

March 4, 2014

Recent Diversity Mandates Impacting US Financial Regulators and Financial Institutions on Both Sides of the Atlantic

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

New York

Doreen E. Lilienfeld
+1.212.848.7171
dlilienfeld@shearman.com

Donna M. Parisi
+1.212.848.7367
dparisi@shearman.com

Russell D. Sacks
+1.212.848.7585
rsacks@shearman.com

Amy Giltitz Bennett
+1.212.848.8974
agiltitz@shearman.com

Jennifer D. Morton
+1.212.848.5187
jennifer.morton@shearman.com

San Francisco

Dana C. F. Kromm
+1.415.616.1124
dana.kromm@shearman.com

London

Barnabas W.B. Reynolds
+44.20.7655.5528
barney.reynolds@shearman.com

Thomas Donegan
+44.20.7655.5566
thomas.donegan@shearman.com

Sam Whitaker
+44.20.7655.5954
sam.whitaker@shearman.com

Azad Ali
+44.20.7655.5659
azad.ali@shearman.com

SHEARMAN.COM

There has been no shortage of press coverage about the lack of employment diversity in the financial services sector. Now, both the US Congress and the European Union have taken action in an attempt to remedy historical practices. The increased focus on the adequacy of an institution's diversity and inclusion initiatives warrants their reexamination in light of regulatory developments and evolving best practices.

Background — The Statutory Requirements of Section 342 of Dodd-Frank

Section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Section 342”) was adopted to help correct racial and gender imbalances at financial institutions and their regulators by prescribing inclusion requirements at the specified US government agencies that regulate the financial services sector, entities that contract with the agencies and the private businesses they regulate. Congresswoman Maxine Waters of California, the author of Section 342, noted that “many industries lack the inclusion and participation” of minorities and women, with none “more egregiously . . . than the financial services sector.” Section 342 provides the opportunity to “not only give oversight to diversity, but to help the Agencies understand how to do outreach [and] how to appeal to different communities.”

US Initiatives

Six US federal agencies (the “Agencies”)¹ have proposed joint standards (the “Proposed Standards”) for assessing the diversity policies and practices at their

¹ The Agencies include: (1) the Office of the Comptroller of the Currency, (2) the Board of Governors of the Federal Reserve System, (3) the Federal Deposit Insurance Corporation, (4) the National Credit Union Administration, (5) the Bureau of Consumer Financial Protection and (6) the Securities and Exchange Commission. Section 342 also covers the Departmental Offices of the Department of the Treasury, each of the Federal Reserve banks and the Federal Housing Finance Agency, none of which participated in the joint policy statement.

regulated entities as required by Section 342.² The Proposed Standards are intended to promote the transparency and awareness of diversity within the regulated institutions and provide guidance for assessing the diversity policies and practices of those institutions, as well as the entities they regulate and with which they contract.

Office of Minority and Women Inclusion

Pursuant to Section 342, each Agency has established an Office of Minority and Women Inclusion (the “OMWI”). The OMWIs and their appointed directors are charged with identifying and addressing concerns of minorities and women and developing standards regarding:

- Equal employment opportunities and the racial, ethnic and gender diversity of the Agency’s workforce (including in senior management);
- Increased participation of minority- and female-owned businesses in the Agency’s programs and contracts; and
- Assessment of the diversity policies and practices of the entities regulated by the Agency.³

Section 342 expressly provides that the OMWIs are not responsible for the enforcement of civil rights laws, although each director of an OMWI is expected to coordinate with Agency leadership to design and implement remedies for violations. Each OMWI is also required to submit an annual report to Congress outlining the Agency’s actions under Section 342. This report must include (1) a statement of the total amounts paid by the agency to contractors since the previous report, (2) the percentage of that amount that was paid to minority and women contractors, (3) the successes achieved and challenges faced by the Agency in operating minority and women outreach programs, (4) the challenges the Agency may face in hiring qualified minority and women employees and contracting with qualified minority-owned and women-owned businesses, and (5) any other information, findings, conclusions and recommendations for legislative or Agency action, as the Director determines appropriate.

Diversity in the Agencies’ Workforces

The Agencies must take specified “affirmative steps” to seek diversity within their own workforces at all levels. These steps must, at a minimum, include recruiting at colleges that have historically had a high percentage of minority and female students enrolled, sponsoring and recruiting from job fairs in urban communities and advertising employment opportunities in publications targeted at minorities and women. Agencies are also encouraged to partner with organizations that focus on developing opportunities and job placement for young minorities and women and high schools with significant minority and female populations (such as inner-city schools and all-female schools) to provide mentoring and establish financial literacy programs. Each Agency’s annual report to Congress must report the successes achieved and challenges faced by the Agency in operating minority and women outreach programs and the challenges the Agency may face in hiring qualified minority and women employees.

