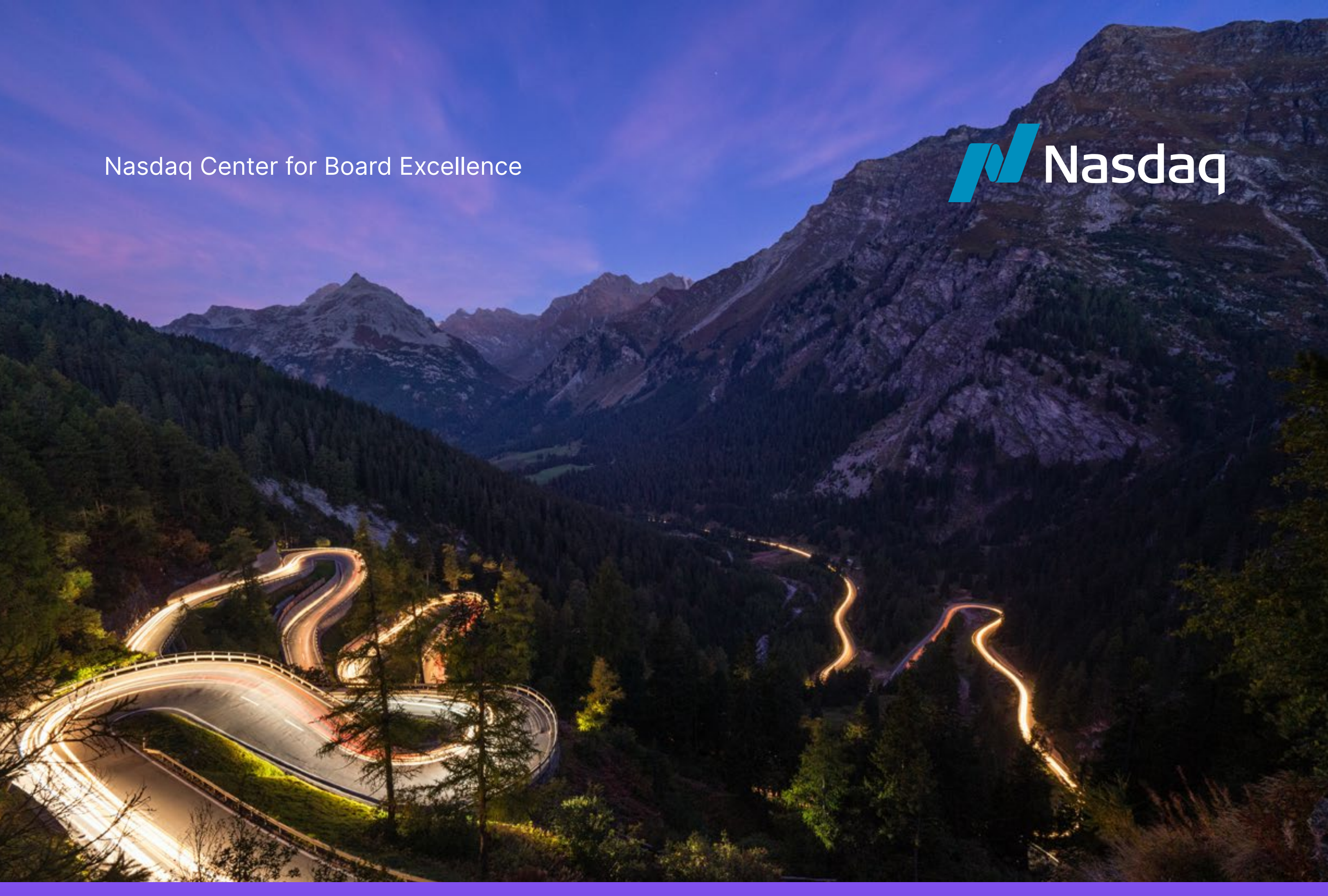

Stakeholder Capitalism Creates Shareholder Value

A Closer Look at How Corporate Governance Is Changing

The past two years have opened boardroom doors to beneficial change. Boards faced an extraordinary convergence of events—a global pandemic, shrinking labor markets, volatile economic markets, state-sponsored cyberattacks, unstable geopolitical conditions, and civil unrest—that brought in their wake a more inclusive, stakeholder-centric perspective to creating shareholder value.

