CFA Society United Kingdom

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FAO: Capital Markets Policy Team

CFA UK Response on Consultation CP21-24: Diversity and inclusion on company boards and executive committees

CFA Society of the UK (CFA UK) [1] welcomes the opportunity to share our views on this consultation, which seeks to accelerate the pace of meaningful change on diversity and inclusion in corporate leadership by improving the transparency and breadth of required disclosures by listed companies.

CFA UK believes that the underlying of policy in this area should be to achieve greater diversity of thought through effective inclusion, welcoming different perspectives because of the value it brings by fostering richer debate and, as a result, better decision-making. Just as Modern Portfolio Theory tells us that investment portfolios constructed from the full market portfolio are more efficient (and should offer higher returns and/or lower volatility) than those constructed from a limited set of securities, we believe that the benefits of accessing the full market for human capital are also clear.

To achieve the desired outcome of diversity of thought and the necessary culture of challenge that is needed to avoid 'group think' in corporate board rooms and within executive teams, more needs to be done to make sure that the pool of talent from which to recruit is broad enough to ensure there are sufficient candidates from diverse backgrounds. We believe that expertise, experience and skills exist in a range of individuals across the country's population and that more active and focused efforts by companies (including in the investment profession) should be undertaken to ensure that those people are aware of opportunities, are encouraged to apply for them and are given due consideration as part of the hiring process.

CFA UK broadly agree with the CP 21/24 proposals, and highlight the following points:

- We propose the ethnic minority target to be a proportion rather than 'just one'. For clarity, the main proposal covers the following targets on board diversity for listed companies:

[1] A synopsis of the mission and scope of both CFA UK and CFA Institute is provided in Appendix I.

  - At least 40% of the board are women (including individuals self-identifying as women);
  - At least one of the senior board positions (Chair, CEO, SID or CFO) is held by a woman (including individuals self-identifying as a woman);
  - At least one member of the board is from a non-white ethnic minority background (as categorised by the ONS).

- We believe targets are useful in acting as a guide and imposing pressure for their achievement. However, they need to be accompanied by a long-term DEI strategy that includes a sustainable pipeline strategy; this is of paramount importance. We would not welcome targets soon becoming de facto quotas and would be concerned about the imposition of a limited timeframe for the achievement of targets.
- We see numerical reporting of diversity data as a useful indicator for clients and investors, in an industry that is mostly numbers driven.
- We encourage wider diversity disclosures, such as ethnicity, sexual orientation, disability, and socio-economic background. We also support extension of these criteria to key board committees and the firm more broadly.
- Generally, we support more DEI numerical reporting, especially since the FCA is taking a phased approach to the targets proposed.
- We see potential challenges with these targets being faced by smaller listed companies and would encourage the regulator to take proportionality into account. However, the benefits to the wider industry outweigh the challenges. We trust that these metrics will benefit the market and reinforce our view that diversity on boards and broadly at firm level has a positive impact on the bottom line and long-term strategies of investees. A phased approach to the breadth of data collected may be beneficial.

Our responses to the specific questions in the consultation are provided in Appendix II.

Should you have any questions or points of clarification regarding this letter or our responses to the questions, do not hesitate to contact us.

Yours sincerely,

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Appendix I: About CFA UK & the CFA Institute

CFA UK: serves over 11,500 members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments, or overseeing pension investments.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behaviour in investment markets and a respected source of knowledge in the global financial community. It aims to create an environment where investors' interests come first, markets function at their best, and economies grow.
- CFA Institute awards the Chartered Financial Analyst® (CFA), and Certificate in Investment Performance Measurement® (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in more than 160 markets, of which more than 175,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 160 local societies.
- For more information, visit http://www.cfainstitute.org

Appendix II: Responses to questions

Q1: Do you agree with the proposed comply or explain disclosure requirement on board diversity targets relating to gender and ethnicity?

We agree with this proposal; having a mandatory disclosure regime would promote a tick-box approach which could produce some sub-optimal outcomes. An explanation of why a company is not complying could be more revealing than straight compliance with the regulation. As outlined further in question 7, we believe the regime should move beyond just these two physical criteria.

