Stakeholder capitalism, executive compensation and corporate governance

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The Business Roundtable recently revised its Principles of Corporate Governance to include a new Statement of Corporate Purpose. The new statement is a significant departure from the past in that it includes serving all "stakeholders," including customers, employees, suppliers, communities, the environment and shareholders. The prior statement only included shareholders.

While many in the legal profession, academia and various "moral" or "conscious" capitalism groups have articulated various forms of the stakeholder argument for a long time, the vast majority of investors, board members and executives of public companies have aligned with the "shareholder primacy" philosophy for the last 30-40 years. Shareholder primacy is based on the belief that generating profits and creating value for shareholders is the primary purpose, if not the only purpose of a corporation. Maximizing long-term shareholder value has been the well-accepted, core measure of success for most corporations, and their management teams and boards, at least since the 1980s.

So, the Business Roundtable's restatement of a corporation's purpose is a rather significant philosophical change. Some have used the word "tectonic." However, the concept that a corporation should deliver value to all of its stakeholders including the broader community is not new. In fact, much of what the Business Roundtable is stating is in line with what many investors and investment managers have already been saying. The Business Roundtable statement follows other groundbreaking statements by investors and fund managers about the importance of companies having a social mission or reason for existing beyond making money.

Increasingly, investors are interested in how companies score on various environmental, social and governance (ESG) measures, including human capital management (HCM). Many of these measures, in essence, capture how a company treats and values its various stakeholders. So, one could argue that the Business Roundtable is responding to investors by being more concerned about other stakeholders. Moreover, the longstanding core objective of shareholder value creation and expanding a company's purpose to better serve a larger group of stakeholders are not incompatible concepts; in fact, achieving the latter should be a means to the end.

A little history and context

Most for-profit corporations and virtually all publicly traded corporations have been operating under the shareholder-first business model for a long time. A large part of corporate governance and the way most boards of directors conduct business is built around this business model. Many would argue that this approach has been quite successful, if not wildly successful for a very long time.

Executive compensation has been heavily geared towards the shareholder primacy viewpoint since at least the 80s. Over the last 30 years, executive compensation professionals have consistently strived to "align the interests of management with those of shareholders." Starting in the 1980s, large stock and option grants – "mega grants" – were made to a few select CEOs. Others followed. Public outrage led to well-intentioned but poorly designed legislation like the million dollar pay cap (IRC Section 162(m)). The 90s saw an explosion of stock option grants to executives and, for a great many companies, to all employees. The mantra was that we wanted to "make employees think and act like owners." In large part, that is what happened. We actually made employees think and act like option holders, which fosters a higher level of risk taking than many shareholders might like, but the focus was still very much on alignment with shareholders, as opposed to any other stakeholder group.

This approach was strongly endorsed by the investment community and many in the academic community. Agency theory was and is the principle academic application of shareholder primacy to executive compensation. The theory, grossly simplified, states that management are the agents of the owners, and that they will act in their own best interests unless they are provided with powerful incentives to act in the interests of the owners. Hence, large grants of stock and options to "align" managements interests with those of the owners.

By the end of the 90s, it was apparent that heavy doses of stock and option compensation was an effective way of focusing management and employees on stock price and shareholder value creation. Some even argued that excessive stock option grants influenced the "irrational exuberance" of

the economy and stock market of the 90s. For that and other reasons (like a market crash and recession), stock and option grants were toned down just a bit in the early 2000s.

Then, in 2005-2006, the Financial Accounting Standards Board implemented an expense for stock options in the form of Financial Accounting Standard 123R (now ASC 718). Almost overnight, companies shifted the mix (but not the size) of stock grants to include more restricted stock and performance-based stock. Long-term incentives became more sophisticated, but still maintained a very strong focus on shareholder value creation.

We now have a heavily tailored mix of stock-based compensation, including a preponderance of "relative TSR" based plans. Each company grapples with identifying the right mix of stock, options and performance plans for their industry, strategy and talent market. If anything, companies have become more sophisticated at tying management incentives and management interests to the interests of shareholders.

Implications for Corporate Governance

The Business Roundtable's statement was signed by 181 CEOs who commit to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders. Based on this fact alone, public and private company boards should probably engage in a conversation with management about what this means for the company going forward. How does the company see its purpose? What is the relative importance of each constituency? Has that mix changed over the last 5-10 years? For example, have employees become more critical to the long-term success of the company? Put differently, has the value of human capital become more important relative to financial or physical capital?

Will resources be allocated differently? Will the company invest more in its employees, or treat its customers or suppliers differently? Will it be more involved in local communities or pursue new environmental initiatives?

Companies may also want to engage in dialogue with investors to learn their views on the importance of other constituents and what they are looking for in terms of demonstrable results with those "other stakeholders." Our guess is that investor viewpoints may vary significantly. Note that while some large investment managers like Black Rock have stressed the importance of purpose and human capital management – in keeping with the Business Roundtable statement, the Council of Institutional Investors had a largely negative initial response to the Business Roundtable's new position.

