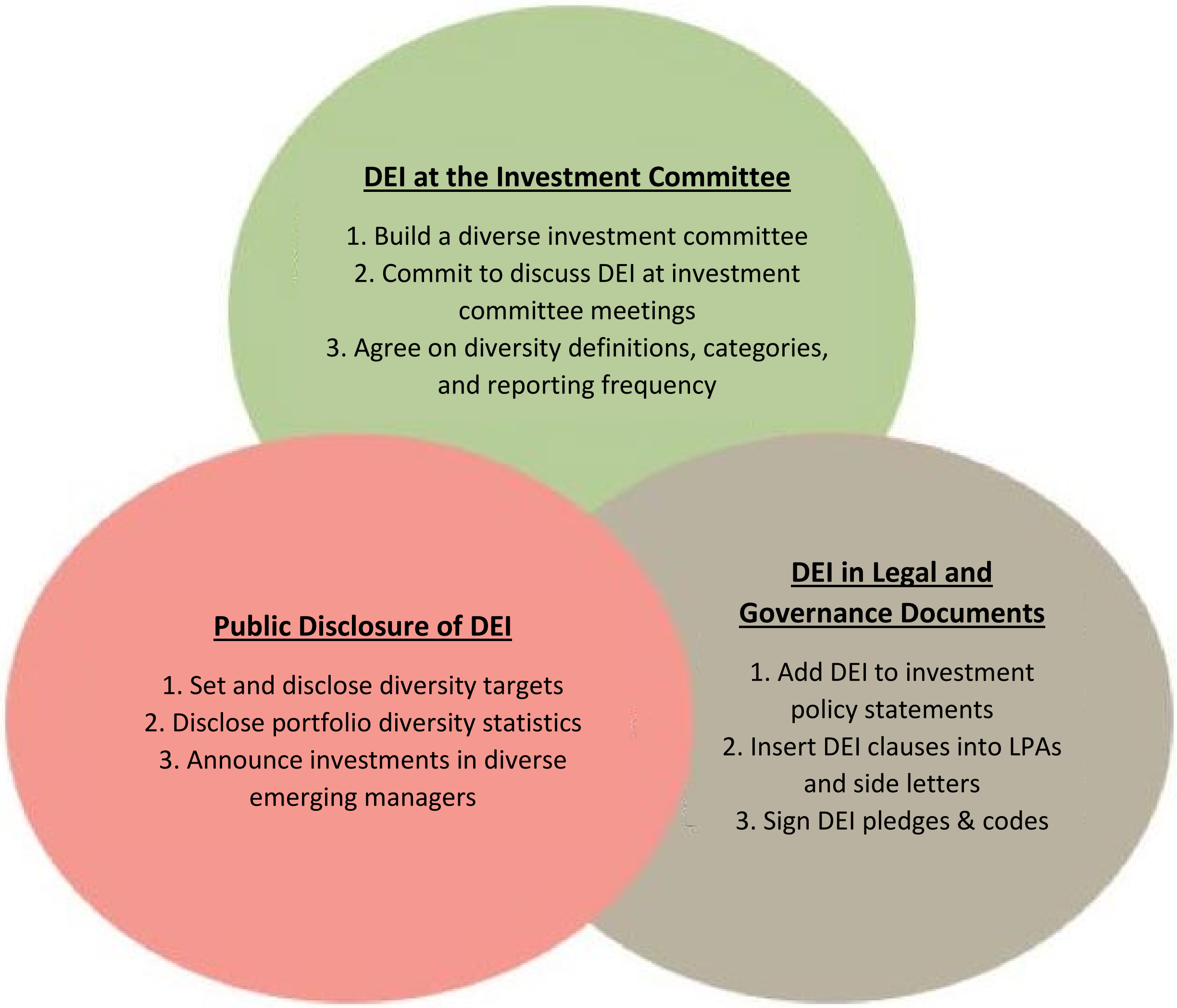
IADEI DEI GOVERNANCE TOOLKIT



IADEI's DEI Governance Toolkit consists of nine practical and evidence-based recommendations for how investment committees and boards can oversee incorporating diversity, equity, and inclusion into investment teams and investment portfolios. This and other IADEI toolkits are the product of multi-stakeholder discussion among the leadership of numerous nonprofits focused on diversity, equity, and inclusion in investing facilitated by IADEI. We have distilled these discussions into nine recommendations for DEI governance into three essential ingredients: DEI at the investment committee, public disclosure of DEI, and DEI in governance and legal documents.