It is difficult to compel firms to have a more diverse board without targets, but we are concerned about the risk of targets becoming de facto quotas. Targets alone will not solve this issue, but they provide useful guidance for boards. In order to achieve these targets, boards need a medium-term DEI strategy that ensures its diversity is achieved based on merit. This is important both for firms and their investors, but also to appointees. It should also be made clear that boards are not expected to comply as quickly as possible as there should be a recognition that meeting the targets should take time. Having said that, this should not be an excuse for boards not to aim to make sustained progress in this area. The explain section will give firms the opportunity to showcase their strategy as well as progress towards the targets even if that is on a more medium-term basis.

As we have mentioned in our response to the DP21/2 “Diversity and inclusion in the financial sector – working together to drive change” to Question 9 [2], in order to achieve more diverse boards we encourage boards to consider:

- Establishing and documenting DEI criteria into their board recruitment process.
- Hiring a DEI consultant to provide education and training for the nomination committee before starting the process.
- Pushing search firms to generate candidates from beyond the usual backgrounds.
- Mandating diverse interview lists. The best candidate may look the same as the existing members however the board should ensure that a range of candidates are interviewed. Even if this means interviewing more candidates.
- Being forward looking and setting criteria for Board appointments which may include life experiences that would be beneficial in the boardroom as a mitigant to group think and those that would be culturally ‘additive’ rather than a cultural ‘fit’.
- Consider candidates from other sectors, who may bring different perspectives as compared with industry peers.
- Consider the value of candidates who may not have had PLC board experience, especially with respect to independence of thought and ability to challenge current board practices.
- Accept and plan that looking for diverse candidates may lead to a longer and more challenging appointment process.
- Openly advertise board roles and commit to a more open and transparent process (e.g. mirroring aspects of the public sector appointments process).

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[2] https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/fac-prudential-regulation-authority-pra-bank-of-england-and-fca.pdf

- Time limits for serving on a board may also ensure there is greater turnover of the board and limit the risk that 'group think' may develop over time.
- To help build a diverse pipeline of Board level candidates, firms could create shadow boards with a maximum 12-month membership that would enable more senior employees to gain relevant experience and develop key skills and knowledge.

Q2: Do you agree with the proposed disclosure obligation to set out numerical data on the gender and ethnic diversity on a company's board and its most senior level of executive management?

Yes, we agree with this proposal. Without collecting and publishing data it cannot be determined whether boards have achieved the goals or what the rate of progress towards the targets is. We believe that collecting this data is vital.

Q3: Do you agree with the proposed scope of who would be required to report under the new Listing Rules proposals, and those we have excluded (e.g. issuers of listed debt)? If you disagree, please explain why.

We agree with the proposal to extend these requirements to all premium listed companies and all standard-listed companies (please also see our response to question 4 below). We support the application of the regulation on a comply-or-explain basis.

For the avoidance of doubt, we also agree the following should be included:

- Close-ended funds and investment trusts
- Sovereign-controlled companies
- Companies with UK-listed global depository receipts (GDRs)

and the following should be excluded:

- Shell companies
- Listed OEICs caught by other regulations

Q4: Do you agree with our proposal to include overseas and smaller issuers in the new Listing Rules proposals? If not, please explain whether you would propose further flexibility within the rules, or would exclude such companies from scope?

Yes, we agree with your proposals to include overseas issuers on the same basis as UK issuers, noting that the regulation is on a comply-or-explain basis. While we support the aim of also encouraging overseas companies towards having more diverse boards, we believe that the standards need to be applied with flexibility to different contexts. For example, an overseas issuer with a board entirely drawn from its local territory might appear to deliver against minority ethnic criteria as designated from the UK, but may well not do so in the local context -- and importantly may entirely lack the diversity of thought and challenge that is the underlying aim of this regulation. We therefore urge that any diversity standards are applied with intelligence to different circumstances and that overseas companies in particular are expected to explain how they have delivered diversity of thought within their boardrooms, rather than complying with any particular ethnic mix set in consideration of UK circumstances. Issuers should be guided or encouraged to explain cultural aspects relevant to the company's data and country of domicile in accompanying narrative rather than simply counting gender and race characteristics.