Diversity and Inclusion in the Agencies’ Business Activities

Each Agency must develop and implement standards and procedures to ensure “to the maximum extent possible, the fair inclusion and utilization” of minorities and women (and businesses owned by these groups) in all of their business activities. This mandate has expansive reach and applies to all Agency contracts of any kind, including those with most financial service entities and law firms.⁴ The Agencies must consider diversity when evaluating contract proposals and

² The text of the Proposed Standards can be found at <http://www.gpo.gov/fdsys/pkg/FR-2013-10-25/pdf/2013-25142.pdf>. Comments on the Proposed Standards were due February 7, 2014.

³ To date, regulations have not been proposed regarding the “equal opportunity” and “increased participation” requirements.

⁴ Section 342(d) states that these measures apply to “all contracts of an agency for services of any kind, including the services of financial institutions, investment banking firms, mortgage banking firms, asset management firms, brokers, dealers, financial services entities, underwriters, accountants, investment consultants, and providers of legal services.” Contracts refer to all contracts for all business activities at all levels, including “contracts for the issuance or guarantee of any debt,

obtain written assurance from the contractor that it will ensure the fair inclusion of minorities and women in both their workforce and the workforce of any subcontractors. The OMWIs are also required to adopt standards and procedures by which the applicable director may determine whether a contractor has made a “good faith effort” to include minorities and women in their workforce. Failure to make a good faith effort can result in penalties, including the termination of the contract or a referral to the Office of Federal Contract Compliance Programs of the Department of Labor, as determined by the Agency’s administrator.

Diversity in Regulated Entities

Section 342(b)(2)(C) requires the director of each OMWI to adopt standards to assess the “diversity policies and practices of the entities regulated by the Agency.” There is no express obligation to report the findings of the assessment to Congress, nor does Section 342 describe the criteria the OMWIs should use to assess regulated entities. The Proposed Standards described below do provide some guidance on the scope of the required assessment.

Section 342 expressly provides that it should not be construed to impose any requirement on, or otherwise affect the lending policies and practices of, any regulated entity or require any specific action based on the findings of an assessment. The Proposed Standards reiterate that Section 342(b)(2)(C) is intended to promote transparency and awareness of diversity policies and not to regulate specific actions.

The Proposed Standards

The Agencies elected to propose joint standards to promote consistency among regulated entities. Many of the Proposed Standards reflect the same sensibilities set forth in the provisions of Section 342 regarding the Agencies’ employment and business activities. In developing the Proposed Standards, the Agencies considered an entity’s individual circumstances, including asset size, number of employees, governance structure, income, number of members or customers, contract volume, geographic location and community characteristics.

The Agencies did not mandate an examination or supervisory assessment process, but instead focused on self-assessment and public disclosure. A model assessment process would include a quantitative and qualitative self-evaluation of the entities’ diversity and inclusion policies and a **voluntary** report of the findings to the governing Agency. Further, the entity would include information regarding its efforts to comply with the Proposed Standards on its public website, annual reports and other disclosure documents.

The Proposed Standards cover four key categories of assessment: (1) organizational commitment to diversity and inclusion, (2) workforce profile and employment practices, (3) procurement and business practices and supplier diversity and (4) practices to promote transparency of organizational diversity and inclusion. Each of the standards should be implemented in a manner reflective of the entity’s size and other characteristics.

Organizational Commitment to Diversity and Inclusion

The Proposed Standards stress that a commitment to diversity and inclusion must stem from leadership. In assessing how an entity can foster a corporate culture that embraces diversity and inclusion, the Proposed Standards suggest:

- Considering diversity and inclusion in both employment and contracting as an important part of the entity’s strategic plan, including hiring, recruiting, retention and promotion;
- Maintaining a diversity and inclusion policy that is approved and supported by senior management and the board;

equity, or security, the sale of assets, the management of the assets of the agency, the making of equity investments by the agency, and the implementation by the agency of programs to address economic recovery.”

- Providing regular progress reports to the board or senior management;
- Conducting regular equal employment opportunity and diversity and inclusion education and training;
- Appointing a senior level officer who oversees and directs the entity's diversity efforts; and
- Taking proactive steps to promote a diverse pool of candidates in hiring, recruiting, retaining, promoting and selecting senior leadership and board members.