Essential Ingredient One: DEI at the Investment Committee

1. **Build a diverse investment committee.** According to New York University Center for Business & Human Rights Senior Associate Director Kerin McCauley, ensuring investment committees include talented women and people of color – and that their voices are heard – strengthens decision making and ability to identify high performance across more diverse networks.

Generally having two or more diverse investment committee members is critical to amplify their voices and offset broader resistance to DEI. It is also crucial for non-diverse committee members to raise diversity issues because doing so benefits the investment committee's work broadly.

2. **Commit to discuss DEI at investment committee meetings.** Diversity, equity, and inclusion (DEI) governance starts with committing to discuss DEI at investment committee meetings. According to a large Midwestern State Investment Board, meeting the legal standard for prudence—that is, making financial decisions using the principles of reasonable risk and common sense—necessitates considering DEI.

3. **Agree on diversity definitions, categories, and reporting frequency.** Thresholds that asset owners use range from 25% to 51%, with a trend of asset owners shifting from the 51% threshold to a broader definition of substantially diverse, which Harvard Business School Professor Josh Lerner defines as 25-49% diverse-owned and numerous investors define as 33%+ diverse-owned. Indeed, the number of managers that are 50% diverse-owned is multiples of the number of managers that are 51% diverse-owned. It is also critical to dollar-weight the percentage of the portfolio that is diverse—diversity is more common among venture capital managers, which tend to be smaller, so tracking the percentage of managers who are diverse-owned or diverse-led is less meaningful than tracking the share of assets that diverse-owned or diverse-led managers manage.

   Asset owners also gauge a range of genders and racial and ethnic groups at various levels and in a variety of functions at asset managers. Some asset owners incorporate managers with disabilities and those who are veterans in their diversity totals. To ease the burden on asset managers and facilitate peer comparisons, Institutional Limited Partners Association (ILPA) maintains a standardized diversity reporting frameworks for institutional investors to use with the asset managers in their portfolios. Developing a common definition of diversity facilitates measuring progress in diversity over time, as well as peer comparisons.

   Some asset owners describe sourcing asset manager diversity data as the biggest struggle in expanding the diversity of their investment portfolios. At least one large asset owner considers termination of managers for refusing to respond to diversity surveys, and a number of asset owners are planning to be more assertive about asking asset managers to add diversity to their investment teams in a particular timeframe.

<u>Essential Ingredient Two: Public Disclosure of DEI</u>

4. **Set and disclose diversity targets.** With respect to targets, in 2019, Kresge Foundation pledged to invest 25% of its US assets under management in female and diverse-owned firms by 2025. Today, 16.6% of Kresge's $4.3 billion portfolio is diverse-owned. Meanwhile, more than 26% of the U.S.-based assets under management for the diversified portfolio of the W.K. Kellogg Foundation Trust ($4.4 billion as of Sept. 2021) are invested with majority diverse-owned firms. Broad-based targets and disclosure could lead to strong results over time.

5. **Disclose portfolio diversity statistics.** Executive director and founder of the Diverse Asset Managers Initiative Robert Raben explains: "Analyzing university endowments' disclosures reveals that virtually all of them group racial and ethnic and gender identities into 'diversity,' making it challenging to know the racial, ethnic, and gender breakdowns of the managers in

their investment portfolios, or even whether the managers are based in the United States." University of California and Georgetown differentiate themselves through their best-in-class diversity disclosure on the managers in their portfolios. UC Investments' second annual report, released this past summer, is the most detailed look at the gender, racial, and ethnic makeup of a college or university endowment to date. Naturally, reporting does not necessarily equate to portfolio diversity, but it does mean a willingness to be held publicly accountable.