We agree that all premium and standard listed companies should be included within the scope of the regulations for the following reasons:

- Whilst individuals cannot be mandated to make these disclosures we note the proforma tables supplied in Annexe II still allow for companies to report individuals as "not specified/prefer not to say";
- We recognise that historically individuals within small firms have been more likely to elect not to make these disclosures to their employer. However, since the proposal to collect this data is limited to the diversity criteria of race and gender it should be less contentious than other diversity data. This data can be collected separately from other internal employee survey data to ensure that no individual could be identified with separate and private opinions or beliefs;
- The number of individuals within the board and executive management layers is not extensive and so the cost to collect the data once a year should be modest;
- The requirements are on a comply-or-explain basis and not proposed to be a mandatory requirement; they also align with Principle J [3] and Provision 23 [4] of the FRC's 2018 Corporate Governance Code.

Q5: Do you agree with proposed targets on gender and ethnic diversity representation at board-level of companies? Should we consider any additional or different targets?

We agree with the targets proposed on the representation of women. However, research by Marianne Bertrand, Sandra E. Black and Sissel Jensen "Breaking the Glass Ceiling" has shown however that whilst the 40% target in Norway has had a direct positive effect on the appointed female board members, there has been less of an observable effect on the wider female population. This reinforces the points made in our response to Q1 that a DEI strategy is needed in order to benefit not just the top layer of the organisation and also to create a pipeline.

On the ethnic diversity target we would encourage the consideration of a proportional target in order to not be discriminatory to smaller boards and for a target that is more ambitious - we would propose at least 10-15% as this more closely mirrors the percentage of non-white ethnic groups in England and Wales as per the 2011 census data.

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[3] Principle J: Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.

[4] Provision 23: The annual report should describe the work of the nomination committee, including:
• the process used in relation to appointments, its approach to succession planning and how both support developing a diverse pipeline;
• how the board evaluation has been conducted, the nature and extent of an external evaluator's contact with the board and individual directors, the outcomes and actions taken, and how it has or will influence board composition;
• the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives; and
• the gender balance of those in the senior management and their direct reports.

We also encourage that over time further diversity targets should be included such as socio-economic background and sexual orientation.

Q6: Do you agree with the format and extent of numerical data reporting proposed in the tables in Annex 2? If not, please explain any changes you would suggest or where further clarity is needed.

We agree and think this is sufficient for now. However as referenced in Q5 in the future data collection should be expanded to capture other aspects of diversity.

Q7: Should we consider requiring similar numerical data reporting for the level below the executive management team of in-scope listed companies and / or seek data on representation by sexual orientation? If so, we welcome any drafting suggestions and views on any impact this may have for the CBA and scope of our proposals.

We support requiring gender and ethnicity numerical reporting data for the level below the executive management team for in-scope listed companies.

A sustainable diverse executive management team should be nurtured through a pipeline that supports diverse talent development who can later step up the executive ladder. Therefore, collecting numerical data on this level can encourage companies to take a mindful look at their executive pipeline, course correct if necessary and provide the UK market and regulators with meaningful long-term trends on diversity in listed firms. We believe in being ambitious when it comes to collecting more diversity data points. This can prove beneficial over the long term, specifically with a phased-out reporting approach that would allow most companies to comply.

In terms of CBA impact, we estimate:

- Having more visibility on company diversity from a pipeline perspective would provide potential investors and consumers with a better long-term view of the companies' leadership and thus lower frictional costs even more than initially estimated in the CBA.
- However, since these disclosures will be done on a comply-or-explain basis, as you have rightfully pointed out in the CP, it will lead to asymmetrical information across companies, with potentially companies which have significant resources for hiring and reporting on diverse talent being favoured by clients and investors, to the detriment of smaller companies.

Smaller size companies might bear a higher cost of reaching set targets and might be disadvantaged by this initiative. The structures that report to the executive management team in these companies are usually nimbler, with fewer members and thus diverse representation is harder to achieve. Attracting, developing, and retaining talent overall will also come with higher costs for these smaller companies. We do not have sufficient data to opine whether diverse talent would gravitate towards smaller companies. However, we believe a particularly impactful metric would be a pay gap analysis triangulated with diversity of workforce and senior leadership data per company to show what firms attract more diverse talent and drive long term meaningful change in hiring conditions and talent fostering.

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Q8: Do you agree with proposed amendment to DTR 7.2.8AR to add to the examples of diversity aspects included in DTR 7.2.8AR which issuers could disclose in their reporting on their diversity policy, and to extend consideration to key board committees? If not, please explain why.

We agree with the proposed amendment to DTR 7.2.8AR.

