

Minority Passthroughs- What They Are and the Case for a New
Measurement of Corporate Supplier Diversity Success

May 16, 2022



Acknowledgements

We want to thank all the MBEs and corporate procurement, supplier diversity, and c-level executives for supporting this research. Without their assistance, this project may have never been completed or long delayed. It was not surprising that because of the sensitivity of the topic, most people interviewed asked that we do not share their names or organizations. This is an important finding. This research will require follow-up studies and analysis that will make it possible for this discussion to be more open in the future.

I want to give special thanks to Annette Stevenson, of Stevenson Consulting Group, the former supplier diversity leader at SAS for her work in making this project a reality. I also want to recognize the support of Michelle Word and Kelly Jeffcote of Burns and McDonnell for sharing with me a case of a minority passthrough that they brought to my attention. I also want to thank my friend Paul Lacchu, the Editor in Chief at **DiversityPlus** Magazine for being willing to share this report with his influential supplier diversity readership.

We hope that this work will be reviewed in the spirit in which it was written, which is our uncompromising support for diverse businesses and the supplier diversity professionals in corporations and third-party certifying organizations that do this important work. We hope we have helped you perform your tasks better for the benefit of diverse entrepreneurs everywhere.

Of course, BJM Solutions is responsible for all errors of commission and omission.

Fred McKinney, Ph.D.
BJM Solutions, LLC
April 31, 2022

Executive Summary

BJM Solutions, LLC conducted this study on the prevalence and structure of minority passthrough businesses in early 2022. We created and distributed a survey that was completed by 38 corporate supplier diversity professionals in multiple industries. We then conducted a follow-up interview with corporate supplier diversity professionals, the leaders of Third-Party Certification Organizations (TCPOs), and other supplier diversity organizations.

We defined MPs as organizations that do not provide “commercially useful functions” but exists to meet the supplier diversity reporting goals of large corporations seeking to boost their diverse spending numbers. We compared MPs to other legitimate forms of businesses including brokers, distributors, value-added resellers and showed that these other forms are providing commercially useful functions for their clients and should not be confused with MPs.

We found that minority passthroughs (MPs) exist across the U.S. industrial landscape and that a significant portion of total minority spend may be with these types of firms. Twenty-eight percent of spending was attributed to MPs by supplier diversity professionals taking the survey. This was an amount larger than we had expected and significantly larger than the amounts thought to exist as reported by the leaders of TCPOs.

Supplier diversity professionals reported that TCPOs should be the first line of defense against MPs and should be weeded out in the certification process. But if this failed, it was the responsibility of supplier diversity professionals to report MPs to the TCPOs and for their companies not to do business with these types of organizations.

A general solution we recommend in addition to the increased oversight responsibilities of TCPOs is for corporations to redirect their focus away from spending, particularly first tier spending, to the concept of minority content throughout the supply chain. Minority content may better reflect the economic impact of corporate supplier diversity in a time when it is not unusual for corporate supply chains to four, five or six tiers. It is more important to capture spending deep in the supply chain with legitimate diverse businesses than it is to capture first, or second tier spend with MPs.

The results of this survey will require additional research and comment. We hope that the result is a return to the original goal of supplier diversity which was to improve economic conditions in minority communities. Being a diverse supplier is difficult enough without having to compete against minority passthroughs. The elimination of these business structures will not level the playing field, but it will make it fairer.

About BJM Solutions

BJM Solutions, LLC is an economic consulting firm formed in 1999 by Gerald Jaynes and Fred McKinney. Both Dr. Jaynes and Dr. McKinney are Ph.D. economists with years of experience in economic and social policy. BJM Solutions is certified with the Greater New England Minority Supplier Development Council, an affiliate of the National Minority Supplier Development Council, the Canadian Aboriginal Minority Supplier Council, and the State of Connecticut. For more information about BJM Solutions, visit, www.bjmeconomics.com.

Introduction

In April 2022, New York Attorney General Letitia James announced a settlement of over \$1.3 million in settlements with 10 New York based firms who were accused of engaging in passthrough activities where the accused firms used non-MWBE (Minority and Women Business Enterprises) firms to perform work, but ran the money and paperwork through MWBE companies.¹ Also in April 2022, the US Attorney indicted a Missouri based construction firm funneled \$900,000 through two minority businesses to meet the diversity goals on a senior housing project.² While these examples involved construction companies on public sector projects, we believe the practice identified in these cases are not unique to construction or to public contracts. This study focuses on the prevalence of passthroughs in the private sector for many of the same reasons we see this phenomenon in the public sector – trying to reach MWBE spend goals.

When the federal government started supplier diversity in the late 1960s, the focus was on creating a black entrepreneurial class. Later with the inclusion of more groups, Hispanics, women, Asians, the disabled, **veterans**, and others supplier diversity spread from the public sector to the private sector. Today, thousands of corporations, cities, counties, states, non-profits, and quasi-government organizations have supplier diversity programs. Fundamental to all these programs is the identification of eligible businesses as participants. In those early days there were no third-party certifying bodies. Government and the private sector relied on self-certification. Self-certification, while efficient and probably adequate for most minority and women owned enterprise, was incapable of keeping out fraudulent businesses that were set up to take advantage of the set-aside programs. Unscrupulous entrepreneurs established businesses that looked like minority and women owned enterprises but were not. Because of these front organizations, third-party certifying organizations (TPCOs) were established to provide public and private sector buying organizations some assurance in the knowledge that the companies they were contracting with were indeed eligible for the programs. The National Minority Supplier Development Council (NMSDC) was formed in 1972 to certify ethnic and racial minority businesses. This was followed by the Women’s Business Enterprise Network Council in 1984 that was established to certify women owned enterprises. This was followed by third-party certifiers for LGBTQ, Veteran, and disabled third-party certifying organizations in the early 2000’s.

Third-party certification was successful through their rigorous processes in weeding out blatant front organizations. This was an important function because without it, the integrity of supplier diversity programs was in doubt by all stakeholders and critics.

In recent years, diverse entrepreneurs and corporations have become very sophisticated in the contracting with and the creation of business relationships that promote minority and women entrepreneurs while also increasing their spending with certified diverse suppliers. Some of these relationships and business creations come close, and some cross the line, that separates legitimate minority and women owned enterprises from enterprises that have nothing more than modern day fronts.

¹ <https://www.constructiondive.com/news/ny-contractors-pay-13m-to-settle-supplier-diversity-allegations/621792/>

² <https://www.constructiondive.com/news/missouri-contractor-charged-with-fraud-for-minority-business-claims/621638/>

These new businesses are often certified and respected members of the supplier diversity community. Their companies have minority and women leaders. They sell hundreds of millions of dollars of products and services to corporate buyers. Many of them have their own supplier diversity programs. The companies that are on the illegitimate side of the line are what are known as minority passthroughs (MPs).

This study was conducted because the lead author was contacted by one of their corporate clients who asked that they review a company that they were considering for a contract, but there was something about the company that did not “feel” right. After reviewing the structure and strategy of the potential minority supplier, the author concluded that this company was indeed a MP. This case was written up and published in the company’s newsletter. This published report was read by several MBEs who were experiencing competition from businesses that they felt were MPs. Those MBEs asked the authors to conduct further research and write a report on MPs to bring light to the subject, and to come up with some solutions to the problem.

After these encounters, BJM Solutions designed a questionnaire and a methodology to study the prevalence of MPs. But before discussing that methodology and the results of the study. We next cover the definitions of the distinct types of businesses and transactions that make up this report.

Definitions

Defining MPs first requires an understanding of supply chains and supplier value. Every company and every industry have a supply chain. Company supply chains can be as simple as transforming their own labor into a service that is sold to their customer, or they can be complex webs involving thousands of suppliers. It has become axiomatic in recent years, that companies do not compete against each other, their supply chains do. So, what are supply chains?

