Harvard Law School Forum on Corporate Governance

What Drives Racial Diversity on U.S. Corporate Boards?

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Editor's note: Vicki L. Bogan is Associate Professor of Finance and Geller Family Faculty Fellow; Ekaterina Potemkina is a PhD student; and Scott E. Yonker is Associate Professor of Finance at Cornell University SC Johnson College of Business. This post is based on their recent paper. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver to All Stakeholders?, both by Lucian A. Bebchuk and Roberto Tallarita; For Whom Corporate Leaders Bargain by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum here); and Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock by Leo E. Strine, Jr. (discussed on the Forum here).

Over the past two decades, the concept of "board diversity" has been synonymous with female representation on boards. Since 1999, nearly 20 governments around the world have instituted gender quotas. Recently however, the notion of corporate board diversity has been expanded. In September of 2020, a California law was signed that mandated boards of California-based firms include "diverse" individuals, those who are racial minorities or those identifying as LGBTQ+. The NASDAQ proposed a "comply or explain" rule in December of 2020 (approved by the SEC in August 2021) that encouraged listed firms to have both women and "diverse" individuals (defined by race or sexual identity). While there is substantial research about the evolution and effects of mandated gender diversity, few academic studies exist that focus on the dimension of race. In our new working paper, What Drives Racial Diversity on Corporate Boards?, we uncover recent trends in board racial diversity and analyze factors that drive the lack of diversity.

For our analysis, we use a comprehensive database covering the race and ethnicity of directors of U.S.-based firms listed on either the NYSE or NASDAQ exchanges (about 3,100 firms per year) from the first quarter of 2013 through the end of September 2021. We uncover a persistent lack of racial diversity on U.S. corporate boards. At the beginning of our sample, less than 10% of board seats of U.S. public companies were held by racial minorities but minorities were estimated to be about 25% of the U.S. population. By 2019, this figure had changed very little. Racial minorities held only about 12% of board seats with over 40% of all U.S. boards still including only white directors. Then in 2020, a dramatic shift occurred. About 25% of all new 2020 board appointments went to racial minorities and so far in 2021 (through 9/30/2021) the share has increased to 40%. Directors from underrepresented minority groups (URM, hereafter), particularly black directors have driven this surge. These data indicate that until recently minorities largely have been left out of the boardroom.

Identifying what drives the lack of diversity that we document is important for understanding whether policy intervention is necessary or appropriate and if so, what type of policy should be implemented. It also helps us understand the likely consequences of increased board diversity at firms. Academics and practitioners have made cases both for and against board diversity. The typical case against mandated diversity is that it leads to selection based on the mandated characteristic rather than qualifications. Thus, opponents argue that quotas will lead to less talented boards, and ultimately firms will suffer from poorer decisions. Research has generated mixed evidence as to whether mandated gender diversity leads to lower board quality (Ahern & Dittmar, 2012; Matsa & Miller, 2013). The business case *for* board diversity focuses on the fact that demographically homogenous boards have the risk of insularity and may not be well positioned to operate in an increasingly dynamic global environment with a diverse global workforce. In fact, there exists academic evidence that boards comprised of individuals with heterogeneous backgrounds leads to better corporate outcomes (Bernile, Bhagwat, & Yonker, 2018). More diverse boards also can address societal concerns of equity, inclusion, and social justice with regard to how firms operate in society.

To understand better the drivers of the lack of diversity that we document, we first characterize the types of firms that appoint racially diverse directors. We find that the current board racial composition is an important predictor of whether or not the board will appoint diverse directors in the future. Through most of our sample period, through 2019, firms with racially homogeneous boards were less likely to appoint minority directors. However, we document a recent sharp change in firm behavior. Since 2020, these firms became more likely to appoint minority directors.

These initial findings suggest that homophily-based networks (people forming networks with those who are demographically similar to themselves) and/or racial bias may play a role in the lack of diversity that we document. To gain further clarity on the mechanisms driving lack of diversity, we run tests around four initiatives/movements that had the goal of increasing minority underrepresentation on boards (NYSE Board Advisory Council, NASDAQ Board Diversity Rule, California Assembly Bill No. 979, and Acceleration of the Racial Justice Movement). As these initiatives targeted different drivers of underrepresentation, we can gather insights into the potential causes for this lack of diversity by testing the effectiveness of each of the initiatives in changing firm behavior.

We find that the murder of George Floyd and the ensuing Black Lives Matter protests, which changed society's perceptions of race and racial discrimination, had the largest effect on the racial composition of board appointments. It dramatically increased the number of black directors appointed to boards, but had no detectable effect on other minority racial groups. We conservatively estimate that the acceleration of the racial justice movement has thus far led to a 120% increase in the number of black directors appointed in the post-Floyd era. Prior to the murder of George Floyd, black directors constituted about 7% of new director appointments. Since that time, they have made up about 23%. In contrast, the introduction of the NYSE Board Advisory Council had no significant effect on the propensity of NYSE-listed firms to appoint racially diverse directors. Since the Council gave NYSE-listed firms the opportunity to use a referral service to identify diverse directors, this finding casts doubt that homophily-based networks were the primary barrier to racial diversity on boards.

The California quota also has increased the number of minorities appointed to boards. However, thus far, this mandate has primarily benefited racial groups that are not traditionally underrepresented. Further, we find evidence that it has little or negative effects on the appointments of black directors. Specifically, the California law appears to have reduced the response of California firms to the racial justice movement, curbing the appointments of black directors that otherwise would have occurred. This underscores the importance of crucial distinctions regarding the development of specific racial diversity mandates and how the application of tools successfully used to increase board gender diversity is less clear-cut when considering issues of race. Depending on the mandate objective, considering races that are not traditionally underrepresented as “diverse” can enable firms to make substitutions that further exacerbate URM director underrepresentation. The NASDAQ rule has yet to generate significant increases in racially diverse board appointments. However, since the rule was recently approved by the SEC, it may be too early to assess fully its effectiveness.

We also test whether the quality of minority directors declines after an increase in minority director appointments. Using observable characteristics of the newly appointed minority directors, we find no evidence that the quality of new directors is lower than that of previously appointed directors, which is inconsistent with the typical arguments against mandated board diversity.

Overall, we provide suggestive evidence that racial discrimination is a key cause of the low board racial diversity levels that we document. Moreover, our results highlight a critical nuance relevant for policymakers when designing quotas—defining diversity too broadly in mandates can exacerbate underrepresentation of already underrepresented groups.

The complete paper is available for download here.