Adding examples of diversity such as ethnicity, sexual orientation, disability, and socio-economic background bridges the gap on diversity aspects that were not addressed at the executive level. By encouraging broader diversity at the level below the executive management team, who can later progress to the C-suite, you are promoting longer-term, meaningful, broader diversity inclusion at the executive level.

In addition, key board committees such as the Management, Remuneration, Audit and Nominations Committees are traditionally the grounds for recruiting the next executive generation, so broadening diversity considerations to these areas is essential in ensuring a sustainable diverse pipeline.

Another aspect to consider is encouraging companies to not only look for diverse talent in these natural 'pools'. A thoughtful firm-wide DEI strategy, as mentioned in answer to Q1, training, opportunities to access key board committees, as well as consistent efforts from management and HR to help identify and foster talent across the company are essential to ensuring a sustainable pipeline of diverse talent.

Q9: Do you agree with our proposed new guidance provision DTR7.2.8CG encouraging in-scope issuers to consider providing numerical data to further inform reporting on the results of their diversity policies? If not, please explain why.

We agree with the proposed new guidance provision DTR7.2.8CG encouraging in-scope issuers to consider providing numerical data on the diversity of the members of the bodies and committees referred to in DTR 7.2.8AR(1)(a) for the following reasons:

- This supports the transparency objective for investors and seeks to align the issuers diversity policy applied to the actual results achieved.
- Advancing diversity and inclusion is an ongoing journey and the publication of wider numerical data on the results of an issuers diversity policy avoids the existence of the policy becoming a tick-box exercise and the results can drive meaningful and targeted change for an issuer.
- With issuers not being mandated to provide numerical data referred to in DTR 7.2.8AR(1)(a), we consider the proposal to encourage issuers to do so on a balanced-approach basis having regard to limitations related to disclose requirements which may pose legal, or data protection issues.
- Encouraging the publication of fuller and wider data sets also aligns with the Public Sector Equality Duty (PSED) to advance equality through evidence-based analytics.
- Publishing generated data on the results of the issuers diversity policies allows issuers to measure the success of their own policies and provide investors with a wider range of data to assess a company's approach and progress.
- Encouraging the publication of wider numerical data allows a sector data-pool to be generated to identify common positive impacts and areas where further policy proposals may be required.

Whilst we support the proposal and method, we do note some challenges:

- The number of individuals on boards and committees may not be extensive and the data-set may not be wide enough to produce reliable wider insight.
- Performance of a diversity policy shall be dependent on the nature, scale, and governance framework of an issuer. The publication of reporting on an issuer's results via numerical data may hold very little value on its own and may not provide investors with easily comparable metrics.

Q10: Do you agree with the proposed implementation timing? If not, please explain why and indicate what alternative timeframe you consider appropriate

We agree with the proposed implementation timing due to the following reasons:

- The number of individuals within the board and executive management layers is not extensive and so the cost and the length of time it would take to collect the data should not be a significant additional burden for issuers. We believe with the right commitment, planning and execution strategy, this proposed implementation timing is achievable.
- Issuers would also have flexibility in the timeframe that they can use for their diversity reporting (for example, in setting the reference date when the data is captured within the accounting period covered in the annual financial report).
- The requirements are on a comply-or-explain basis and not proposed to be mandatory requirements, therefore, if issuers need to explain why they haven't been able to comply, they should be able to disclose this in their annual reports. This would provide additional transparency and clarity on the journey and roadblocks that issuers might face even if the desired outcomes have not been achieved.

Q11: Do you agree with our phased approach to improve our use of data over time? Should we consider other approaches? If so, please suggest these

We agree with the phased approach to improve the use of data over time. We think it's practical and helps increase the likelihood of issuers being able to comply in stages. These proposed changes should be viewed in the context that globally we are still going through the coronavirus pandemic. Issuers may be dealing with staff shortages, supply chain disruptions and most recently the gas crisis in the UK, to name a few of the potential challenges.

To the extent possible, we think there would be benefit for issuers to be informed of all the potential metrics and targets that might become requirements in the future so that they could take this into account in the planning and execution process of data collecting. The phased approach also would allow relevant parties time to digest and evaluate the newly provided information given that D&I data is still so new. We do believe that over time, the time series of D&I data would become more useful for different analysis of the effectiveness of the changes in policy as well as being able to give market participants a clearer view of what's going on with the human capital of an issuer.