Investopedia defines supply chains as “a network between a company and its suppliers to produce and distribute a specific product or service. The entities supply chain include producers, vendors, warehouses, transportation companies, distribution centers and retailers.” This definition also illustrates important aspects of the value of converting raw materials and labor into consumer products. We often make the distinction between producer products and consumer products; the fact of the matter is everything is ultimately a consumer product. Economists recognize this reality in our calculation of gross domestic product (GDP). GDP captures the dollar value of all final goods and services produced within our borders during a particular period. We understand there is no need to count the value of intermediate/producer products, because all that value is captured ultimately in some product or service consumed by individuals, households, or governments.

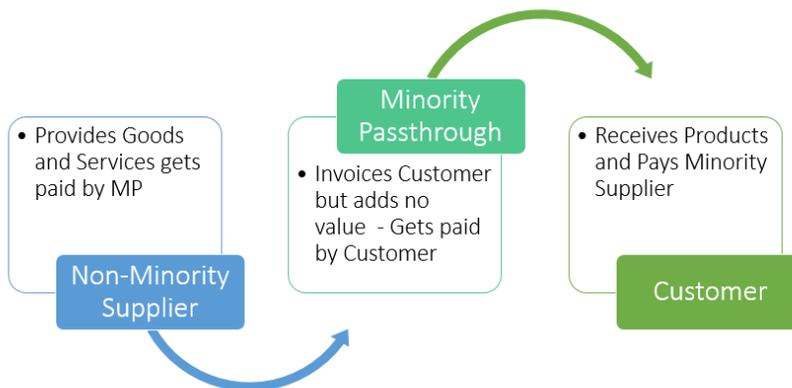
Companies occupy some part of the value chain in this conversion of raw materials and labor into consumer products. Mines that extract natural products from the earth and sea are creating value in that process. It is also clear that manufacturers who use those raw materials and convert them into manufactured goods by combining those raw materials with labor and capital are also creating value. It is also clear that transporters who move raw materials to manufacturers and finished manufactured products to warehouses and distributors and finally to retail stores are creating value. And it is also clear that those warehouses, distributors, and retailers are also important stages in the value creation

process. At each stage in this value creating process, companies earn their revenues and their profits from their contributions.

MPs are part of corporate supply chains, but the only value they offer is the value of their status as a diverse supplier. There are hundreds of thousands of diverse suppliers that are providing real economic value in corporate supply chains. The definition of MPs is not about these legitimate diverse suppliers who are serving as extractors of raw materials, scientists, manufacturers, transporters, distributors, warehouses, or retailers. The owners of MPs may look like the owners of these legitimate diverse suppliers, but they differ fundamentally in that they **DO NOT** create value.

How do you know they do not create value? We know because if they were to go away, the only harm done would be the inability of their customer to claim that spend as diverse spend. The product or service they “provide” would not be any different in their absence than in their presence. Their subtraction from the supply chain would not be noticed by the consumer. The product or service they provide would continue to be manufactured, shipped, warehoused, and sold just as when they were in the supply chain. The only material change that would be noticed would be on the addresses of the invoice and who the check is made out to.³ The diagram below shows how MPs work. In some cases, the non-minority supplier does not even bother to ship the goods and services to the MP; they simply ship the goods directly to the customer.

Pure Minority Passthrough



It is important to make some distinctions between MPs and other legitimate, and similar activities. The example of a broker comes to mind. Brokers provide value to their customers because they have proprietary knowledge of markets and can use that knowledge to save their customers money, buy higher quality goods and services, or in other ways satisfy some need of their client. For this service,

³ The minority partner in these passthroughs would notice if this practice stops because they would not be able to cash in the retainer for their efforts in this enterprise.

brokers earn a fee. Brokers are not expected to take possession of the goods and services they are buying on behalf of their client. They are facilitators of transactions not actively involved in the transaction as a principal.

MPs differ from brokers because MPs are often hobbled by the non-minority firm they are collaborating with as their supplier. The broker has the independence to source from any supplier that meets their customers' needs. MPs often only sell the products of their primary supplier(s). Brokers act in the interest of their customer - not their suppliers.

MPs, because they are essentially representing and selling for their non-minority supplier/partner, also look very much like independent sales organizations. The key distinction between MPs and independent sales organizations, is the independent sales organizations are free to buy from which ever supplier offers the best deals where MPs are not. Without this independence, MPs act more like sales agents for their primary supplier.⁴

A third category of companies that are close to but differ from MPs are distributors. Distributors provide a valuable service to their clients by inventorying products from original equipment manufacturers (OEMs) and possibly other distributors. Manufacturers value those distributors because they perform a critical sales function that allows the manufacturer to focus on manufacturing and their biggest strategic clients. Distributors often own or rent warehouse space to inventory the products and services of multiple OEMs. MPs may own or rent warehouse space, although they often don't. They simply "drop-ship" their orders from their supplier to their customer, eliminating the need to take possession of products. The other key distinction between MPs and distributors is that MPs often do not inventory the products of other companies, particularly companies that compete against their primary supplier/collaborator.

A fourth type of business that can be confused with MPs are subcontractors. In construction, contingent labor, and in some other businesses, subcontractors are used to provide a specialized service for a general contractor. The value of subcontractors is in the role they play to complete a project. MPs also play a role in the completion of a project. The product/service MPs provide are not needed. The difference between subcontractors and MPs is that subcontractors are producing the goods or services, whereas MPs are only arranging for those goods or services to be delivered. Subcontractors are a necessary part of the production process, MPs are not.

Minority Passthroughs are also not value-added resellers (VARs). VARs are organizations found in several industries, but often in equipment, information technology and computer industries. The key distinction between VARs and MPs is the concept of value added. VARs in computer and software often install the software or equipment, monitor use, replacement and warranty provisions and often are responsible for recycling of used equipment. These are all necessary functions that customers are either willing to pay for or must pay for. MPs provide none of these services.

Minority Passthroughs are also not Managed Service Providers (MSPs). MSPs are companies that provide a range of services for their clients including temporary labor, project management, IT services, security services and other activities that the client has outsourced. Corporations have gone to MSPs to

⁴ Several of the MPs I have witnessed were owned by former employees of their primary supplier. Many of these former employees were former sales employees of the company they are now serving as a MP.

save cost, remove some services from budgets, and improve quality. While MSPs are inherently not MPs, there are some MSPs that operate like passthroughs. For example, a diverse MSP could be hired to provide services to a large client and that MSP might use the services of a non-minority firm to provide those services. If that minority MSP is not engaged in the actual management of their non-diverse supplier and the client is counting all that spend with the diverse MSP even though most of the revenue is passing through to the non-diverse company, those transactions are passthroughs. We found in our interviews that some supplier diversity professionals believe the treatment of these types of transactions are not being treated the same for all organizations and as a result, some corporations might be reporting the total value of these transactions as minority spend when only the service fees to the MSP should be counted.

Another dimension of MPs is based on the transaction not the business entity. Legitimate distributors can engage in transactions that are passthrough transactions. For example, a diverse distributor might be approached by an OEM who sees an opportunity to sell their products to a customer by partnering with a diverse distributor or other firm.⁵ A passthrough transaction would occur if the diverse firm simply invoiced the client, gets paid from the client, deducts their fee, and sends the bulk of the proceeds on to the supplier/collaborator. Transaction based passthroughs are challenging to police because the participating firms have other legitimate activities, often with the same clients.

