Vanguard Investment Stewardship Insights

Shareholder proposals: Diversity, equity, and inclusion

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Vanguard publishes Investment Stewardship Insights to promote good corporate governance practices and to provide investors and public companies with our perspectives on important governance topics and issues that come up for shareholder votes.

Risks to shareholder value associated with diversity, equity, and inclusion (DEI) remain a top engagement priority for Vanguard with our funds' portfolio companies. Increased focus—from companies, regulators, investors, and employees—on racial and ethnic discrimination has heightened scrutiny of public companies' DEI-related risks and opportunities, as have the COVID-19 pandemic and challenging economic conditions.

Vanguard has long advocated for diversity of experience, personal background, and expertise in the boardroom. In 2020, Vanguard continued to call for enhanced board diversity across dimensions of gender, race, ethnicity, age, and national origin.[1] We reiterated our expectations that boards make progress in their diversity strategy and that where progress falls behind market norms and expectations, the Vanguard funds may vote against company directors. We also outlined our views on diversity beyond the boardroom and our expectations of a board's role in overseeing DEI risks within the workplace.[2] We illustrated the case for getting it right and the risks of getting it wrong.

These expectations reflect our views on the importance of strong board oversight of strategy and risk—including material social risks such as those related to DEI. While our push for oversight of strategy and disclosure of progress on DEI on the board and in the workforce is an expectation for companies across our global portfolio, our focus on DEI-related matters is particularly acute for U.S. companies that have received a range of DEI-related shareholder proposals in the 2021 proxy season.

How we evaluate DEI shareholder proposals

Vanguard's Investment Stewardship team evaluates all shareholder proposals case by case and analyzes whether they are in the best long-term interests of shareholders. We start by viewing each proposal through the lens of financial materiality to the company. We also assess the reasonableness of the proposal and whether the requested action addresses a gap in a company's current practices or stated intentions.

Our analysis of shareholder proposals this proxy season includes a range of DEI-related shareholder proposals at companies in the U.S. Some of these ask for enhanced disclosure or commitment to board diversity, or for disclosures of DEI issues in the workplace (including DEI programs, goals, and demographic metrics). Others address DEI issues that span a company's operations. In that category, some investors are raising concerns about inequitable racial impacts on a company's employees, customers, and the communities in which it operates, and they are asking companies for enhanced disclosures, reports, or other actions such as third-party audits.

As a fiduciary for our more than 30 million investors, Vanguard must distinguish between general societal concerns about DEI and the financial materiality of DEI risks to a particular company when evaluating individual DEI-related shareholder proposals. As with all shareholder proposals, we also must evaluate the reasonableness of the request and whether it addresses identified gaps in company practices. Market expectations for disclosure on DEI-related matters continue to expand and evolve. Peer comparisons, industry standards, and market norms all help to inform our view of reasonable disclosure expectations of companies.

1 See *Insights: A Continued Call for Boardroom Diversity.*
2 See *Insights: Diversity in the Workplace.*

DEI disclosure shareholder proposals

Most DEI disclosure-focused shareholder proposals request enhanced reporting, and they often focus on quantitative and qualitative disclosure of the current composition, policies, and programs regarding gender, racial, and ethnic representation on the board or throughout the workplace. In other cases, the request may highlight a specific metric or be expanded to include disclosure specific to a company's core business operations and delivery of its products and services.

Materiality. In our view, many DEI-related risks, especially those related to the board and workforce, may be financially material to companies across all industries. Human capital is a critical asset in most companies, and in recent years, many have self-identified common DEI risks (for example, failure to retain and promote employees from underrepresented groups at equal rates).

Reasonableness. Boards are responsible for providing clear disclosure of material risks, and we expect companies to continue refining their disclosures to reflect evolving market, industry, and competitive norms. DEI disclosures, including current workforce or executive-team demographics, along with details on DEI programs or identified risks are generally viewed as useful information for investors at most companies.

The Vanguard funds are likely to vote in favor of shareholder proposals that call for reasonable enhancements to financially material DEI risk disclosures. However, the funds may not support such proposals where companies are already providing sufficient disclosures, or where a request is determined to be overly prescriptive.

