# DECHERT ON ESG

## DIVERSITY AND INCLUSION IN ASSET MANAGEMENT

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# Dechert on ESG: Diversity and Inclusion in Asset Management

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In recent years environmental, social and governance ("**ESG**") factors have become a key discussion point within asset management, with many managers now incorporating ESG considerations into their investment processes. One significant ESG factor is diversity and inclusion ("**D&I**") which is, of course, also a broad topic in its own right. Indeed, a number of key ESG texts focus on D&I, including the United Nations Sustainable Development Goals (which cover both reducing inequality in general and improving gender equality more specifically).

D&I impacts the asset management industry at a number of pressure points and managers should expect it to arise with increasing frequency and in different guises. This is due to a long-term shift in culture (as demonstrated by the recent #MeToo campaign, for example), coupled with factors such as more millennials (who have grown up versed in these issues) moving into more senior, decision-making roles in the industry, both as investors and managers.

Key areas where the issue of D&I particularly impacts the asset management industry include: (i) investor-level focus on the issue, (ii) D&I's potential impact on a fund's downstream activities, and (iii) D&I's impact on the ongoing management of the manager's business (including as relates to economic return, legal obligations and human resource management). Various regulators are also beginning to focus on the issue.

As with many issues, it is important to understand the scope of a problem in order to be able to begin to address it and historically data on D&I has been patchy. The majority of available data regarding D&I in this area relates to gender, which will be the main focus of this article. However, many of the challenges and solutions to promoting gender equality are applicable to individuals who are diverse for other reasons.

Any efforts to improve D&I must be made in compliance with local law requirements (for example, quotas may be illegal in some jurisdictions, mandatory in others), which can be particularly challenging (but not unsurpassable) in an industry where businesses, structures and investments span multiple jurisdictions.

## ESG pressure points in the asset management ecosystem

### Investors

Investors are ultimately the source of the key input – cash – in the asset management ecosystem and through this can exert significant influence on managers to improve their D&I statistics. D&I can be an important issue for certain investors in light of their own stakeholder expectations (particularly institutional investors: for example, in the case of pension plans, the underlying holders are often diverse). While not the norm, it is becoming more common for a significant ticket to be rejected by an investor because the relevant manager fails to meet applicable D&I metrics. As a matter of perception, failing to at least engage with the issue could lead to wider questions about a manager's broader awareness of market forces.

D&I may be an issue at a number of touchpoints during a fund's life-cycle. For example, it commonly arises as part of initial due diligence (e.g. DDQ questions may ask for D&I data in relation to the manager), as a periodic reporting request and at ongoing investor meetings. The focus may be on D&I at the manager level (for example, a request for a breakdown of senior management by gender, racial or other diversity characteristics) and/or at the level of the fund's underlying investments (for example, queries regarding the governance of investee companies). Some investors may focus on the bias towards non-investment roles of women working in the industry[1] and look for indications that the relevant manager is seeking to combat this, for example, by having women in senior management roles and/or on investment committees.

As investor due diligence is key to securing an investment, it is worth noting that common due diligence templates (such as those endorsed by the Alternative Investment Management Association and the Institutional Limited Partners Association) touch upon D&I, with questions on whether the firm encourages portfolio companies to adopt external standards and codes (such as the United Nations Global Compact) or is a signatory to the United Nations Principles for Responsible Investment.

## Underlying investments/portfolio companies

Much research indicates that D&I has a positive impact on business performance and innovation generally. Whether it similarly influences financial performance remains the subject of academic debate. Managers and investors who are aware of this are therefore likely to seek out investments that take D&I into account.

Funds, when acting as investors, may be able to leverage significant influence on their underlying portfolio businesses through their voting powers and, where relevant, the negotiation of investment terms. Specific fund investor level requests may also trickle down into the fund's investment process.

Organizations such as the 30% Club (particularly its Investor Groups operating at the national level) encourage managers to make conscious investment decisions and influence the underlying businesses they invest in. The 30% Club Investor Groups focus on women at senior management level in listed companies and expect active engagement with investee companies on corporate governance and D&I issues.