MPs are not brokers, distributors, independent sales organizations, MSPs, or subcontractors. And some legitimate diverse businesses and their collaborators might engage in passthrough transactions, opportunistically. But how do MPs sustain themselves, particularly in competitive markets? For the suppliers of MPs, the fees paid to MPs are a selling expense. These expenses, whether paid to internal sales professional employees or paid to MPs, make trivial difference to the supplier/collaborator of the MPs. Using MPs is therefore not necessarily going to increase the cost of the suppliers/collaborators. MPs can remain profitable if they keep their administrative expenses to a minimum. MPs have little in their cost structure other than appearances of running an independent business. MPs might have elaborate websites. MPs might attend and even sponsor diversity conferences. The owners of MPs might be respectable members of minority communities as a representation of diverse entrepreneurial success. MPs are however vulnerable to changes in policies of their supplier/collaborator and changes in policies of their clients who might have second thoughts about the legitimacy of the MP and the reputational risk associated with using MPs.⁶

Going beyond what MPs are not, let us describe what they are. MPs are often relatively small employers because they are primarily billing their customers, depositing their checks, and paying their supplier/collaborator. It is common for MPs to have millions of dollars in sales and only a handful of office clerks and senior managers. Usually when firms have large sales per employee, it indicates great productivity. MPs are example not of productivity, but of being paid for doing nothing. Other tell-tale signs of MPs are they are often co-located with their supplier/collaborator. While minimizing overhead is an effective way to increase profitability, co-location should disqualify the business from certification. Additionally, MPs were often employees or sales staff of their supplier/collaborator before they started

⁵ It is also possible that the diverse firm approaches the OEM with an opportunity to represent their product in a transaction that benefits the OEM and the diverse firm and provides the client with diversity spend.

⁶ Of course, the client can claim the MP is certified and they assumed they were dealing with a legitimate diverse business.

the business or gained the new contracts. Reviewing the MP's resume is one way to check for this. MPs sometimes have board seats or senior management positions held by senior managers at their supplier/collaborator. MPs also frequently can be found prominently displayed on their supplier/collaborator's website usually as their "diverse solution partners." These are the practices TPCOs, and supplier diversity professionals need to be looking for when screening for MPs.

Examples of MPs

Example 1: Case of Minority MP in Technology

The following case was shared during an interview. It involves a long-term relationship between a multi-billion-dollar corporation (a global distributor) and two technology companies owned by one woman who is also an ethnic minority. The two technology companies are each certified as a MBE and WBE and resell major IT brands. They promote themselves as a "top tier distributor that generates economic benefit for both the companies and communities it works with."

An initial look at the companies and everything appears as a normal contracting relationship between a corporation and a MWBE. The MWBE benefits from a contract with a steady revenue stream and the corporate distributor benefits from achieving Diversity Spend – dollars they can claim Tier 2 Spend.

However, a closer look at the contracting process between the diverse firms and the corporate distributor raises questions about the authenticity of the transactions and spend. The organizations had developed the process of using numerous unique product suffixes. This process makes a reseller, any reseller, appear to be a minority company (like the certified MWBE), but in fact it is not. If you understand the internal coding and audit the compensation trail, you will discover that this is not spend with a diversity supplier but just passthrough transactions. The spend with this minority firm enables any nondiverse firm to achieve diversity spend.

During this review, we also learned that the multi-billion-dollar corporation had two other "dedicated" diverse partners (a Native American firm and a Service-Disabled Veteran owned firm) that they would pair with nondiverse resellers to compete and achieve federal small business contracting requirements.

Also, a deeper look at the current structure and past organization of the diverse companies makes one ask, is this really a MWBE firm that is owned, operated, and controlled by the MWBE? The website does not identify the owners of the diverse company but does display Senior Staff members- who happen to be former employees of the multi-billion-dollar corporation - the distributor. In fact, the current VP of Sales for the MWBE firm was a sales manager for the corporate distributor. Is this all a matter of coincidence or a strategy to apply control within the MWBE firm?

There is a significant negative impact on MBEs that participate in this type of passthrough business arrangement. Besides limiting their own business growth, other MBEs in the same field cannot effectively compete because of such low margins. A 1% or 1 ½% fee cannot cover the actual Value-added cost of doing business with a major corporation. A quote from one of our interviewed MBEs, "It

would be crazy to start a business or try to enter this IT space when you know that you are being undercut by diverse pass-through businesses. “

Finally, what is suspect is that the MWBE company's homepage - which promotes themselves as a certified diverse company – claims to have a unique value-added diversity program. This diversity program is not outlined but states that it can help in procurement by helping diversify a customer's supply chain. So how is this achieved? It is not clear and appears to be a play on words. Yes, it brings a minority, woman firm into the supply chain, but where is their value- a price reduction? A value-added service? Better components or speed to market?

This website messaging is counter to what supplier diversity professionals teach potential suppliers working to enter their corporate supply chain. A supplier should primarily promote their company's goods and services and their KSAs (knowledge, skills, and ability). They need to articulate the value they bring – their niche– and then identify them as a diverse supplier. In corporate America contracts are awarded based on the value the supplier brings. Contracts are not awarded just because the supplier has a diversity or small business designation. *Some questions to consider: is the internal organizational pressure to “achieve diversity spend goals” having unintended consequences and driving unwanted behavior? Are organizations using MPs purely as a tactic to make sales and gain market share?*

Example 2: Case of the MP in Manufacturing

As CEO of the GNEMSDC, I used to welcome the opportunity to conduct site visits of prospective certified MBEs. The certification process involved a detailed application that describes the ownership and the purpose of the business. Supporting tax documents and other official documents proving eligibility is an important part of the certification process. But for me, the most important part of the process has always been the site visit. Going to the place of business seeing the operation, talking to the owners and employees you get the best understanding of the business, and it provides ideas on how you can assist the newly certified business. Only companies that provide all the correct documentation get to the site visit stage. In addition to seeing how the TPCO can help the newly certified business, the site visit also is the last opportunity to see if there are signs that there are characteristics of the business that would disqualify it for minority certification.

One case I recall was of a manufacturer of machine parts for the jet engine business. The business was in an industrial park in the northeast corner of Connecticut. The “owner” of the business was African American. The paperwork looked in order. But when I arrived to meet with the owner, I immediately noticed that there were two names on the building: one for the MP and one for the supplier/collaborator. Both the African American man and the non-minority owner of the supplier/collaborator were sitting at a conference desk. When I asked the two to introduce themselves, the non-minority person indicated that he was the owner of one of the companies and was a “minority” owner in the company applying for MBE certification. Red flags all around. I learned that the white owner of the supplier/collaborator company formed the company with his African American worker so that the certified business could win more business with their existing clients and provide some security in the event the collaborating company lost business to legitimate certified businesses. After a few more questions, I told the two men that based on what I witnessed and heard, the company applying for certification was ineligible for certification. They complained and threatened to challenge my decision. I explained the challenge process and wished them well.

This prospective certified business was a classic case of a MP. These may be legitimate businesses, they are just not, nor should they be certified. If they were to get business, the beneficiary of the business would have clearly been the supplier/collaborator. It is difficult to tell once a company like this is certified, how the proceeds are distributed. It is clear that this MP could have siphoned business away from legitimate certified businesses and would have had only marginal impact on the economic status of minority communities.

Example 3: An MP Transaction in a Diverse Distribution Firm

Minority passthroughs can also take the form of specific transactions carried out by certified diverse businesses who are offered an opportunity to make a little extra money. In one case we heard about during the study, a certified diverse business in the distribution industry was approached by a manufacturer of products the MBE distributed. The manufacturer sold direct to large clients and used distributors to supply smaller clients or smaller orders. The manufacturer approached the certified MBE with an offer to invoice a large client that had created a supplier diversity goal and a second-tier goal for all their major suppliers. The manufacturer/collaborator wanting to satisfy their client and expand or protect business came to the MBE with a plan. The MBE would be told by the manufacturer what the client needed, how much to charge the client, where and when to have the product shipped and the types of reporting to do. The manufacturer also told the certified MBE that they were not to contact the client about any other business. The certified MBE's sole role was to invoice the client, collect the check, pay the manufacturer/collaborator. The MBE would retain an agreed upon amount from the client's payment for this service as an MP.

The MBE declined this offer because they knew it was a passthrough transaction. The MBE was concerned about their reputation in the industry, and importantly, they did not feel a need to engage in these types of actions at this stage in their business history. The business was already well established and had deep and profitable relationships with some of the same clients the manufacturer/collaborator wanted them to defraud.

These types of transactions where the diverse firm is doing nothing but getting something for their certification status can occur with firms that are not exclusively MPs. Corporate supplier diversity professionals and TPCOs need to pay attention to transactions as well as to businesses that operate exclusively as MPs. Monitoring transactions is much more difficult than monitoring businesses. But it is in these transactions that corporate buyers are most vulnerable to passthroughs, particularly large dollar value ones that seem legitimate given the companies involved.

