Article 4. Measuring the Impact: Key Considerations for Your Firm's DEI Programs and Racial Equity Audits

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Measuring the Impact: Key Considerations for Your Firm's DEI Programs and Racial Equity Audits

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I.Integration of Diversity, Equity and Inclusion (DEI) Programs into ESG Goals and Strategies

A.Role of DEI within ESG

DEI represents one key aspect of the "Social" prong of ESG. However, in recent years, particularly in response to global protests related to race and social issues that began in 2020, there has been increased attention to DEI. Accordingly, "[i]nvestors are increasingly applying these non-financial factors as part of their analysis process to identify material risks and growth opportunities."1 This concept of diversity being an important factor and consideration in corporate culture is not novel. As early as the end of the nineteenth century, "some public companies tracked the sex of their own shareholders and disclosed it in their annual reports. Some government agencies also tracked and reported on the sex of stockholders in the early twentieth century…suggest[ing] that business leaders believed that shareholders' sex *mattered*—and that information about shareholders' sex [may] shed light on business itself."2

In addition, governments around the world are increasingly introducing legislation to ensure that businesses and investors are delivering social value.3 For example, California passed an amendment to the California Corporations Code requiring corporations to have at least one director from an underrepresented community by the end of 2021, corporations with five to eight directors to have at least two directors from underrepresented communities, and those with more than eight directors to have at least three directors from underrepresented communities by the end of 2022; noncompliance will "incur an initial financial penalty of $100,000."4 While both this law and a similar law requiring public companies in California to have at least one female director by the end of 2019 and up to three female directors by the end of 2021 were subsequently overturned, the fact that the California legislature passed them to begin with indicates a real recognition about the need to diversify boards.

In addition to legislation at the international, national and state level, regulators have pursued disclosure rules in relation to DEI. For example, the Nasdaq Stock Exchange recently submitted a proposal to the SEC to change its listing rules to mandate disclosures in relation to board diversity.5 The SEC approved this proposal in April 2021; the rule, like the California analogs described above, is currently being challenged before the Fifth Circuit Court of Appeals on First and Fifth Amendment constitutional grounds. Despite these legal challenges, these rules demonstrate that DEI is not only one aspect of general ESG principles but also a reflection of the continuing importance and emphasis being placed on these programs at a macro level.

B.DEI and Risk Management

The impacts of an effective DEI program may "positively affect decision-making, levels of employee engagement, reputation amongst stakeholders, innovation and access to untapped markets."6 In recent remarks at the Risk Management Association's Risk Management Virtual Conference, the Acting Comptroller of the Currency, Michael Hsu, noted that "[while] effective risk management depends on many factors[,]… even the best risk management framework [cannot] be effective without the right team to carry it out."7 With a diverse background of individuals, different perspectives are brought to the table, enhancing a company's risk management capabilities. He further noted that "[u]nless people with diverse experiences and points of view feel empowered to speak up about the risks they see and to share their ideas for managing those risks, we will be stuck in an old mindset, always fighting last year's war and overconfident in our risk management capabilities."8

To achieve the impacts of a robust and thoughtful DEI program, companies should strategize thoughtfully and become familiar with tools that will help them establish an effective DEI program that will grow and thrive over time.

II.Tips for Achieving an Effective DEI Program

Effective DEI programs should be tailored to a company's specific mission, culture and values, as opposed to incorporating off-the-shelf strategies and initiatives. The following are key tips to establishing an effective DEI program.

- 1.

  Take a tone-from-the-top approach, with the board and senior management prioritizing DEI to increase buy-in from employees,

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customers and communities. Public companies are increasingly establishing DEI councils that sit at the management level and are run by a DEI officer who reports to the CEO and/or the board or a board committee. The board may accomplish this by establishing oversight of human capital management matters, including diversity, equity and inclusion, at the board or committee level. Human capital management oversight often rests with the compensation committee, and, in certain examples, some have been renamed as compensation and talent management committees or human resources committees.

- 2.

  Establish diversity goals based on a company's unique position and business model and collect data to measure progress over time. Over the past few years, companies have been conducting so-called ESG materiality assessments to help identify areas of priority from the perspective of the company's internal and external stakeholders, including shareholders, employees, customers, vendors and community members, including with respect to DEI matters. Understanding priority DEI issues of its key internal and external stakeholders can help a company set DEI goals that are specific to its needs and aligned with its overall business strategy.9

- 3.