Workforce Profile and Employment Practices

Regulated entities are encouraged to promote the fair inclusion of minorities and women in the workforce. The Proposed Standards suggest the following steps that they can take to effectuate this goal:

- Adopting metrics to evaluate and assess workforce diversity and inclusion efforts, including recruitment, applicant tracking, hiring, promotions, separations (voluntary and involuntary), career development support, coaching, executive seminars and retention across all levels and occupations of the organization, including executive and managerial ranks;
 - Entities that file an annual EEO-1 Report⁵ with the Equal Employment Opportunity Commission or Annual Affirmative Action Plans as required by Executive Order 11246⁶ can use these reports to help assess workforce diversity and inclusion efforts. Entities not subject to these requirements may wish to use these procedures as models;
- Maintaining policies and practices that create diverse applicant pools for both internal and external opportunities, including (1) participation in conferences, workshops and other events to attract minorities and women and inform them of employment and promotion opportunities and (2) outreach to organizations and educational institutions primarily aimed at serving minority and female populations; and
- Holding management accountable for diversity and inclusion efforts.

Procurement and Business Practices—Supplier Diversity

Similar to the requirements applicable to the Agencies under Section 342, the Proposed Standards suggest promoting inclusion and diversity in business activities of the regulated entities. The Agencies recognize that because there is limited public information regarding supplier diversity, comparing supplier policies will be challenging. Steps to be taken could include:

- Adopting a supplier diversity policy providing for a fair opportunity for minority- and women-owned business to compete in the procurement of business and services;
- Adopting procedures to evaluate and assess supplier diversity, which could include metrics relating to the entity's annual contract spending and the percentage spent with minority- and women-owned businesses, the percentage of contracts with minority- and women-owned subcontractors and the demographics of the workforce of contractors and subcontractors; and

⁵ The EEO-1 is a compliance survey report that private employers with more than 100 employees and certain US Federal government contractors are required to file annually with the equal Employment Opportunity Commission. This report requires the employer to provide detailed statistical information on the racial and gender composition of its workforce.

⁶ Executive Order 1126 requires government contractors with 50 or more employees and contracts of \$50,000 to establish written affirmative action plans for women, minorities and individuals with disabilities. Affirmative Action Plans should analyze the current work force, identify under-represented areas, and specify specific procedures to provide equal employment opportunity.

- Adopting practices to promote a diverse supplier pool. This would include (1) outreach to organizations and participation in conferences and workshops, in each case geared towards minorities and women and (2) publicizing procurement opportunities.

Practices to Promote Transparency of Organizational Diversity and Inclusion

Transparency in an entity's diversity and inclusion program is crucial to attaining the objectives of Section 342. The Proposed Standards provide that publicizing an entity's commitment to diversity and inclusion in its workforce and business activities, its plans for achieving its goals, its progress against those goals and the metrics it uses to measure success are important to achieving transparency. In this regard, the Proposed Standards recommend making this information available to the public annually on the entity's website and annual shareholder reports. While the current proxy rules require disclosure regarding policies for considering diversity in the director nominee process, no other diversity disclosures are required.⁷

Initiatives in the European Union

Within the European Union ("EU"), similar requirements on diversity have recently been introduced.

The Capital Requirements Directive IV ("CRDIV")

CRD IV, which became effective on July 17, 2013 and applies with effect from January 1, 2014, includes provisions on diversity that will apply to large banks and investment firms in the EU. These provisions are meant to encourage management bodies of such institutions to be sufficiently diverse in terms of age, gender, geographical provenance and educational and professional background. Gender balance is of particular importance. Relevant institutions will be required to establish a nomination committee that must set a target for representation of the underrepresented gender for its board and prepare a policy on how to achieve that target. They will have to publicly disclose this policy, its objectives and any relevant targets, and the extent to which these objectives and targets have been achieved. The relevant regulatory authorities in each EU member state and the European Banking Authority will then use disclosed information to benchmark diversity practices at local and EU levels respectively.

Other Relevant EU Diversity Initiatives

Two other EU diversity-related initiatives are currently in the draft legislative stage. These initiatives would apply to all larger companies in the EU, rather than specifically addressing entities in the financial services sector.

First, in April 2013, the EU published a proposal for a directive under which companies with more than 500 employees would be required to disclose relevant, material environmental and social information in their shareholder annual reports. In relation to diversity, this would require the disclosure of information on diversity policies covering age, gender, geographical diversity and educational and professional background. The disclosures would set out the objectives of the policy, how it has been implemented, and the results. Companies lacking a diversity policy would be required under a "comply or explain" regime to explain why.