DEI board oversight shareholder proposals

DEI board oversight shareholder proposals typically focus on a board's responsibility to oversee DEI-related risks and to disclose those risks to shareholders. These proposals tend to request a report (usually annually) that provides insight into a board's process and/or assessment of management's effectiveness in identifying, managing, or planning for DEI-related risks and strategies. Some proposals may explicitly request the board's assessment—or opinion—on how effectively management is mitigating a specific risk (such as underrepresentation of diversity at the executive level), or they may seek a broad report on potential areas of concern (such as one encompassing all areas of possible discrimination related to a particular practice or business operation).

Materiality. Our evaluation of the materiality of the risks addressed in these proposals follows the same approach as our assessment of DEI risks in a DEI disclosure proposal (as described in the preceding section).

Reasonableness. Boards are responsible for overseeing a company's long-term strategy and material risks and for providing clear, decision-useful disclosure of those risks. Where a company lacks sufficient disclosure or demonstration of an effective process for oversight of these risks, we would generally consider shareholder proposals that request these actions, without being overly prescriptive, to be reasonable.

Generally, the Vanguard funds will support DEI board oversight shareholder proposals if the requests are clear and focused on DEI risks that are likely to be financially material to the company and could affect long-term shareholder value. Where a company is already sufficiently addressing the topic or has credibly committed to address the request in a reasonable time frame, or where the request is overly prescriptive, the funds may view the proposal as misdirected and withhold support.

Third-party racial equity audits

Third-party racial equity and civil rights audit proposals are gaining prominence on U.S. public company ballots this proxy season. Shareholder proponents filing these proposals ask that companies conduct a third-party audit of potential DEI-related risks to provide an independent assessment of any direct or indirect impacts a company may have on communities of color.

We evaluate each third-party racial equity audit proposal as we would any other proposal to audit a specific facet of a company's operations. We expect to see a clear link between the topic addressed by the proposal and the company's long-term value, as well as a clear need for third-party involvement. For proposals that request an audit, we first look for whether the proposal addresses a gap in the company's existing practices or disclosures for financially material risks, then assess whether closing that gap is best addressed by an audit. Where a gap in addressing and disclosing financially material risks exists, either additional disclosure or a shareholder request for third-party involvement may be warranted.

Materiality. As with other DEI-related shareholder proposals, we start with the view that DEI-related issues at a company may be financially material to investors and may affect long-term shareholder value. These issues require further scrutiny across different industry sectors and companies. Many of these risks are human-capital-related, focused on board, executive team, or workplace DEI. Issues may include risks associated with an inequitable board or executive recruitment process or reputational, financial, and strategic risks associated with an inequitable or discriminatory working environment. In some industries, the risks may also be linked to consumer-facing activities (for example, a restaurant business's systematic discriminatory treatment of customers, or a bank's lending policies repeatedly leading to higher costs or lower access for people of color).

We observe that some racial equity audit proposals call for the audit to cover all activities of a business, which may include coverage of risks that are not financially material to the company's shareholders. Furthermore, these risks may or may not already have been identified by the board as a risk-oversight priority. In evaluating each proposal, Vanguard will consider the likelihood that the requested audit will find financially material risks beyond those the board has already disclosed and expressed an intent to oversee.

Reasonableness. Proponents of third-party audits cite a belief that independent assessments provide greater objectivity and credibility, presumably more than a board or management could provide. Proponents also cite examples of third-party racial equity audits conducted elsewhere as a reference for other companies to follow. Although some companies may have had positive results from voluntarily conducting a third-party racial equity audit, we do not believe there is a "one-size-fits-all" approach to risk oversight concerns, nor to identifying material risks.

We agree that an assessment of a company's DEI-related risks warrants independence from management and requires credible topic expertise. Our stewardship program is grounded in the basic tenet that good corporate governance starts with a company's board of directors. An effective board should be independent from management and be able to provide appropriate risk oversight in most instances. We further expect boards to proactively build expertise in areas they oversee and to demonstrate to shareholders that they have an effective oversight process for identifying and mitigating risks that may affect long-term shareholder value. Given the wide range of risks that boards oversee, in many cases this may require that they call upon additional resources when warranted.