This study was designed to see how prevalent MPs and passthrough transactions are in corporate America. The next section discusses our methodology for trying to answer this important question.

Methodology

Beginning in February 2022, we began a survey of corporate supplier diversity professionals. We sent a link of 14 questions to over 400 supplier diversity professionals.⁷ Thirty-eight supplier diversity professionals completed the survey.

We also conducted interviews with 12 supplier diversity professionals, diverse business owners, and representatives from supplier diversity third-party certifying organizations.⁸ These interviews provide context to the survey results. We agreed not to share the names of the people or companies surveyed or interviewed to encourage candor.

Summary of Survey Results

The MP survey was completed by companies representing several different industries. Banking, Manufacturing and Healthcare were the three largest industries represented in the study, but “Other” was the most common industry listed. The industries that were specifically identified in Question 1 were manufacturing, Information Technology and Computers, Telecommunications, Banking and Finance, Insurance, Healthcare, Retail, Distribution and Logistics, Construction, Transportation, Energy Production and Distribution, Oil, Gas and Other Mining. responses to “Other” wrote in their industries which included higher education, agriculture, entertainment, consulting, government, hospitality, non-profit (life science), and Food and Facility Management.

Companies ranged in size from under \$100 million (8) to over \$25 billion (6). There were nine companies with annual revenues between \$10 billion and \$25 billion. This was the most common group by annual revenues.

When asked how frequently certified businesses they suspected were passthrough tried to do business with their firm, 47% responded “Sometimes” with 34 percent responding “Rarely”. When asked how frequently the corporate representatives had uncertified businesses attempt to do business with their firms, they suspected of being passthroughs, “Sometimes” was the most frequent response at 50% of the responses to that question. Rarely was reported 32% of the time. There does not appear to be much difference in the response based on whether the businesses were certified or not.

Respondents were asked what industries were most likely to have passthrough businesses. Construction had the greatest number of respondents saying passthroughs were most likely to occur, followed by manufacturing, information technology, and distribution. But respondents indicated that passthroughs occurred in all the industries identified.

When asked if passthrough businesses harm legitimate certified diverse businesses, 89 percent indicated they do harm legitimate certified businesses. One respondent wrote in that passthroughs “sometimes have the ability to help diverse businesses grow.” We could not follow up with that respondent because of anonymity, but it would be interesting to explore this further. We know that

⁷ The questions are included in the appendix.

⁸ A summary of those interviews is included in the Appendix.

MPs do provide a financial benefit to the minority entrepreneur in the form of a “commission”. That commission could be large on large corporate transactions.

When asked how passthroughs harm legitimate diverse businesses, 82 percent of respondents stated that passthroughs diminish the intent and goal of supplier diversity. This was followed by 68 percent reporting that passthroughs impede the development and growth of certified diverse businesses. Several respondents also spoke about how passthroughs diminish the credibility of corporate supplier diversity and how passthroughs inflate corporate spending with diverse suppliers. It is clear from these answers that corporate supplier diversity professionals see passthroughs as a moral problem as much as an economic problem. The issue of reporting diverse spend came up in the interviews as a major motivation for corporations to use MPs. Spending with MPs can be simple with little perceived quality or financial risks because the collaborators are often current well known and large suppliers to the client claiming the diverse spend. The incentives to conduct these types of transactions are significant because of the competition to report ever increasing diverse spending dollars.

Fifty-four percent of respondents believe that their competitors use passthroughs to increase their reported spending with diverse suppliers. *If over half of supplier diversity professionals view their competition as boosting their spend numbers by using passthroughs it says there is a need to increase the professionalization of supplier diversity professionals.* We suspect, and we heard in our interviews with supplier diversity professionals, that people in these positions are not trained well enough to distinguish legitimate certified businesses from passthroughs. It also indicates that supplier diversity professionals are under significant pressure to increase the reported spend with certified diverse suppliers. Some know that there are few if any economic value to these transactions, but they look the other way.

Seventy-one percent of respondents reported that policing passthroughs should be a top priority. Over 18 percent reported that it should be the most important priority while only 11 percent said it is not very important. Given that almost 90 percent see a significant role of third-party certifying bodies policing this phenomenon suggest more resources and more training is appropriate. Related to this question was the broader question of whose responsibility is it police passthroughs. Thirty-nine percent of respondents reported that it was the responsibility of third-party certifying organizations (TCPOs). Twenty-four percent stated it was the job of the supplier diversity professional and 21 percent said it was the job of the buyers. Clearly many corporations rely on the third-party certifier to weed out these businesses, but when they get through or go around certification, it becomes the job of the supplier diversity professional followed by the buyer. Several respondents answered that it is the responsibility of each of these groups.

When it comes to the actions third-party certifying bodies should take when passthroughs are discovered, 42 percent reported that they should be banned from future certification. Several respondents recommended suspension and education of diverse entrepreneurs. In speaking with several diverse entrepreneurs, it was brought to our attention that passthroughs may occur in businesses that are legitimate but are offered an opportunity by an unscrupulous non-minority corporation to get something for nothing. For struggling diverse entrepreneurs faced with competitive challenges, taking the effortless way out might be the choice they make.

When asked why their fellow corporate representatives use passthroughs, the most common answer was to increase their diversity spend (66 percent), followed by “to help specific entrepreneurs”.

Interestingly, 37 percent stated that corporate buyers do not know the difference between passthroughs and legitimate diverse suppliers.

The final question of the survey asked supplier diversity professionals what percentage of diverse spend in U.S. corporations do you think is with passthrough businesses. The average spending estimated was 28 percent. This was surprising to us and provides a clear call to action. This finding was the most important finding in the study. If 28 percent is more than just a perception of how much MP spending is occurring, it means the entire supplier diversity effort has a major problem of legitimacy and it is in the interests of all stakeholders to root out these practices and return supplier diversity to a goal of improving economic conditions in minority communities by supporting legitimate minority businesses from these communities.

Result of the Interviews

We conducted several interviews with supplier diversity professionals, MBEs, and leaders of supplier diversity organizations. We asked the following questions of the interviewees and tried to encourage an open-ended dialogue to provide context to the survey results.

The questions:

1. What do you know about passthrough businesses?
2. Have you ever had experiences with these types of businesses?
3. What was that experience like?
4. What should be done about passthroughs? Should they be sanctioned and if so, how?
5. Are there any industries where you are more likely to see passthrough businesses?
6. Do these businesses have a negative impact on "legitimate" M/WBEs?
7. Are there any characteristics of passthroughs that help you identify them?
8. Are your competitors using passthroughs and why?
9. Right now, the survey reports 26 percent of businesses with diverse businesses is with passthroughs. Do you think this number is high, low, or about right?
10. Whose job is it police these types of businesses: NMSDC/WBENC, the supplier diversity professional, the Department of Justice, corporate buyers, others?

There were several key themes that were revealed during the interviews with supplier diversity professionals, diverse suppliers, and leaders in supplier diversity organizations. One of the important findings was that MPs are known to operate in the supplier diversity world as both certified and uncertified suppliers. The fact that MPs exist is not news. What was confirmed in the interviews by some but not all the interviewees are that the utilization of MPs by corporations is significant in terms of total spending with diverse suppliers. We were surprised at the estimated percentage of spend with MPs was reported in the survey, but in speaking with stakeholders, we are now confident that MPs represent a significant amount of spending with diverse suppliers, potentially as high as 20 percent of total diverse corporate spend could be with MPs or passthrough transactions with otherwise legitimate diverse firms.

As mentioned, not all the interviews agreed with the size of spending with MPs as reported in the survey or with the other interviewees' assessment of the amount of spending with MPs. Some of these respondents indicated that spending by their companies or reported to their organizations was

validated in a way to minimize if not eliminate spending with MPs. *However, the problem is not one of verification or auditing the spend. The problem is what is counted and should not be counted. If the MP is certified, auditing cannot determine if that spend should be counted or not. Auditing verifies the certification status of the supplier, not the quality of that spend.*

It was interesting to hear respondents opine on which industries are likely to have MPs. While several industries were repeatedly mentioned like construction, manufacturing, distribution, information technology and computers, most thought the practice is pervasive across most industries.