In terms of selecting investments, managers may want to be aware of their process of vetting investments and ensure that they are not biased in favor of introductions based on existing networks as this could immediately filter out opportunities that may result in better investment returns. This can be a particular issue in the venture capital industry where a significant number of potential deals are considered relative to those funded and may often rely on these 'warm' introductions.

## Managers

As a general business management point, managers will want to be versed in D&I best practices, both in order to engage in effective talent management and to ensure compliance with applicable laws and regulations (such as the Equality Act 2010 in the United Kingdom).

From a talent management perspective, there are some structural issues peculiar to the industry which can limit progress on D&I at the manager level. These include a focus on carried interest and other long term incentive plans (which discourage turnover at senior levels) and the need to 'put skin in the game' (which could, for example, affect social mobility and/or disproportionately affect women and carers who may have financial commitments elsewhere and are, accordingly, unable to contribute meaningful capital into a fund). The need for a constant track record can also hamper investment professionals (particularly women) who take career breaks.[2] In addition, there are often legacy issues associated with how the industry operates, including a reliance on pre-

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[1] This is significant given that investment professionals are often paid significantly more than their colleagues. The organization *100 Women in Finance* have launched a Female Fund Manager visibility campaign on this issue.

[2] On the other hand, there is beginning to be some recognition from both investors and managers that investment management is a team activity and that results are not based solely on the talent of an individual. Similarly, contrary to traditional attitudes to turnover within an investment team, this is increasingly viewed as a positive sign as turnover permits an influx of diversity and the benefits associated with this.

existing (and non-diverse) networks to build business. Issues such as these may also discourage high quality diverse candidates from entering the hiring process.

D&I at firm level is a focus for industry participants and government bodies alike. For example, earlier in 2019, the U.S. Government Accountability Office published the highlights of testimony on the representation of minorities and women in management and practices to promote diversity, which focused on finance. The report found that, while private sector organizations are increasingly recognizing the importance of employing minorities and women in key positions, from 2007 to 2015 the representation of minorities in management positions within the financial services industry increased only marginally, and representation by women remained unchanged. The report identifies a number of challenges to improving D&I and suggests practices to combat these challenges – a number of these which are touched upon in the box entitled ‘Potential Actions’ below.

### Service providers

Certain managers may extend their D&I efforts more generally to their and their funds’ service providers, such as law firms and administrators, through the initial tendering process. In this vein, a number of in-house general counsel recently published an open letter to law firms setting out their expectations with respect to law firm diversity.

***New opportunities***

*The current focus on D&I has also led to new investment products with strategies focusing on D&I. This includes so called ‘gender lens’ investing where the investment strategy involves promoting gender equality. As with other social impact products, there can be qualitative and quantitative issues with assessing the impact of these products – hence branding under regimes such as the LuxFLAG label (LuxFLAG is an independent non-profit association which provides accreditation to products which meet certain criteria; LuxFLAG considers reducing inequality and gender equality under its ESG label criteria) can be a useful tool for both managers and investors.*

## Legislative and regulatory initiatives

Certain regulators have started to incorporate D&I issues into the factors they consider when regulating firms. For example, the UK Financial Conduct Authority (the “**FCA**”) has indicated that D&I issues could affect its assessment of an individual’s fitness and propriety under the Senior Managers & Certification Regime. In a recent speech, Andrew Bailey, the Chief Executive of the FCA, noted that, “The culture and governance of firms is a priority. We do not make rules to say you must have a good culture or else, that wouldn’t work. But our objectives and rules shape culture and we are very interested in how cultures influence firms.…We care about it because it is a key cause of major conduct failings.”[3] In addition, the FCA has also flagged that, from a financial regulator’s point of view, an open and inclusive culture is less likely to encourage unethical conduct and that it wishes to encourage a ‘speak up, listen up’ culture in financial services in order to dissuade ‘group-think’.