Shareholder primacy is yielding to more robust stakeholder-oriented capitalism. The Business Roundtable's 2019 Statement on the Purpose of a Corporation marked the beginning of the era of stakeholder governance in the United States. The European Commission made stakeholder governance the foundation of the 2021 Sustainable Corporate Governance Initiative. The UK led in legislating the concept of "enlightened shareholder value," or consideration of stakeholder impact in decision making, as early as 2006 through Section 172 of the Companies Act. Reporting on how these considerations have been evaluated is now firm practice in the UK and influencing governance trends around the world.

As 2021 was ending and 2022 beginning, a new variant of Covid-19 precipitated yet another global wave of infection that continues to strain the capacity of businesses and healthcare systems and fatigue an already battered and weary workforce. While the challenges remain daunting, the global economy is maintaining resiliency. We have learned that stakeholder-centric corporations may wield greater influence and have a more trusted role to play in crisis response and societal stability than was previously thought.

The past two years demonstrated that directors are more than prepared to answer the call to stakeholder-oriented governance. As a cohort, boards around the globe appear to be exhibiting more agility, tech-savviness, risk awareness, forward-looking perspective, and resilience. As they continue to steer their companies through current and emerging challenges and find opportunities in evolving markets, these battle-tested boards will sharpen their focus on four key areas:

The Stakeholder Governance Framework

Human Capital Management

ESG and Sustainability

Risk Oversight

The Stakeholder Governance Framework

Embracing Stakeholder Capitalism

Corporate Social Responsibility (CSR) was the short-lived precursor to stakeholder capitalism. Since the Friedman doctrine dominance of the 1980s, CEOs have been presented with the inherent conflict between operating under the mandate of shareholder primacy and leading with a stakeholder-oriented perspective. The unprecedented level of disruption during the past two years has thrust turmoil and change onto the CEO's agenda in ways not experienced in living memory.

> In the decades ahead, the winners will be companies that embrace multiple stakeholders. Sustainable, long-term value creation can only happen when the vital stakeholders—customers, workers, shareholders, the corporation itself, communities, and the planet—are taken into consideration, optimized, and the company's capability to produce value over the long term, embraced.
>
> —Peter Georgescu, Chairman Emeritus of Young & Rubicam

This phase of "revolution" in the business cycle has appeared to accelerate the understanding that stakeholder capitalism is, in fact, a means to business prosperity over the long term by attracting loyal customers, cultivating a healthy and engaged workforce, remaining relevant with customers, being a good community and business partner, and pursuing long-term shareholder value over short-term gains.

As a result, board leaders are adopting a stakeholder-oriented governance mindset that serves the business' interests over the long term. Boards are seeing that shareholder value creation is ensured by the well-being of stakeholder constituencies. A forward-looking, strategy-aligned focus on board composition and director skills has set boards up for success far better than just a decade ago. So, too, has the emergence of big data, which arms boards with the cross-enterprise real-time performance metrics that serve the insight needs of a modern board.

Extending Duty of Care to All Stakeholders: A New Era of Humanity

Stakeholder governance imbues capitalism with a greater sense of humanity; by extension it does the same to the principle of duty of care for corporate boards. Stakeholder-oriented boards understand that the long-term interests of a company and its most important asset, people, are inseparable. The duty of care obliges boards to consider how company activities will likely impact financial risk as it pertains to customers, employees, partners, suppliers, communities, shareholders, and long-term profitability.

To effectively discharge the duty of care through a stakeholder-oriented perspective, directors and management must define who their stakeholder population is and gain better understanding of their demographics and particular interests. Once stakeholder constituencies are defined, directors should review and balance stakeholder interests against a pending board decision's impact.