Several interviewees stated that the subject of a “diverse solution” was broached by the non-minority supplier/collaborator to save or grow the business with their clients. These supplier/collaborators offer their MP partners as a supplemental or a replacement supplier knowing that they – the collaborator – will still end up with the lion’s share of the business.

Another of the interesting learnings from the interviews was the observation that federal procurement practices are designed to catch and eliminate MPs from federal contracting. The federal government has the concept of “commercially useful function.” Passthroughs have no commercially useful function and are therefore not eligible for federal contracts. The concept of a commercially useful function is also well defined in some state contracts. California’s definition of commercially useful function is a potential model for how third-party certifying bodies could screen diverse businesses and how corporations could reduce the utilization of MPs. Below is what California uses to describe or delineate firms that have commercially useful functions from those that don’t.⁹

- “Executes a distinct element of the contract scope of work including supply of goods and services.
- Performs, manages, or supervises the work including supplying of goods/services.
- Performs work that is normal for the firm’s business and services and functions.
- Is responsible, with respect to products, inventories, materials, and supplies required for the subcontract, negotiating price, determining quality and quantity, ordering, installing (if applicable) and paying for material.
- Does not subcontract a portion of the work greater than expected by industry practices.”

All the interviewees stated that MPs have a negative impact on “legitimate” diverse businesses because they take away business, and they ruin the reputation of supplier diversity in general. The supplier diversity professionals interviewed all agreed that one way to check these practices is to better train corporate supplier diversity professionals. It was stated by several interviewees that many experienced supplier diversity professionals are retiring from the profession, or are being promoted to new positions, and that the incoming cohort of supplier diversity professionals may not have the experience or training to distinguish between MPs and legitimate diverse businesses.

All the professionals believe that policing MPs is the responsibility of third-party certifiers, [supplier diversity professionals](#), corporate buyers, and diverse businesses. However, all agreed that third-party certifiers play a critical role of being the initial gatekeeper.

⁹ <https://www.dgs.ca.gov/PD/Resources/Page-Content/Procurement-Division-Resources-List-Folder/Commercially-Useful-Function-for-Certified-Firms>

What are the Policy Implications of These Results?

The main finding of this report is that MPs exist, and they occupy a sizable portion of total diverse spend by corporations. As is the case with most studies, these results encourage further study. We were shocked at the finding that corporate supplier diversity professionals estimate that as much as a quarter of all diverse spend is being done with MPs. This finding calls for more observations to be surveyed and to ask the question differently than was asked in this survey. While thirty-eight corporate responses are a sizable number, when conducting studies, there is always the possibility that participants may not be representative of the population of corporate supplier diversity professionals. The solution to this problem is to survey again and include more participants. Secondly, we should ask the question differently. We asked supplier diversity professionals how prevalent they think MPs are in general. This is a good question to help us understand perceptions, and as they say perceptions are reality. However, an additional and more probing question would be to ask supplier diversity professionals how prevalent are MPs in their own supply chains? We might be capturing a “natural” tendency to report a greater amount of bad behavior in our neighbors than what is going on in our own homes. Further study would help us understand if this is the case.

Third-Party Certifying Organizations (TPCOs)

The survey asked for recommendations to address MPs from the interviewees, it was also a question on the survey. The consensus was that a multi-layered approach should be used to minimize the phenomenon. Third-party certifying organizations play the key role of reviewing the eligibility for certification. While the certification process can reduce MPs, the focus of certification has been to confirm ownership, management, and control by eligible diverse entrepreneurs, not to fully understand where that diverse firm is in corporate supply chains.

One solution to this problem is for third-party certifying bodies to specifically use the language on federal (and state contracts) that define “Commercially Useful Function” on certification applications. Prospective M/WBEs should have to demonstrate the value they are creating for their clients, and that value must go beyond their minority or women status. The value of certification is that it enhances the ability of M/WBEs to do business with corporations. It does not and should not work in reverse: where corporations are only doing business with M/WBEs because they are diverse and certified. MPs operate as if the latter is the purpose and goal of supplier diversity. The goal of supplier diversity is to increase opportunities for certified diverse businesses, generate wealth and income in previously underserved communities, and grow the overall economy.

The reason to try to reduce the prevalence of MPs is that they do cause harm. Legitimate certified diverse businesses lose business to MPs and have little way to demonstrate their strategic advantages compared to MPs that are fundamentally no different than their non-minority collaborators. One of third-party certifying organization’s goals is to promote and develop legitimate certified businesses. Monitoring and eliminating MPs from their ranks would be a step in the right direction.

Identifying MPs and preventing them from being certified would be an important improvement in the supplier diversity ecosystem. It should also be the responsibility of TPCOs to enforce their brand by

sanctioning MPs who have been revealed to be in violation of certification standards. One sanction that was discussed with interviewees was to ban MPs from certification for some period and to scrutinize their return before granting them certification in the future. Certification is and should be a privilege not a right.

TPCOs have significant reputational self-interest as stake when it comes to policing MPs. If their corporate members do not think TPCOs are adequately policing MPs, corporations will not trust their certification standards and might consider creating their own or using a new one. Given the current state of technology, this is more feasible today than it was when TPCOs were first created, and manual certification processes were required. With information technology, large, detailed databases of suppliers, video technology and elaborate public and private search engines, we can find out just about everything we need to know about a potential supplier with the click.

Supplier Diversity Professionals

We also heard that supplier diversity professionals have a role to play in reducing the prevalence of MPs. Primarily, supplier diversity professionals need to be trained to understand the several types of businesses that occupy their corporation's supply chain and operate in the industry. This understanding will help to catch MPs that might get through the certification process before they enter their corporate supply chain. With the assistance of TPCOs, supplier diversity professionals can demand all suppliers claiming minority status, should be required to be certified.

Training supplier diversity professionals on the practices of MPs is an important second line of defense if MPs do make it through certification. All their diverse suppliers should be able to demonstrate that they offer commercially useful functions as generally understood. If a supplier cannot pass this test, they should consider them ineligible for corporate supplier diversity programs, and spending with those firms should not be counted as diverse spending.

This last point, that spending with MPs should not be counted as corporate diverse spend is an important finding. Companies and organizations like to promote how much spending they are doing with diverse suppliers. That spending needs to be with certified diverse firms and that spending needs to be done with firms that are not MPs. Inflating spending by counting MPs not only inaccurately reflects the economic impact of supplier diversity, but it also takes away from the opportunities legitimate diverse firms might have in their absence.

Corporate Procurement in General

A third line of defense against MPs is corporate procurement departments. Procurement professionals are the employees of the corporation who makes the recommendations and decisions on which suppliers to use. The vetting process typically includes factors like total cost of ownership, pricing, quality, delivery, ease of communication, agility, and innovation. Procurement professionals should know when they are contracting with MPs. They are trained to the point where it is second nature for them to sniff out MPs and other fraudulent practices. If MPs get through TPCOs and supplier diversity professionals, procurement professionals must be encouraged to identify these questionable businesses and report them to their internal supplier diversity professional to get clarification of the MPs status and eligibility. The supplier diversity professional working with procurement can then determine the eligibility of the business for supplier diversity programs. If the supplier is determined to be engaged as

an MP, the supplier diversity professionals and procurement then should develop strategies for intervention. Intervention could be to “pull” the contract and put it out for re-bidding. It could also include banning the supplier from future contracts. They could have a policy of reporting the company to the certifying body that granted the certification expressing their concerns and findings. Any policy needs to be developed by the corporation and not just supplier diversity or procurement. The reputational and financial risks are not insignificant, particularly if the corporation is supplying goods and services to the public sector. It would be better for the TPCOs to police these practices, but corporations should not hesitate to act if MPs get through the certification process to eliminate them from their supply chains.

