeking experienced directors, which can make it hard for those outside the most senior executives and those with previous board experience to gain a seat. The pool of diverse candidates with leadership and board experience at this level is relatively small. If they wish to bring multi-dimensional diversity to their boards, including those in roles beyond CEOs and CFOs, companies may need to find ways to provide qualifying experience to more potential board candidates.

To drive greater diversity in the board pipeline, many companies should put themselves in a position to develop and support a variety of qualified board candidates.

As a leading practice, organizations with subsidiaries can create impact by assigning a diversified cohort of directors to their subsidiary boards. Doing so may allow executives of the organization to obtain insight into how boards work and what it means to provide oversight of a business. They may also grow the confidence they need to serve effectively on public and private corporate boards in the future.

OUTSIDE INVESTORS AND LEGISLATURES DRIVE CULTURAL DIVERSITY

Why the focus on diversity? In addition to feeling that it's "the right thing to do," many investors and legislatures are demanding it.

As noted in Deloitte's 6th edition of their *Women in the Boardroom* report, key investors, including BlackRock, State Street, and Vanguard, have promised to vote against directors who fail to demonstrate or promote board diversity.[5] Nasdaq also published a Board Diversity Rule that requires listed companies to publicly disclose their board diversity statistics and provide an explanation if they do not have at least two diverse directors.[6]

Some state legislatures have also increased pressure on organizations by instituting quotas. Washington now mandates that public companies have gender-diverse boards, comprised of at least 25% of individuals who self-identify as women, or provide a "board diversity discussion and analysis" in its proxy statement or on its website.[7] Other states, including Maryland,[8] New York[9] and Illinois,[10] now require boards to disclose their demographic representation. Illinois also requires boards of companies headquartered in the state to submit their plans for promoting diversity to the Secretary of State each year.[11]

While the move toward cultural diversity has been slow - particularly in light of the social justice movements spawned in 2020 — many investors, customers, employees, and other stakeholders have stepped in to demand a reckoning and it will likely be increasingly important for companies to be in position to respond to these constituencies.

Potential Benefits of Subsidiary Board Service to Candidates and the Organization

Creating a pipeline of diverse candidates for an organization's subsidiary boards isn't a check-the-box exercise. It requires a well-considered strategy that addresses everything from the definition of diversity to change management. By deploying such a strategy, organizations may be able to cultivate the next generation of board members while candidates might enjoy the benefit of significant professional development. Three specific value drivers can typically be expected:

1. Gain Value from Demographic and Cognitive Diversity

While much attention is focused on diversity in terms of gender, race, and ethnicity, organizations that define diversity more broadly tend to be more successful. For example, research from the Credit Suisse Research Institute, as cited in the *Missing Pieces Report*, found that shares of companies with a market capitalization of more than $10 billion that have female board members outperformed competitors with all-male boards by 26% over six years.[12] Diversity of thought stems from not just demographic diversity but also cognitive diversity, which includes educational and functional diversity.

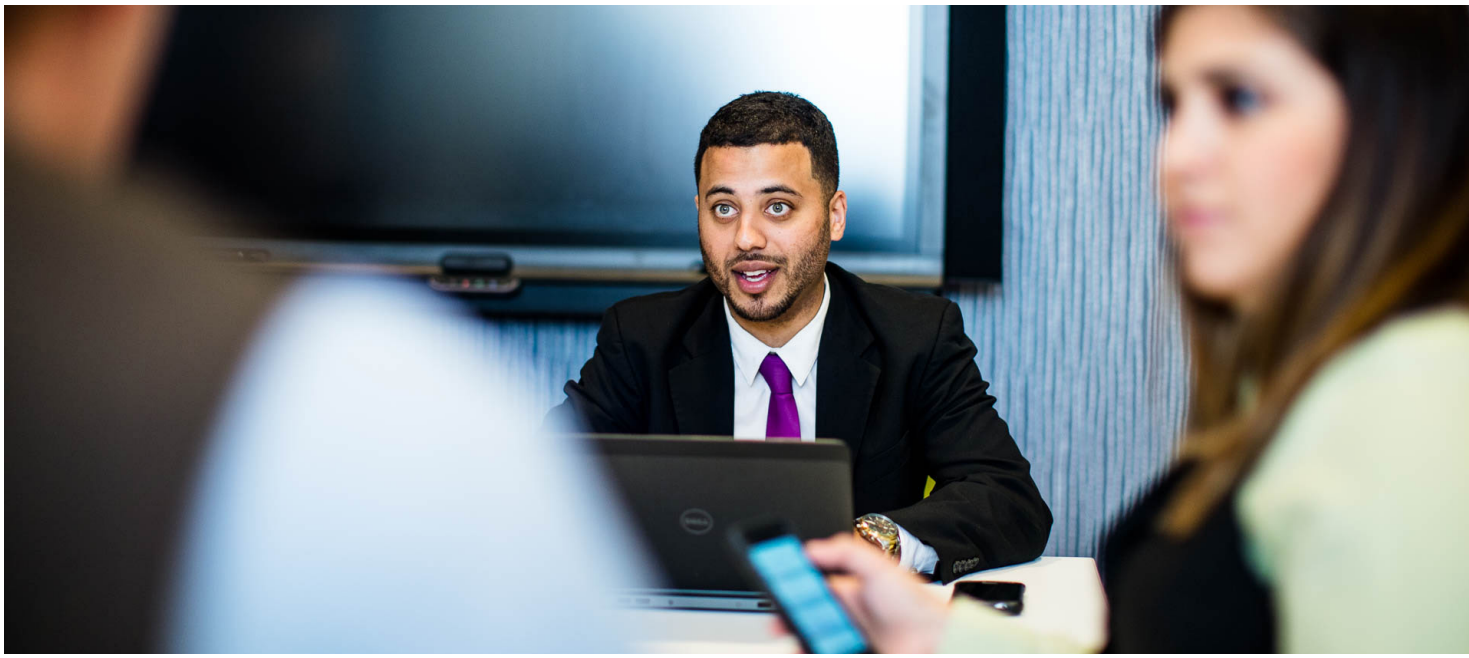
So, while it is important to recruit candidates from a variety of ethnic backgrounds and gender perspectives, it's equally important to look for candidates who bring a breadth of experiences and professional backgrounds that can create a rich discourse in the boardroom that is invaluable to strong decision making. Board candidate qualifications beyond being a CEO and CFO may also lend different perspectives that are often overlooked on boards. Placing risk or sustainability officers, DE&I leaders, innovation officers, and other leaders in the next class of subsidiary board members can bring different perspectives to the organization.