Resultantly, boards that aim for excellence are taking a thoughtful and robust approach to succession planning to ensure board composition diversity. Diversity of thought offers greater opportunity for deeper discussion and more informed decision-making, also spawning courageous discussions that reveal the values of diversity, equity, and inclusion (DE&I) among the board. Through this, they are better able to work with management on setting goals that promote diversity and inclusivity for stakeholder groups, such as employees and customers, in order to maintain the corporation's relevance and competitiveness.

Once a board achieves its desired diversity, it can more meaningfully focus on key areas where strategy and risk intersect and fulfill its duty of care under the modern context and definition. Many boards demonstrated a fulsome approach to duty of care in overseeing and supporting their management teams during the pandemic response. They moved quickly to form partnerships that ensured people had personal protective equipment, food, and technology to operate virtually and safely. We suspect this is the primary driver of people placing more trust in businesses—ahead of government, media, and religious institutions—since the pandemic began.[1]

Onboarding for Excellence

Given that directors are required to monitor a wide range of operational areas that can materially impact a company, such as human capital management, digital transformation, supply chain management, and cybersecurity, effective onboarding and continuous director education are essential. An effective formal onboarding program accelerates the process of getting directors comfortably engaged with fellow directors, familiar with senior management, knowledgeable about the company, and empowered to contribute insightfully to discussions. Director onboarding should include immersion into the company's stakeholders, business model, operations, and competitive landscape, and result in directors who are committed to the company's purpose and goals and clearly understand the stakeholder constituencies they represent.

An effective program of continuing director education complements effective onboarding and helps ensure that directors remain current on important governance, market, and industry trends and developments. Establishing a formal program (versus an ad hoc

approach) also helps ensure that directors consistently leverage opportunities available to them. Along with committing to the duty of care, oversight, loyalty, and business judgment rule, it can be said that a duty of curiosity is implicit for a future-ready board member. A thirst for continuous education is a core component of effective board service.

Human Capital Management

Increasing Focus on DE&I and Talent Acquisition

Employees have emerged as key stakeholders requiring the board's attention. One of the biggest concerns we heard from CEOs and directors during the initial wave of the pandemic was for the overall well-being of the workforce. Directors have become deeply concerned with DE&I and talent acquisition, as the ability to attract and retain the best talent at all levels of the company has become a competitive differentiator.

Boards are being pressured by investors and regulators alike to enhance oversight of and, by extension, disclosures around human capital management (HCM) issues. Where once boards may have received a cursory annual report on human resources matters, directors now want to acquire literacy on the full range of issues that comprise HCM. Many companies are elevating the profile of the human resources function by creating C-suite human resources roles that more frequently and substantively report to the board, which helps improve the oversight of HCM and related discussions in the boardroom. This enables the board to proactively work with management on HCM.

Key HCM areas expected to be in focus during the year include:

- **Succession planning:** Boards are going deeper with succession planning, assessing the diversity and depth of talent two or three layers down from the C-suite.
- **Corporate culture:** As younger generations gravitate to purpose-driven companies, boards are becoming more sophisticated at promoting the desired company culture and assessing it.
- **Employee engagement:** Boards are gaining more direct insights into employee engagement and understanding of workforce sentiment and conditions.
- **Long-term strategy:** Boards are examining how DE&I and talent acquisition programs can further a company's strategic goals and ensuring the right HCM policies and practices are in place to support those goals.
- **Performance management metrics:** Boards are driving performance for people-based initiatives by setting goals and defining metrics for management—whether DE&I is tied to executive compensation or not.
- **Inclusion:** Inclusion is the differentiator for companies looking to advance diversity strategies and goals, so boards will be evaluating whether the company culture and DE&I programs attract and amplify diverse employees' success.

Enhancing HCM Disclosures

HCM programs impact every stakeholder and are increasingly important to the board in terms of facilitating healthy corporate culture, mapping strategy, and achieving business goals. Accordingly, regulators and investors are demanding information that brings visibility to employee demographics, working conditions, and talent acquisition strategies to better assess the "people risk" companies face.