  Disclose DEI goals, data and progress to not only increase transparency and accountability but also to build trust with key stakeholders over time. The best shareholder activism preparation typically is based on transparency, active communication10 and regular dialogue with investors. ESG strategies generally should be forward-looking and rooted in long-term value for the business.

- 4.

  Test that technology is "built on data that is fair to socio-demographic groups—such as different racial groups," to the extent the company is deploying technology solutions to implement DEI initiatives.11 With over 100 DEI technology solutions currently in the market, many companies have been exploring technology solutions to help "improve diversity, mitigate bias and reinforce inclusion," from online training resources to helping with recruiting efforts to DEI analysis and monitoring.12 However, bias in technology is a key issue that companies should be aware of when deploying DEI technology solutions. For example, the technology itself "may have biases due to the data sets on which the algorithms are trained or the lack of diversity among the technologists that created it."13 To mitigate bias in technology, companies should aim to periodically test the models and/or audit their DEI technology solutions.

- 5.

  Provide appropriate grievance reporting mechanisms. Progress is not linear, and companies should avoid painting an overly rosy picture when it comes to DEI matters to build trust and accountability with stakeholders. For instance, a 2021 survey of 700 global institutional investors, including 100 US institutional investors, found that 82% of institutional investors believe that companies frequently overstate or exaggerate their ESG progress when disclosing results. 14 Meaningful DEI progress necessitates an honest approach to dealing with DEI issues, such as workplace discrimination and harassment. Accordingly, companies should develop grievance reporting mechanisms, take complaints seriously and abide by processes put in place to prevent retaliation. In addition to formal, legalistic complaint systems, companies may also consider adopting alternative mechanisms for reporting grievances, such as employee resource plans, an ombuds office and transformative dispute resolution models.15 Regardless of the type of grievance mechanism a company utilizes, it is important that the company addresses the systemic factors at play that led to the particular cases of discrimination, harassment and/or retaliation.

Once a company begins to implement DEI initiatives, a company may consider carrying out specific audits and examinations of its business, including third-party audits, to analyze the effectiveness of its DEI strategy and initiatives and to identify areas of improvement.

III.Scope of a Racial Equity Audit

There is no one-size-fits-all definition of the scope of a racial equity audit, also referred to as a civil rights audit. Often, the audit scope will be dictated by the most pressing racial equity issues faced by a company at the time it is considering, or forced to consider, whether to conduct such an audit. These issues are often unique to a company and specific to the industry and cultural settings in which the company operates.

There are five fundamental questions a company and its auditor should consider when formulating an effective and efficient strategy to define the scope of an audit:

- (1)

  when in the process should the scope be assessed and determined?

- (2)

  why should the scope be defined?

- (3)

  what should the audit scope cover substantively?

- (4)

  where (or in what legal jurisdictions) should the audit be conducted?

- (5)

  who should the scoping process involve?

The below discusses how a company and its auditor should approach each of these questions.

- A.

  When and why should the audit scope be determined? An audit's scope should always be determined at its outset not only to ensure the

audit will follow a well-thought-out plan and budget, but also because a company's management and its board of directors require the information uncovered in the scoping process to understand both the costs of conducting such an audit and the costs of *not* doing so. At the end of the scoping process, a company's management and its board of directors should know and weigh the audit's costs (which include any fees paid out to lawyers and experts as well as the resources, such as management's time, that will be taken away from the company's day-to-day operations) against the significance of the implications for not conducting such an audit, which could include potential loss in the company's goodwill, risks of future litigation and noncompliance, and unrealized financial gains that could derive from the audit.

  - Aside from being a useful and necessary tool for the auditor, the scoping exercise is also a consensus-forming process for management and the board to identify areas of potential disagreements regarding whether such an audit is needed and, if so, how broad the audit should be. It is important for management to resolve disagreements at the outset so they can set a unifying tone at the top and ensure conflicts do not come up later in the process that will impede a successful audit.

- B.

  What should be the substantive scope of an audit? Generally, a comprehensive racial equity audit should focus on a company's internal policies and practices and its approach to its products and services. For example, a 2021 civil rights assessment report notes that the audit included the progress the company had made not only on key initiatives to foster an internal culture of equity and inclusion within its corporate structure, but also on key customer and community initiatives, such as ensuring that its stores have an environment free of bias for all.