It would be better for the TPCOs to police these practices, but corporations should not hesitate to act to eliminate them from their supply chains if MPs get through the certification process.

Diverse Businesses

In the early days of minority certification and minority set-aside programs, it was often legitimate diverse business owners who informed and exposed front organizations. While no one wants to create an environment where successful suppliers are wrongly accused of being MPs, we also should encourage legitimate diverse businesses to feel comfortable reporting to certifying bodies and corporate supplier diversity professionals their knowledge of MPs in their industries. No firm likes to lose a contract opportunity, but no diverse firm wants to lose a contract opportunity to a MP. Legitimate diverse firms however need to know the facts and they also need to know what “commercially useful function” means. Legitimate diverse firms have a dilemma when it comes to reporting what they “know” about MPs to corporations using those MPs. In many ways, this is a no-win situation. They lose or lost in the bid competition and reporting the MP does not make them welcome to the corporation, that might be aware that they are buying from a MP, but simply look the other way. In which case, the corporation (more likely the buyers) may not be happy to award the business to the legitimate diverse business who exposed the situation. But this is a cultural issue that needs changing if it describes the behavior of procurement employees in the company.

About Economic Impact, Supplier Diversity and MPs

In the early days of supplier diversity, the key metric of success was spending with certified diverse businesses. I remember when I was president and CEO of one of the regional NMSDC councils, at our annual meetings we used to have an evening of fun called the Tally Rally. The Tally Rally usually took place on Halloween evening. In keeping with the spirit of the season, each regional council would have their staffs, their boards, and their MBEs dress in Halloween costumes. It would be a big show. Every council’s CEO or chairperson would lead their council onto the stage where the NMSDC CEO would be sitting, also often in costume, once on stage, the regional council would report the total minority business spend of corporate members in their region. At the end of a long ceremony the national CEO would report the total for the year, and this admittedly imperfect process would come to an end. The Tally Rally no longer occurs.

The point of this story is that M/WBE spend was the most important metric. I believe the time has come to add additional metrics. Most importantly, economic, and social impact is what supplier diversity

should be addressing. How many jobs, particularly in minority communities are being created by corporate supplier diversity is a much better measure of impact than spending with diverse suppliers.

Are communities being transformed by supplier diversity and if so how? Nobody expects extraordinarily successful minority entrepreneurs to live and work in communities that do not offer the amenities they can afford. But it is reasonable to expect that corporate supplier diversity has the effect of shrinking distressed communities and growing vibrant economically sustainable minority communities.

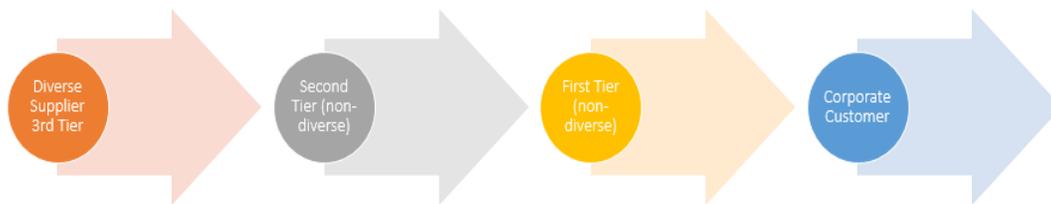
MPs are not likely to provide much economic or social impact other than making the owner of the MP wealthy. MPs are often identified by how few employees they have, how low or non-existent their costs are. Taking business away from MPs and giving it to legitimate diverse businesses, who do provide commercially useful functions, would provide economic and social impact.

An emphasis on economic impact combined with the problems MPs present suggests supplier diversity may need to reduce the emphasis on spend as the most accurate indicator of the effect of a corporation's supplier diversity program. An alternative to spend might be "diverse content." Diverse content measures the actual economic value supplied by certified diverse companies. For example, a one-million contract with a certified diverse firm that in turn contracts with a non-diverse firm to supply \$950,000 of the goods and services to the client is \$1,000,000 in spend with a diverse firm. However, from a diverse content perspective, this contract is valued at \$50,000. It is the \$50,000 that is flowing potentially to the diverse firm. The balance of \$950,000 is flowing to the non-diverse firm and is not likely to have the economic impact a similar contract would have if the diverse firm supplied all the goods and services. If one firm counts diverse spend and another firm counts diverse content, the firm counting diverse spend appears incorrectly to be having a bigger economic impact on diverse communities.

Counting diverse content also has its challenges. Very few firms self-perform everything they sell. Diverse content requires the focus to be on economic value added provided by the firm. This is a concept familiar to macroeconomists who know that the sum of economic value added in a supply chain equals the market value to the consumer. This is the reason macroeconomists measure the value of final goods and services to determine GDP not the sales of all companies in the economy. Doing this would result in massive double counting and an inaccurate view of economic activity. Supplier diversity needs to begin looking at this approach in the measurement of the value of corporate supplier diversity.

Measuring diverse content would require companies to have greater visibility into their own supply chains. In the Case Study #1 discussed above, we found there are minority manufacturers and OEM who are not counted as diversity spend because they are too many tiers below in corporate supply chains to be visible to large firms who drive corporate supplier diversity practices. One solution to this problem is measure diverse content in products and services regardless of whether it is first, second, or third tier. This is particularly important to counter the pressure on non-minority suppliers to create MPs to meet the desires and needs of their clients.

Third Tier Diverse Supplier Content



Admittedly, measuring diverse impact is more difficult than measuring diverse content. Diverse content would look deeper into the supply chain. Organizations like the NMSDC, WBENC, and the Billion Dollar Roundtable measure first tier diverse spend only. This not only encourages MPs, but it is also fundamentally inaccurate. This is regardless of whether those spending numbers are audited or not. The problem is not in the counting, it is what is counted. The appropriate measure should be diverse content regardless of whether that spend is first tier or fifth tier. The diagram above shows that diverse suppliers in the third tier of the supply chain may not have their contribution counted by the customer. And if the first and second tier suppliers to the customer do not track supplier diversity spend, this third tier spend will simply not be counted anywhere or by any entity.

A major recommendation of this study is for companies to begin to measure diverse content. In some cases, diverse content and diverse spend are the same, but in far too many cases there are differences which distort the impact and the original goals of supplier diversity.

Appendix A: Survey Questions and Answers (PDF to add)

Appendix B: Summary of Interviews

We interviewed several corporate supplier diversity professionals and several certified MBEs. Below is a representation of some of those interviews. The names of the individuals and the companies have been removed as per their requests.

Interview #1 - a certified MBE:

In this example, a certified MBE reached out to a multibillion-dollar corporation for business opportunities. Specifically, the MBE wanted to be able to sell a variety of IT goods and Third-Party Maintenance Services through the channel of this major corporate distributor.

The Senior VP of Sales for the MBE firm connected with the corporation (distributor) that promoted having a Supplier Diversity program. They discussed diversity status and offerings- but then the conversation stopped. The MBE firm was informed that we already had a diversity solution and the interaction was stopped. There was no vetting or conversation about value add or cost savings, sales strategy or building a partnerships to allow for mutual revenue growth.

A few weeks later the MBE discovered that the corporation had posted a presentation online that identified their practice of having a few “go-to” diverse suppliers that non diverse resellers could use - depending on their federal contract need. Basically, the information publicly posted said the corporation had one Native American MBE, one SDVOSB and one WBE that can be assigned to help facilitate a contract win- with minimal disruption in the internal sales cycle.

The MBE later discovered that this corporate supplier diversity program was in fact being led by a person who was identified as a Sales contact in the Federal Sector of the corporation. The “supplier diversity program” was not being administered in corporate procurement where it is typically positioned. This practice appeared questionable to the MBE who again offered to work with the corporation to provide value-added services which would result in true diversity spend. Their request to be a diverse supplier was again declined. The conversation ended when the MBE firm pointed out that this was blatant pass-through activity -that did not have to occur- and that this practice totally defeated the purpose of supplier diversity.

In the end, this passthrough activity was in fact being enabled at the top leadership of a major corporation – they not only allowed it -they encouraged it.