Second, in November 2013, the EU issued a draft directive requiring publicly-listed companies to address the chronic underrepresentation of women among nonexecutive directors, to ensure that by 2020 (2018 for certain state-controlled undertakings) at least 40% of nonexecutive directors of such companies should be female. The proposal would require that if a publicly-listed company does not have 40% of women among its nonexecutive board members, it would be required to introduce a new selection procedure for nonexecutive board members that gives priority to female candidates. It should, however, be noted that the requirement is only to give priority to a female

⁷ Item 407 of Regulation S-K requires disclosure as to whether and, if so, how a registrant's nominating committee considers diversity in identifying director nominees. If the nominating committee has a diversity policy, the registrant must disclose how the policy is implemented and how the committee (or the board) assesses the effectiveness of the policy. Diversity is not defined.

candidate where that woman is equally as qualified for the position as a male candidate – not a requirement to appoint a candidate simply because she is female.

For executive directors, the same proposed directive would also introduce a “flexi quota” imposing an obligation on companies to set individual, self-regulated targets regarding the representation of both genders among executive directors to be met by 2020 (2018 for certain state-controlled undertakings). In contrast to Section 342, the Proposed Standards and the US proxy rules, this directive would impose penalties on companies that fail to come into compliance, which would include the exclusion from public procurement and partial exclusion from the award of funding from the European structural funds.

Initiatives at an EU Member State Level

In addition to various initiatives at a pan-European level as outlined above, many EU countries are independently taking their own action to address gender diversity issues. So, for example, in 2003 Norway introduced a mandatory requirement for a minimum quota of 40% of women on boards of directors. Quota systems are also used in Spain and Italy. France has introduced legislation that would mandate 20% of women on boards of directors of listed and certain unlisted companies with effect as of 2014 and 40% with effect as of 2017 (those unlisted companies that are subject to this law would be those with more than 500 employees and annual revenue of more than 50 million euros). In the UK, the UK Corporate Governance Code (applicable to UK listed companies) was amended in 2012 to include requirements for listed companies to disclose in their annual reports a description of the board’s policy on diversity, including gender, objectives it has set for implementing that policy and progress in achieving the objectives.

Conclusion

While the Proposed Standards in the US may impact employment and recruiting practices at the Agencies and regulated entities, many of those institutions have already implemented programs and policies that should satisfy the standards. For example, to ensure compliance with employment laws, most entities maintain equal opportunity policies and have adopted procedures to handle discrimination and harassment complaints (including anti-retaliation policies). Many also gather statistical data regarding the gender and racial demographics of their employee populations and applicant pools in connection with the preparation of Forms EEO-1 and Affirmative Action Plans. Further, forming an office of diversity and employing a senior diversity officer has become commonplace, particularly at large public companies. Finally, many entities actively recruit minority and women candidates and maintain outreach and mentoring programs to foster racial and gender diversity in the leadership ranks. Most will not be starting from scratch, but all Agencies and regulated entities should revisit their current policies and initiatives in light of the Proposed Standards and the final version of the regulations once promulgated.

Section 342 and the Proposed Standards leave unanswered questions regarding their reach and enforceability. As described above, there is no enforcement mechanism under Section 342. The Proposed Standards emphasize internal assessments and public disclosure of diversity and inclusion practices, rather than required reporting or other specific actions. The rationale for this approach is that public awareness and transparency will drive changes in practice. In this regard, the Proposed Standards are similar to the Securities and Exchange Commission’s (“SEC”) executive compensation disclosure rules as overhauled in 2006 and subsequently. While the SEC did not regulate the amount or form of compensation, the enhanced disclosure requirement permitted the public to better understand an issuer’s compensation programs and to use their voting power and the press to effectuate change in compensation practices.

Within the EU, the pressure for more prescriptive action on addressing gender diversity seems to be gathering pace. Whilst CRDIV is relatively generic in its requirements, the legislative proposals for minimum 40% female representation of nonexecutive directors of listed companies are clearly much more prescriptive and this is also reflected in many initiatives being undertaken at an individual EU member state level.

ABU DHABI | BEIJING | BRUSSELS | FRANKFURT | HONG KONG | LONDON | MILAN | NEW YORK | PALO ALTO
PARIS | ROME | SAN FRANCISCO | SÃO PAULO | SHANGHAI | SINGAPORE | TOKYO | TORONTO | WASHINGTON, DC

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069

Copyright © 2014 Shearman & Sterling LLP. Shearman & Sterling LLP is a limited liability partnership organized under the laws of the State of Delaware, with an affiliated limited liability partnership organized for the practice of law in the United Kingdom and Italy and an affiliated partnership organized for the practice of law in Hong Kong.