Where boards are already demonstrating risk oversight, or where the financial materiality of the risks in question is not clear, we do not believe that a third-party audit of all business activities is an appropriate next step for shareholders' long-term interests, and requests for such audits may be overly prescriptive. First and foremost, Vanguard would expect enhanced disclosure from the board on its oversight of the risks in question and clarity on the board's assessment of the materiality. Where financial materiality is unclear but possible, Vanguard may encourage the board to demonstrate that it has (or will have) a thorough process to consider and oversee the risks and disclose relevant aspects of this process to shareholders. This review process may or may not involve a third-party audit at the board's discretion, and we expect companies to articulate the rationale for their oversight and disclosure approach.

The Vanguard funds may support a racial equity audit shareholder proposal where a board's current oversight processes or disclosures suggest a failure to sufficiently oversee the company's DEI risks, or where the company endorses the proposal on its merits. We have seen many company boards increase their attention to DEI-related risks over the past year, and we expect that focus to continue. As part of our due-diligence process for any type of management or shareholder proposal, we are likely to directly engage with a company to help us understand how the board and management are overseeing financially material risks to long-term investors, and if we believe that a third-party audit is in the best interest of shareholders based on our assessment, we are likely to support such a proposal.

Using our vote and our engagements to raise concerns on DEI risk oversight

Where we observe a lack of board oversight on a material risk such as DEI, the funds may also withhold support for the election of relevant directors in order to express our concern. Before arriving at this decision, we analyze the company's corporate governance history, the specific weight of the material risk in question, and what it means to long-term shareholder value.

We advocate for good governance to safeguard shareholder value through direct company engagements as well as through "one-to-many" forums. We call for companies to proactively enhance disclosures of their commitments, strategy, and key risks related to DEI issues, along with boards' process for overseeing these matters.

What we expect from companies

It is the job of a company's board to seek diverse external perspectives, challenge management, and hold company executives accountable for addressing material risks to shareholder value. Through strong, independent leadership, boards can cultivate a culture that supports diversity, equity, and inclusion throughout an organization and can manage the reputational, regulatory, legal, and strategic risks related to potential discriminatory business practices. We have previously published our expectations on board and workplace diversity and have highlighted the importance of effective oversight of risk and strategy broadly (including material environmental and social risks). We encourage companies to also view widely recognized industry disclosure frameworks (generally quantitative metrics) as a helpful baseline and method for highlighting transparency into financially material risks. Where risks lack standards for disclosure, boards can demonstrate their process—including their expectations of their management teams and responsibilities they take on themselves—to oversee risks and stay up to date (see the callout for further considerations).

This matter will remain a focus of our engagements with companies as we monitor increasing regulatory risks and each company's progress on its journey toward improved DEI practices based on its own material risks and strategies. Vanguard encourages companies to be strategic and attentive to their DEI strategy, as we believe that failure to develop appropriate strategies can have a negative impact on a company's long-term performance and investor returns.

Boards should expect management teams to:

- Establish an ongoing process to identify, mitigate, and remediate company policies, practices, operations, and business cultures that may lead to inequities, including those related to gender, race, ethnicity, or other categories that include historically underrepresented groups.
- Maintain an open, two-way exchange of information with the board regarding its strategy oversight and risk disclosure.
- Dedicate the necessary resources to the risk identification, oversight, and remediation process. Employees should be included in this process, and management teams should seek consultation from external stakeholders to continuously evolve their approach as better business practices for managing DEI risks emerge.

At the same time, we expect boards to:

- Establish strong oversight of a company's long-term strategy and provide clear, decision-useful disclosures of material risk and related practices. Such reporting can demonstrate the board's ability to assess the effectiveness of a company's strategy and understanding of its long-term goals.
- Educate themselves on competitive dynamics and seek outside opinions to credibly challenge management on DEI issues. Examples of enhanced board education may include directly increasing the diversity and expertise of board directors, forming a diverse advisory council with expertise in areas of inequity relevant to a company's industry, and seeking firsthand input from affected employees, customers, and communities.

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