Interview #2 – A corporate supplier diversity professional (retired)

The subject of the interview is a supplier diversity professional and consultant. He worked in corporate America for 20 plus years— primarily in the automotive industry; He now has his own business helping clients with Supplier Diversity programs and helping firms make connections. He is a member of several supplier diversity related organizations and serves on several nonprofit boards.

1. What do you know about diverse passthrough businesses?

The interviewee had a few experiences in his career with passthroughs. He believes the practice is still prevalent today.

2. Have you ever had experiences with these types of businesses?

Yes, there were two incidents that stood out to him: One experience was with a Women owned business – her father died and then the husband had the business put in his wife’s name so she could lead it...but it quickly became apparent in the supplier vetting process that she was not in control of the company. They never saw the woman engaged in the meetings or operations and if she did attend a meeting – she barely spoke.

The second experience was with a Native American company that had fought for over seven years to get certified. There was only one Native Indian in the company and the person clearly could not make binding decisions and was not able to run the business – the American Indian person appeared to only be a “talking piece” for the company. Meanwhile – the other company contact had a ponytail and had a suntan and wore attire to “appear” Native American, when in fact-he was not Native American.

3. What was that experience like?

It was disappointing and frustrating – especially since there were “true” diverse suppliers that were being left out while the supplier diversity professional had to work thru issues with the passthroughs. The interviewee was also asked – “Hey, you are a minority, we can run our business thru you!” ...to which the interviewee politely declined.

4. What should be done about passthroughs? Should they be sanctioned and if so, how?

The interviewee thinks if a passthrough is identified – the MBE should be decertified for sure...but maybe have a path to “come back” if there are new business practices in place and be subject to strict scrutiny and possible audits....as for the company using the MBE as a passthrough....”that is another bigger discussion....”

5. Are there any industries where you are more likely to see passthrough businesses?

Yes, the interviewee expected to see it more on the Manufacturing side. He believes any business is “vulnerable” to the temptation. He believes businesses must have integrity – to have true skin in the game as a supplier and not just take the easy road of being a passthrough. “If

you are getting a set salary – you need to be adding value and earning it.”

6. Do these businesses have a negative impact on “legitimate” M/WBEs?

Yes, the interviewee believes this practice has a negative impact on legitimate M/WBEs. The diverse suppliers already have a mountain to climb...so if they suspect they are being approached to be a passthrough – the MWBE needs to understand the implications and limitations to the arrangementand say no!

7. Are there any characteristics of passthroughs that help you identify them?

Yes, the interviewee has raised suspicions when in a meeting the M/WBE does not talk a lot or frequently defers to his “partner” when negotiations are in progress. This is an indication that the M/WBE is not in control or has little expertise in the area.

8. Are your competitors using passthroughs and why?

(Automotive industry) The interviewee does not believe that his competitors knowingly were using passthroughs – but he does think it was happening. He stated that he didn’t think some of his peers were as stringent as he was – they didn’t do the required due diligence.

9. Right now, the survey reports that 26% of business with diverse businesses is with passthroughs. Do you think this number is high, low, or about right?

The interviewee thinks the number is a bit high, he would have initially estimated at 15 - 20%. However, as he considered ALL the industries - the 26% is probably accurate. “I don’t believe they (M/WBEs) could all pass the sniff test.”

10. Whose job is it to police these types of businesses: NMSDC/WBENC, the supplier diversity professional, the DOJ, corporate buyers, others?

The interviewee thinks the NGOs are the first line of defense. They need to be very diligent in their vetting process of how the business is owned-operated and controlled. The next line is the Supplier Diversity Professional – he believes we must do a holistic view of the M/WBE. We must look at what makes sense and what doesn’t – look at who is at the table – be able to identify whether the MWBE really does or does not know the ins and outs of the business. There usually are signs IF we are paying attention and asking the right questions.

This interviewee thinks we need additional training in this area – a “how-to” on how to spot a passthrough and a class that addresses integrity in procurement and supplier selection.

This interviewee is the CEO for a NMSDC certified MBE company. He reports to the company President (the MBE) who owns 100% of the company.

1. What do you know about diverse passthrough businesses?
2. Have you ever had experiences with these types of businesses?
3. What was that experience like?

This interviewee knows that there are numerous diverse passthrough businesses being used today by multibillion dollar corporations (“yes, we have names”). He has not seen it in our own supplier dealings – but has seen it in their industry.

Quote: “We see that the diversity passthrough practice has been growing as more companies are looking to shift their spend to MBEs. The nondiverse suppliers want to protect their market share so they are creating *unique arrangements* to meet their own customer requirements for the diversity credits.” The interview stated that without any industry oversight or governance, this is how the passthrough/fraud is occurring and growing (unchecked).

4. Have you ever had experiences with these types of businesses?
5. What was that experience like?

The interviewee shared, “We have seen the increase of passthroughs in our industry (hardware, software – the technology industry). We have also seen a few legitimate value-add diversity suppliers – however in the last 15 years we have also seen an increase in the blatant use of passthrough businesses. Pressure has increased from major corporations (esp. in Telcom) to have diversity spend – direct or Tier2 – and it is driving this bad behavior.” The interviewee went on to share – “earlier in my career, I had an \$80 million dollar contract in the pipeline –that I had worked on a long time – in fact, it was ready to close...and suddenly it was stopped and awarded to a diverse supplier. Obviously, I was furious and didn’t understand why – but now I do, it was shared with me that the change occurred so the Telcom could obtain diversity spend credit.”

6. What should be done about passthroughs? Should they be sanctioned and if so, how?

The interviewee thinks both the supplier and corporation should have consequences, but it would be a slippery slope, depending on who would “call out” the behavior. It’s not the federal contracting world where the DOJ could get involved...I am not sure what is the best way but at least de-certify the diverse supplier.

7. Are there any industries where you are more likely to see passthrough businesses?

Yes, the interviewee thinks it happens in some way, form or fashion in all industries – but he thinks it’s a very high probability in IT or where goods are being sold in a channel.

8. Do these businesses have a negative impact on “legitimate” M/WBEs?

Yes, this interviewee strongly believes there is a negative impact - a legitimate firm would find it hard to “beat the competition” of a passthrough firm. The margins are too low.

9. Are there any characteristics of passthroughs that help you identify them?

Yes, the interviewee states that the amount of fee/compensation is a big indicator. If you are adding value, true value, then there is a cost, and there should be properly compensation in order to sustain and grow the business. If you look at the compensation model and it is 1% or less...then that would be a big flag indicating a passthrough.

10. Are your competitors using passthroughs and why?

YES! Our MBE firm has seen the practice enabled at the top leadership of a major corporation – they not only allow it, they encourage it. We have also just seen a salesperson at a multibillion-dollar company post slides that identified their practice of having a “go-to” supplier depending on the contract need: “We have a Native American, a SDVOSB or a WBE supplier that can be assigned to you to help you facilitate a contract – with minimal disruption in the sales cycle...” This is just not right.

11. Right now, the survey reports that 26% of business with diverse businesses is with passthroughs. Do you think this number is high, low, or about right?

This interviewee thinks the number, 26%, is about right. He believes it is happening out there – people just aren’t paying attention to it. There is no one policing corporations like the DOJ does for the federal government contracting.

12. Whose job is it to police these types of businesses: NMSDC/WBENC, the supplier diversity professional, the DOJ, corporate buyers, others?

This interviewee thinks it is a two-fold responsibility: the third-party certifiers and the corporate buyers who need to do the due diligence. They need to ask the question of the diverse supplier – are you

1. creating a product or service – or
2. enhancing i.e. OEM with technical prowess to aid in deployment etc. or
3. simply reselling – transactional only | no value-add | no development service | no response to bid

The interviewee thinks some diverse companies enter into contracts with the best intent – then they get addicted to the “easy transaction” to the “easy money”. He believes that another well-known, multibillion dollar MBE firm started off as legitimate diverse supplier – however they have grown so big that they now have some questionable practices.⁴

The interviewee stated that, “we have to look at diverse companies and the percent compensation they are receiving. If the percent is low (1% or 1 ½%) there is no way they are able to cover their overhead and costs. They cannot grow – they are not able to invest in capacity building....they have obtained revenue but not true profitably. Sadly, they are probably passthrough.”