  - On the other hand, a targeted audit serves a limited purpose and thus has a narrower scope. For example, in 2020, another company announced a multi-billion-dollar racial equity commitment to help close the racial wealth gap among black, Hispanic and Latino communities. Their November 2022 report only showed the audit of results achieved under its racial equity commitment program, which did not include a review of its internal racial equity policies and practices. As such, the substantive scope of an audit varies from one company to another, depending on, among other factors, the purpose for such an audit.

- C.

  Where (i.e., in what legal jurisdictions) should the audit be conducted? For companies in the US, the scope of an audit should generally be limited to a company's US operations. In addition to recognizing this as the customary approach for racial equity audits, rooting a racial equity audit in US civil rights law, history and cultural context creates a significant benefit, as cultural norms as well as racial and ethnic considerations differ across geographic markets. Limiting the scope to US operations also helps a company and its auditor maintain a workable scope that does not require diverting an unreasonable amount of resources, especially given that data collection in non-US jurisdictions may require additional resources.

- D.

  Who should be involved in the scoping process? In addition to a company's management team, the scoping exercise should also involve interviewing or surveying (i) its existing civil rights partners, employees and shareholders (especially those who have advocated for conducting such an audit); and (ii) other independent civil rights and technology experts. Meetings with existing civil rights partners and current shareholders and employees will help the auditor identify the current state of the company's racial equity strategies, the scope of what has been done (including recent enhancements), what stakeholder concerns have been raised, any planned improvements or other items in the process of being addressed, and where the hardest work is yet to be done. As such, these meetings enable the auditor and management to make better-informed decisions with respect to the substantive scope of the audit as well as the necessary budget. Further, meetings with independent civil rights and technology experts help provide constructive and diverse feedback on how they think the company's internal and external approaches to racial equity should be assessed. Having this independent perspective will enhance the reliability of the audit report and inspire trust in the audit process.

IV.Impacts of a Racial Equity Audit

A.Positive Impacts

When properly conducted, the impact of a racial equity audit typically reflects the desires and demands that prompt the audit in the first place: increased transparency and accountability regarding gaps in the company's racial equity policies and practices. In return for being more transparent about and accountable for promoting racial justice, companies can increase their profitability and competitive advantage. For instance, a 2018 McKinsey study found that "companies with the highest degrees of ethnic/cultural diversity were 33% more likely to outperform their less diverse peers and companies with the most ethnically/culturally diverse boards of directors are 43% more likely to experience higher profits than their less diverse peers."16 Additionally, a global economist found that "closing racial gaps would have generated an additional $16 trillion in economic output since [the year] 2000," and by closing the various gaps between Blacks and Whites, the US could stand to gain an additional $5 trillion in economic activity over the next five years.17

B.Negative Impacts

Despite the positive impacts of racial equity audits, negative effects are also likely, especially from poorly prepared and mismanaged audits. Among the reasons cited by companies urging their shareholders to vote against proposals for civil rights audits are concerns over potential interference with a company's day-to-day operations and unnecessary costs due to an overbroad or duplicative audit agenda of existing policies and practices. The derivative impact of these negative perceptions, if not realities, of a racial audit is the lack of buy-in from management, employees and/or other key stakeholders, whose participation are key to a meaningful audit. Armed with sufficient information collected from answering the above questions on scoping, management and the board should be able to form a consensus on whether a racial equity audit is right for the company, including whether the expense of conducting an audit is worth incurring for the potential benefits.

In addition, negative publicity may also be an undesired consequence of a poorly managed audit. While negative press may simply amount to an unflattering headline, criticism can be nuanced, and companies will want to avoid the audit's scope and independence being put under a microscope. Companies should control the messaging from day one by clearly communicating to the public its goals, its intention to take responsibility for any possibly damaging issues the audit uncovers and its plan for remediation; and, to ensure accountability, the company should consider publishing subsequent interim reports to keep the public informed of its progress.

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Racial equity audits are continuing to gain traction and popularity as can be seen by the rise in shareholder proposals requesting such audits in recent years.18 While a well-conducted racial equity audit can build trust and accountability with a company's key stakeholders, such as customers and employees, a poorly managed audit that lacks appropriate buy-in and communication from senior management and the board can lead to heavy criticism, negative press and distrust among stakeholders. Given the increased focus on racial justice issues in the wake of George Floyd's murder, management and boards should be prepared for stakeholder engagement on DEI issues, including racial justice issues and possibly racial equity audits.

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