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Using ESG Tools to Help Combat Systemic Racism and Injustice

Events of recent weeks and months have starkly illuminated the effects of systemic racism and injustice on Black Americans, including threats to physical safety, psychological trauma and economic disparity. CEOs worldwide and across industries have spoken out, expressing their horror and outrage, as well as their resolve to do more. Companies have announced significant financial commitments; others have referred to actions to be taken, and early movers have begun to announce or amplify business-related initiatives. Institutional investors, asset owners, asset managers, private equity fund limited partners and investor groups have also begun speaking out and considering action with respect to companies in their portfolios. The question for all is how to follow through on the sentiments expressed and drive positive change: what tools are available to address systemic racism and injustice and the threats they pose, and how can those tools be used?

ESG metrics, including those of the leading voluntary disclosure frameworks, provide valuable tools and models to help both public and private companies and their investors and other stakeholders (including employees, customers, business partners and communities) understand their progress on these issues. These tools can also support and facilitate constructive engagement and discussion with such internal and external stakeholders on how companies can further foster and integrate inclusion and diversity into their day-to-day business and interactions.

For example, the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI) and the consultation draft standards proposed by the International Business Council of the World Economic Forum (IBC-WEF) include categories addressing dignity, equality, diversity, inclusion, discrimination, community, ethical behavior, human rights and social impact/vitality, as well as employee engagement, human capital and compliance. Each of these frameworks contemplates for at least some companies the annual disclosure of percentages of management and other employees by gender and, where relevant, racial, ethnic and other minority status, as well as information related to gender-based pay disparity. Measurement along these lines should not be particularly difficult for any U.S. company. A number of companies, including as a result of shareholder proposals or other engagement efforts, have also begun disclosing pay disparity information by race and ethnicity as well as gender.

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Expectations are likely to increase with regard to widespread disclosure of these metrics so as to allow stakeholders to view these issues across companies and industries. Individual companies may find additional statistics or metrics to be helpful to understand their particular circumstances; especially where explained and disclosed on a consistent basis from year to year, these metrics are useful to track a company's progress against its own stated goals and against peers and industry leaders. On the heels of enhanced corporate responsibility and sustainability reporting, late 2019 saw the emergence of the first stand-alone "Human Capital Management Reports" that also address these issues and related actions. More such reports will come in the future.

While an improvement from the current practice of many companies, measurement and disclosure alone will not live up to the aspirations of those companies that have pledged to effect change. Here again, ESG board and management practices can help. Boards play a pivotal role in setting the right "tone at the top" and, with management, shaping a company's culture and purpose. In addition, as ESG-competent boards are well aware, once a material ESG issue has been identified, an important question is where those issues "live" in the corporate governance structure and the board's role. It is now widely recognized that the board's role includes oversight of the company's human capital management and people-talent-culture strategies, including diversity and inclusion goals and progress, and oversight of the risks to the company and its stakeholders arising from failing to address such topics effectively. The extension of diversity and inclusion beyond the workforce to customer and supplier relationships, business development and marketing strategies, and products and services demonstrates that many aspects of a business are impacted, and these areas too may be overseen by the board and reported on by management.

In addition to the broader issues of anti-racism, racial justice and equality, their nexus with employment, culture, human capital and talent development issues and business strategies and structures might be best suited for a board-level committee, whether a compensation/human resources/human capital committee or an ESG, sustainability or public policy and reputation committee. Whatever the assignment is, which is a company-specific determination, the board should decide where this responsibility lies; that committee should, together with management, regularly monitor the company's progress and report to the full board. As with other important ESG issues, so with diversity and inclusion: the relevant committee and the full board should understand how these priorities align with strategy and planning, how the company measures, assesses and drives progress and what is done in response to shortfalls.

Tools are available not merely to monitor but to spur progress on these and other ESG issues. Companies have long known how to incentivize employees to achieve quantifiable financial goals; ESG goals are no different. According to a report issued in April by Willis Towers Watson, just over half of the S&P 500 uses ESG metrics in incentive plans (almost entirely in annual plans). However, Willis Towers Watson reports that ESG is largely treated as a subjective matter – only approximately 15% of the S&P 500 companies use hard quantifiable metrics to measure ESG performance. Especially in areas such as diversity and inclusion which have historically been evaluated using qualitative criteria, boards seeking to operationalize their aspirational goals should review the hard data, to better understand whether payouts on this criteria match company performance.

In addition to compensation, companies are seeking to drive their ESG goals with respect to economic and social injustice by additional means, including working with (and providing incentives and penalties) to customers, suppliers and third parties on these issues, signaling intent and providing economic incentives for change. While the issues covered may differ, major investors already use this type of tool through their stewardship efforts; banks address it through a combination of lending mechanisms (such as sustainability-linked financing) and exclusionary factors (such as divesting from coal); many companies do it through supply chain purchasing policies, other incentives and community involvement. It was notable that when Neuberger Berman recently became the first U.S. asset manager to implement a sustainability-linked revolving credit facility, Neuberger specifically selected increasing diversity at management levels as one of the key ESG metrics that would impact borrowing costs. The heightened focus and appreciation for "EESG" imperatives generally (*i.e.*, employees warranting their own dedicated focus, rather than being encompassed generally in other buckets) in the context of the COVID-19 pandemic also holds promise with respect to these areas.

In order to drive greater and more permanent impact, an increasing number of companies and funds are considering how to adapt the internal and external methods they have taken towards addressing other ESG priorities, such as environmental sustainability, to these issues. Such methods have leveraged corporate scale, impact, partnerships and sustained focus at individual companies, across industries and within communities to achieve the desired goals. These approaches may be useful models for new or expanded business initiatives aimed at tackling racial injustice, inequalities and disparities and achieving inclusion, diversity, and equity.

The final piece is engagement. As the private and public sector "build back better" in the next phase of pandemic recovery, confronting and addressing these

issues are squarely part of the go-forward agenda and will remain salient. This is not only because major institutional investors and asset owners are themselves concluding that these matters impact both values and value, but also due to a broad range of company stakeholders, including employees and customers, focusing on these issues. Companies that are committed to effecting change either within their own businesses and workplaces or in the broader community, and whether through recent statements or longer-standing commitments to UN Sustainable Development Goals or other priorities, should ensure that their major shareholders and other stakeholders know that the issues are taken seriously, why they are important to the long-term success of the business and how they are being prioritized. It will be significant and critical for institutional investors, asset managers and asset owners to provide support and backing in these areas as they are saying they will do, including – especially for asset owners that have expressed similar commitment to change – allocating assets and voting with their feet to ensure that their invested dollars remain only with managers that support these initiatives.

Numerous companies have issued statements decrying the state of affairs, recognizing the wide gulf that needs to be crossed to achieve our country's ideals of equality and justice, and promising to do better. The problems are longstanding and multifaceted and will require efforts across the private and public sector and over many dimensions, well beyond corporate governance, board practice and appropriate consideration of stakeholder interests. But for companies and investors seeking to act on their statements and be a part of eradicating racism and discrimination and their legacies, ESG tools can contribute.

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