Interview #4 – Corporate Supplier Diversity Professional

The subject of the interview is a procurement professional and supplier diversity professional – certified/credentialed by ISM (Institute of Supply Chain Management). She has worked with a NGO (TPC) and in corporate America for 30 plus years and currently serves on several nonprofit boards.

1. What do you know about diverse passthrough businesses? Is passthrough terminology familiar to you? Have you ever had experiences with these types of businesses? What was that experience like?

“Yes, it is familiar to me. ‘It is when a diverse firm allows usage by a nondiverse firm – for billing purposes only – there is no commercially useful function. I don’t like them, and I tell them that I don’t...and you can quote me on it.”

I think the practice is less prevalent today than when we first started....there is a difference in a “front company” versus a “pass through” company. We must take a look at the JV – or the Mentor Protégé agreement very closely. What is the value the supplier is bringing? Is there a clearly defined scope of work?

Our corporation does business in all three sectors – federal/state-local and corporate America. We must separate supplier diversity from the small business programs.

2. Are there any characteristics of passthroughs that help you identify them?

Yes, a flag is when I don’t see the MBE owner understanding the opportunity. In conversation they continually refer back to the (nondiverse) partner. Other characteristics: there is no investment in people, process or product, there is “not an ongoing business concern”; they have no risk to manage, no loss liability. This is why we must certify to NAICS codes. WWT is an example of a VAR reseller – they warehouse (have risk), there is ownership, they forecast and know “how to”

I have not seen pass throughs in a while. We work to ensure this does not happen thru our vetting in our prequal process. The flag is “we can’t do ABC but we have a partner that can” ...so we ask, then what do you do and defer them -maybe later.

I think there is a difference though between Agents and Brokers...there is knowledge of the industry, that is their value-add.... Brokers and agents are not certifiable unless they meet industry standards...like Realtors – a standard in the industry...i.e. Insurance Brokers You have to

look at the agreements – what is risk of loss, liability, ownership

3. Are there some industries more likely to have pass throughs?

I think it is across all industries – but a lot in construction – “I am a GC but have no capacity to do the work.” It is easy to put a pass thru together – unless you are working for DOT. I know the Association of General Contractors did a lot of pass throughs.

4. Right now, the survey reports that 26% of business with diverse businesses is with passthroughs. Do you think this number is high, low, or about right?

I think the number is high for the corporate sector – I estimate it at 5-10%..but I think it is higher in the Public Sector.

5. Whose job is it to police these types of businesses: NMSDC/WBENC, the supplier diversity professional, the DOJ, corporate buyers, others?

I think we have different roles here (on a team). The NGOs can weed out front companies but not pass throughs.

I think Corporate Supplier Diversity Professionals should primarily be responsible for policing these types of businesses. We need to ask probing questions – understand what the value-add of the firm is.

I am a strong supporter and believe in professional certifications. I am a CPSD (Certified Professional in Supplier Diversity) and CPSM (Certified Profession in Supply Management) thru ISM (Institute of Supply Management). I also believe in ongoing training

We know there are three types of Supplier Diversity folks:

1. Must “wine and dine me” before I do anything
2. Referral System – they pass along EVERY business card to the buyer without doing any vetting
3. True Supplier Diversity Professional – they get to know the suppliers – advocate on their behalf – they Identify why (or not) they would be a good fit or bring value to a corporate supply chain.

Interview #5 – A corporate supplier diversity professional

The subject of the interview is a procurement professional and supplier diversity professional. She has worked with a NGO (TPC), state/local agencies and in corporate America for 20 plus years and currently serves on several nonprofit boards.

She is the Director of Purchasing and & Supply Chain and Supplier Diversity. She has worked in Supplier Diversity over 15 years in the corporate automotive industry and state/local government initiatives.

1. What do you know about diverse passthrough businesses?

I know there are diverse businesses being used as a passthrough.

2. Have you ever had experiences with these types of businesses?

I have no direct experience with using a passthrough business because I won't engage in conversation when I see where it's going. I shut it (the conversation) down. I state that we are not accepting passthroughs. We prefer to work directly with Diverse Suppliers versus working with one who is trying to keep the business by using a Passthrough and only pay them a percent.

3. What was that experience like?

It was a challenging experience. They were difficult and direct conversations – but they needed to happen in order to prevent the pass through from happening. I have had a couple of current, big, nondiverse suppliers say, "I have an MBE we could deploy for your diversity credits..." – and I said no. We were not going to allow that type of behavior.

4. What should be done about passthroughs? Should they be sanctioned and if so, how?

I think we need more conversations about this topic. A lot more seasoned supplier diversity professionals are retiring or getting promoted to other roles – so there is a gap in training and experience. I hear things like, "Oh-I didn't know it's an issue" – the new professional is not proactively engaged in really knowing and understanding procurement. I think we need constant training about fraud and pass throughs -we can't address the problem if we don't talk about it.

5. Are there any industries where you are more likely to see passthrough businesses?

I think you will see it a lot in the automotive industry – there are a lot of opportunities here – especially if a nondiverse supplier is not hitting their targets – they begin to see how they can save or increase their business by using a diverse passthrough.

6. Do these businesses have a negative impact on "legitimate" M/WBEs?

Yes, I definitely think there is a negative impact. Yes, being a passthrough could be an opportunity for a diverse supplier to first get in the door but the problem is that we don't really get to know you if you are a passthrough. You are a 2nd Tier and not a Prime supplier. The diverse supplier is still in the background and can't build the direct relationship.

7. Are there any characteristics of passthroughs that help you identify them?

Yes, usually when a nondiverse supplier states – “we have a partnership with a diverse supplier...” I then ask who the PO will go thru – the nondiverse supplier or the diverse supplier? I ask a lot of questions to find out who really is in control – who is taking the risks or adding value or making decisions.

8. Are you competitors using passthroughs and why?

I do not know – we really don’t have conversations on this topic. We normally just share if we have a good diverse supplier.

9. Right now, the survey reports that 26% of business with diverse businesses is with passthroughs. Do you think this number is high, low, or about right?

I don’t know. This number is shocking and disappointing to me.

10. Whose job is it to police these types of businesses: NMSDC/WBENC, the supplier diversity professional, the DOJ, corporate buyers, others?

I think it is all of our responsibility – if we are committed to an inclusive supply chain, we should all be responsible for it. How? By doing our due diligence... we must have 1) ongoing monitoring (example, an MBE firm gets sold to a nondiverse company and 2) we need tools in place to give us warning – so when a MBE firm gets sold we stop counting the spend. Frequently we find the new nondiverse supplier will piggy-back off the MBE’s certification. We need good contract language to address this scenario. We also need the NGOs to notify corporate members when there is a sale or lost of certification so we can update our database and delete them from our supply chain.

I also believe in mentoring. Professional credentials are okay, but I think we really should have mentoring between supplier diversity professionals – to share best practices, tips and tricks. Need to share about how some suppliers try to play/game the system.

I also think supplier diversity as a whole needs a refresh. We are still operating on processes from the 1950’s and 1960’s. We can’t just look at spend as a success metrics. We need to look at IMPACT – at jobs created, jobs retained -the creation of wealth in the community. We need to be able to articulate the business case as it pertains to now – way beyond “the right thing to do”. I like what Ford’s new angle is – Diverse Supplier Engagement – not just Supplier Diversity. DEI needs to be a pillar in the program – like “Diverse Supplier & Inclusion”.

Another problem I see is Diverse owned companies – doing business with themselves. The original diverse business obtains the diversity certification – then creates another company to do the manufacturing and just use that same certification. They make it look like a diverse business is doing business with another diverse supplier, when in fact they are doing business with themselves – it looks like they are doing millions in business with another diverse company (and winning awards for it) when in fact they are not – it's just intercompany.