2. Improve Subsidiary Governance

As a recent Deloitte study on the value of legal entity management in mergers and acquisitions found, inadequate subsidiary management can lead to negative impacts on deals, including a potentially lower enterprise value.[13] A potential advantage to giving executives subsidiary board experience is the heightened focus it may be able to give to the oversight of those subsidiaries. Visibility into the operations of legal entities becomes critical when a transaction is imminent or underway. Having executives serving on subsidiaries' boards may improve that visibility and may mitigate the risk of a deal being threatened by surprises or unknown issues that surface in legal entities during the due diligence process. Moreover, in situations where a subsidiary represents a significant portion of the overall organization's revenue or assets, consideration could be made to place an executive on both the parent and that subsidiary's audit committees. This could provide even greater oversight to mitigate risk.

3. Develop Rising Stars

Recruiting from a deeper pool may do more than just improve the board. It can be a career enhancer for the executives themselves. When an organization creates policies that allow executives to serve on subsidiary boards, it may help executives diversify their own experience and ways of thinking. Overseeing and advising a subsidiary that may be an organization unrelated to their own can enable an executive to see things in a different light. Board service may enhance an executive's experience to make the executive more effective in their own organization with an opportunity to accelerate their own path to additional roles within the organization. It may pave the way for the executive to be considered for additional board service roles.



Obtaining Buy-In

Growing a diverse pipeline of subsidiary board candidates typically requires buy-in from both prospective and current board members. Organizations can encourage executives to join subsidiary boards by explaining that the time and energy they invest may compound due to the expertise they will gain and the career growth opportunities they may encounter. For example, executives sitting on a board may gain:

- Experience in overseeing a subsidiary's management, operations, and governance.
- Improved understanding of how businesses grow and succeed.
- Exposure to different sets of issues that affect business.
- Insight into thinking and making decisions like an investor.
- An expanded focus on complex issues such as long-term strategy, risk, ESG, finance, and hot topics in the regulatory and industry landscapes.
- Communication skills needed to speak to the organization's parent board, executives, and investors.

In certain circumstances, current subsidiary board members may resist the idea of bringing on and developing inexperienced members or have concerns about conflicts of interest between a parent and subsidiaries. Other challenges may materialize, such as existing subsidiary board members concerned that they don't have access to the same information that an executive from the parent company, placed on their board, may have.

Organizations should consider creating a vision for the change, building a strong business case that demonstrates the potential business impact of diverse candidates overseeing the organization's subsidiaries, and forming a coalition of champions capable of influencing others.

Putting official policies in place to allow for and encourage board service, whether in subsidiaries or outside organizations, can help drive a culture that fosters strong board candidate development.

Ultimately, the issue may come to a head because of a board refreshment initiative driven by current board or organization leadership, or by investors. The goal of such an initiative is to bring fresh perspective and new skillsets and represents a perfect time to incorporate multi-dimensional diversity into board strategy. For those organizations that are pushed by investors (or possibly customers or regulators) to refresh their board, having an established pipeline of qualified diverse candidates on subsidiary boards may be beneficial.

Finding the Missing Pieces of Future Board Talent

Today, despite the evidence that there is value from demographically and cognitively diverse slates of directors, none of the companies in the Fortune 500 have boards that reflect U.S. demographics, falling well short of the benchmarks of 50% women, 13% Black, 18% Hispanic or Latino, and 6% Asian/Pacific Islander, according to our *Missing Pieces* report. One possible approach to enhancing diversity in the boardroom is to consider candidates serving on subsidiary boards. Companies have an opportunity to build the skills and experience of their executives from marginalized groups interested in board service. Subsidiary board experience may be one way to accomplish the goal of intentionally developing board members who may not have the background typical of most directors, while also helping its executives grow, providing value for both the organization and its executives.

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