6. **Announce investments in diverse emerging managers.** Large endowments and foundations publicly announcing emerging manager investments would be very helpful to the emerging managers. There are limitations on the ability of public pensions to do this, but endowments and foundations do not have these types of limitations. Allowing emerging managers to disclose large endowments and foundations as limited partners is also likely to catalyze capital flows to emerging managers.

Essential Ingredient Three: DEI in Legal and Governance Documents

7. **Add DEI to investment policy statements.** A number of asset owners have codified their own approach to DEI by incorporating it into their investment policy statements (IPSs). According to Intentional Endowments Network research, this can range from Rockefeller Brothers Fund equating advancing diversity in asset management with fiduciary duty to preserve its endowment in perpetuity to Warren Wilson College describing management and board diversity of portfolio companies as a positive screen. IADEI and Intentional Endowments Network are collaborating to collect from and share IPS DEI language with the endowments and foundations community. Such public disclosures should help asset owners do the peer analysis to pinpoint the right balance of advocating for DEI and not constraining returns with excessive restrictions.

   For investment committees and investment teams that are not yet ready to incorporate DEI into their investment policy statement, a DEI investment team mission statement is a step forward.

8. **Insert DEI clauses into limited partnership agreements (LPAs) and side letters.** Limited partners (LPs) are increasingly inserting DEI clauses into LPAs and side letters. In addition, side letters mandating diverse board members are becoming more prevalent, and asset manager resistance to those side letters is declining. Diverse asset managers and asset managers responding to requests from large LPs tend to be more receptive. For example, according to its former Chief Investment Officer Rodrigo Garcia, the State of Illinois has been inserting DEI principles into LPAs and side letters since 2017, particularly when its investment size exceeds 10% of AUM. asset owner includes a provision to claw back carried interest in the case of sexual harassment. If LPs agree on common language, their leverage in negotiating with asset managers should increase.

   LPs should also ensure alignment of consultant and fund of fund incentives with DEI. Side letters in which consultants and fund of funds require fee breaks or no-fee or no-carry co-investments when engaging with diverse and emerging managers can deter some of the strongest emerging managers and create friction with the pursuit of DEI.

9. **Sign DEI pledges and code**s. Some institutional investors create or sign DEI pledges or codes. For example, the CFA Institute is rolling out its new Diversity, Equity & Inclusion Code in early 2022. Code signatories commit to (i) promoting DEI and improving DEI outcomes and (ii) increasing measurable DEI results in the investment industry; (iii) measuring and reporting on progress in

driving better DEI results to senior management, the board, and CFA Institute; (iv) expanding the diverse talent pipeline; (v) designing and implementing inclusive and equitable hiring, on-boarding practices, (vi) promotion; and retention practices. CFA Institute DEI Code was developed and designed by a diverse team of investment leaders to meet the investment industry where it is in DEI terms and accelerate cultural change.

ILPA's diversity in action initiative, launched in December 2020, is another investor-driven initiative. All signatories are required to (i) have a public DEI strategy or statement and/or a DEI policy communicated to employees and investment partners that addresses recruitment and retention, (ii) track internal hiring and promotion statistics by gender and race/ethnicity, (iii) set organizational goals for more inclusive recruiting and retention, and (iv) request that LPs and GPs provide DEI demographic data for any new commitments or fundraises. There is also a list of nine optional activities that participating organizations can choose to adopt.

With respect to racial equity, two investor codes from 2020 are noteworthy. First, Confluence Philanthropy's Belonging Pledge signatories commit to discussing racial equity their next investment committee meeting and sharing next steps and results to identify industry-wide barriers and the technical resources required to advance the practice of investing with a racial equity lens. Second, the Investor Statement of Solidarity to Address Systemic Racism and Call to Action signatories commit to actively engaging with, amplifying, and including Black voices in investor spaces and company engagements; embedding a racial equity and justice lens into their own organizations; integrating racial justice into investment decision-making and engagement strategies; reinvesting in communities; and using investor voices to advance anti-racist public policy.

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