Similarly, the Central Bank of Ireland has been vocal on the issue, stating that “the Central Bank considers that diversity and inclusion in all their forms are important components of well-managed, financially resilient, strategically-minded firms, and therefore pertinent to the Central Bank’s mandate.”[4] It has also warned about the dangers of a lack of D&I in regulated firms and publishes the gender breakdown of applications for its Fitness and

[3] “The Importance of Diversity” FCA, February 2019.

[4] https://www.centralbank.ie/regulation/how-we-regulate/diversity-and-inclusion-in-regulated-firms

Probity test for Pre-Approval Controlled Functions to provide some transparency on the matter. The Central Bank intends to keep pressure on firms to ensure D&I and to encourage better pipelines of talent and has not ruled out putting specific requirements in place if it does not see improvements in D&I at senior levels on a voluntary basis.

Legislation not specifically linked to the asset management industry may also impact on D&I in the sector. For example, the UK gender pay gap reporting regime, which came into force in April 2017, aims to provide focus and accountability in respect of gender pay gap issues through requiring certain employers to publicly publish their statistics annually. Equivalent regimes exist in other countries and many anticipate that ethnicity pay gap reporting may follow shortly in the UK. From a US perspective, from September 30, 2019 the Equal Employment Opportunity Commission has required companies with more than 100 employees to disclose pay information by gender, race, and ethnicity in an effort to collect more accurate information about pay disparities that affect women and minorities (although such information is not generally publicly disclosable).

Another regime that relies on accountability is the HM Treasury's Women in Finance Charter, which requires signatories to have one member of its senior executive team responsible and accountable for gender D&I, set internal targets for gender diversity in senior management and publish their progress online annually. While HM Treasury is a UK institution, signatories are not necessarily headquartered there, with some participants based in the US, Europe and Asia.

## Potential issues and responses

There are a number of practical ways that managers can seek to improve their approach to D&I – common (often interlinked) themes include: improving the pipeline of diverse candidates; retaining and investing in existing diverse staff; developing a network of sponsors for women and minorities; ensuring the firm has visible role models and promoting an inclusive culture. The box below sets out some further practical suggestions for managers:

| Potential Actions | |
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| **Pipeline - recruitment** | ▪ Use strict scoring systems in interviews to reduce inconsistent treatment.<br>▪ Use blind CVs (at least at a junior level).<br>▪ Impose diversity targets on recruiters.<br>▪ Provide training on bias.<br>▪ Provide sessions for university and school leavers.<br>▪ Recruit from talent pools other than the 'elite' universities. |
| **Pipeline – promotion to senior positions** | ▪ Provide management training on promotions, appraisals and encouraging inclusive decisions.<br>▪ Offer mentoring and leadership programs.<br>▪ Engage in longer term succession planning. |

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| **Retention** | ▪ Supportive parental leave programs (prior to, during/after leave).<br>▪ Introduce appropriate flexible working regimes.<br>▪ Provide for emergency/senior care. |
| **Inclusive culture** | ▪ Support from management; leading by example.<br>▪ Implement and promote a D&I strategy and associated policies and procedures in respect of anti-harassment policies, etc.<br>▪ Form affinity groups.<br>▪ Avoid meetings at antisocial hours.<br>▪ Mix up time and content of work social events.<br>▪ Link management pay to D&I targets. |
| **Visible role models** | ▪ Ensure diverse speakers at internal events and at external functions such as conference panels.<br>▪ Encourage networking opportunities. |

## Conclusion

D&I is, and continues to be, a relevant topic to the asset management industry, whether clothed as an ESG issue or otherwise. It is relevant to many stakeholders: many investors wish to see diverse and inclusive cultures; many believe that it assists with business performance (both at manager level and at the level of underlying portfolio companies); and it is increasingly a focus of regulators. Given this, at the very least, we would suggest that managers should expect that D&I issues will continue to be part of the conversation in the industry and anticipate any weaknesses in their own organizations. Further, with proper time and intention, asset managers can disrupt the status quo and develop a diverse and inclusive culture within the industry.

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