Boards may need to determine whether change is needed in how strategy is articulated, priorities are established, and performance is measured and assessed. Will short- and long-term success include goals and measures around customers, employees, suppliers, etc.? How will the Board provide oversight over these areas? What committee will be responsible for which stakeholder group? What data will need to be reviewed and how often? How will success be defined?

Boards may want to work with management to develop "stakeholder scorecards" that provide an oversight view into how the company is performing with each constituency, and how that performance changes over time (and, possibly, how it compares to other companies).

Lastly, and perhaps most important – what new information will be shared with investors and the public about a company's commitment to, and results with each of their stakeholders?

These and other questions should be carefully discussed and evaluated in light of the evolving business and economic environment, the relative importance and value of various constituents in the firm's economic model, and the changing preferences of investors.

Please reference Willis Towers Watson's recent white paper on Company Purpose and Sustainable Human Capital for more on how effective human capital management enhances performance and value.

Implications for executive compensation

If companies are to shift their priorities from a heavily shareholder-centric model to one focused in a more balanced way on multiple stakeholders, it would follow that executive compensation should also change. How can and should this take place? Growth, profits and returns drive value creation. It is difficult to serve other stakeholders without providing returns and value to shareholders. So, we don't

recommend any kind of radical departure from the time-tested shareholder value model of executive compensation. However, some possible actions include:

- **Include new measures in annual incentive plans.** A small percentage of companies currently include environmental, human capital or governance measures in their annual incentives (fn). For most of these companies, it is a small percentage of the total incentive. This is a good place to start.
- **Add a "stakeholder modifier" to the long-term incentive.** We know of a few privately-owned companies that have such modifiers, or other factors in the long-term incentives. Privately-owned – and especially large family-owned – companies are more likely to acknowledge the importance of other stakeholders and include something significant in their long-term incentives to acknowledge this. For example, one company makes significant adjustments to LTI payouts based on how it scores on annual employee surveys that test how well the company lives by its values.
- **Track and adjust "sharing ratios."** Again, this is something we see more commonly at privately-owned companies. These companies calculate the percentage of profits shared with owners and executives, versus employees, the community and the environment. They are willing to reduce the percent to owners if they think it will create a healthier and more sustainable company in the long term.
- **Make long-term incentives truly long term.** Many have argued the main problem with the shareholder-first business model is an overly short-term focus on results and stock performance. A longer term focus would allow for investments in people, innovation, product development and other stakeholder interests to pay off and contribute to longer term performance. Hence, longer term vesting or holding requirements, or possibly longer term performance cycles, may help balance results for multiple stakeholders.

Executive compensation has been one of the principle tools of shareholder primacy for at least 30 years. Executive and management incentives have basically cemented this way of thinking into the fabric of most companies. If those companies, their CEOs and boards are serious about changing the business model to serve all stakeholders, and do so with accountability, executive compensation will have to change. People generally do what you pay them to do; so if you want them to do something different, their pay will have to also be different.

A principles-based approach

We at Willis Towers Watson have advocated a principles-based approach to the design and governance of executive compensation for many years. Executive compensation can be very complex and very controversial. There is rarely a 100% correct answer to a given set of challenges. Every company is different. In addition to publicly-traded, for-profit organizations, we also work with for-profit companies owned by founders, families, foundations, private equity investors and various combinations of owners. We work with co-ops owned by their customers or suppliers. We also work with a wide range of non-profit organizations, including health care providers, academic institutions and associations. Each has its own purpose, mission, strategy and set of constituents it serves. So, we are not strangers to the concept of an organization serving multiple stakeholders. Nor are we unfamiliar with designing and governing incentive programs geared towards those stakeholders.

Consequently, we operate by a set of Guiding Principles, which include detailed operating standards, and four overarching principles:

- **Purpose:** Executive compensation programs must be aligned with, and promote the achievement of the organization's purpose, mission, strategy and objectives.
- **Alignment:** Executive compensation programs should foster alignment between the interests of a company's management and those of its owners and other stakeholders – as well as alignment across business units and geographies, and among employees at multiple levels.
- **Accountability:** Compensation and incentive programs are a core part of the accountability structure of most organizations. They are often the primary means by which goals and objectives are communicated and people are held accountable for their achievement.
- **Engagement:** Compensation and incentive programs must be competitive, meaningful, understandable, fair, and tied to achievable yet challenging objectives. They should be powerful tools to communicate what is important and motivate desired behaviors and results.

These principles have been effective for the governance of most executive compensation programs for many years. As we move forward into a new age of stakeholder capitalism, we may need to add principles like stewardship, sustainability and responsibility to reflect both the broader purpose of corporations and the broader oversight role of boards. We look forward to partnering with our colleagues and clients in this fascinating and important evolution of business purpose, governance and pay.

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