2022 will be only the second proxy season since the U.S. Securities and Exchange Commission (SEC) requested that companies enhance HCM disclosures in Form 10-K. We expect HCM disclosures to evolve rapidly during the next several years as boards and management teams work together to define which HCM matters are material to their companies and industries, to establish frameworks and metrics for assessing material HCM initiatives, and to benchmark HCM disclosures.

HCM disclosures should be the tip of a very large iceberg of dialogue at the board level on a host of topics that can include talent acquisition and retention, DE&I, employee health and safety, employee satisfaction, culture, training, and pay equity. Companies can bring structure and consistency to these discussions by developing frameworks—or aligning with existing frameworks—to aid in the assessment of HCM strategies, practices, and policies. This includes the identification of relevant metrics.

ESG and Sustainability

Defining Effective ESG Oversight and Accountability

Environmental, social, and governance (ESG) matters have become a strategic priority for companies, largely due to pressure from investors and other stakeholder groups. Boards are grappling with understanding the impact on the principal-agent relationship, where board or management decisions may illustrate a misalignment between shareholder value and wider stakeholder concerns. We continue to see a wide range of approaches towards ESG management: On one end of the spectrum, companies may limit their efforts to "greenwashing" disclosures, while at the other end, companies may leverage ESG initiatives to demonstrate stewardship and transparency in creating long-term value.

Boards that have matured beyond treating ESG as the in-vogue disclosure requirement have thoughtfully considered what the E, S, and G factors each mean to their companies and their stakeholders. They are determining how some elements are already built into their businesses and what further initiatives will enhance their strategies, operations, and performance. When viewed as integral to how the business operates, many boards are centralizing ESG oversight by delegating responsibility to an existing committee or establishing a stand-alone ESG committee and identifying appropriate executives to have accountability for the performance of these goals and management of their associated risks.

Some companies are utilizing smart technology to mine internal data across the enterprise to create a holistic view of the ESG risk spectrum. By breaking operational silos, boards and management teams get visibility into how ESG factors impact every facet of the business, from supply chains to the labor force to brand reputation to regulatory compliance to business strategy.

In the face of increasing pressure, companies are also rapidly maturing their approach towards ESG disclosures. A sampling of best practices we observe in companies at the forefront of ESG disclosures include:

- Mapping board skills, expertise, and experience to relevant ESG domains including HCM, supply chain management, sustainability, cyber risk, and environmental initiatives.
- Referencing alignment with ESG frameworks and standards, such as SASB, TCFD, GRI, and CDP.
- Reporting goals and progress towards ESG initiatives and KPIs.
- Highlighting ESG programs and accomplishments with graphics.
- Aligning disclosures in ESG reports with narratives in the proxy statement.

Embedding Sustainability Into Corporate Strategy

Boards are taking a wider view of sustainability, recognizing it is not just about mitigating climate change and natural resource exploitation, but also ensuring long-term viability of business models. Companies are becoming increasingly adept at finding the sweet spot where sustainability initiatives drive long-term value and viability. For example, real estate conglomerates are exploring adaptive reuse of buildings in their portfolios, car manufacturers are transitioning from gas powered to electric vehicles, and energy companies are investing in renewable energies such as solar and wind.

As more companies "walk the talk" with sustainability initiatives, we see disclosure practices evolving in tandem. Boards are looking carefully at how best to enhance disclosures related to climate change oversight and risk management. This is no easy task given that a universal framework has yet to emerge, leaving companies to choose from a veritable alphabet soup of recommended disclosure standards and frameworks, including SASB, TCFD, GRI, and CDP.

Help may be coming from the International Financial Reporting Standards Foundation, which announced in November 2021 that it intends to form an International Sustainability Standards Board (ISSB) to deliver a "comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions."[2] In the meantime, BlackRock stated in its 2022 update to Investment Stewardship policies that "we are evolving our perspective on sustainability reporting to recognize that companies may use standards other than that of the Sustainability Accounting Standards Board (SASB)," but went on to emphasize that whatever standards or frameworks companies are using for reporting, they should highlight metrics that are industry- or company-specific.[3] And, stakeholders are increasingly aware of, and even seek to work for or invest in, a company culture that underpins sustainability.

On Monday, March 21, 2022, the Securities and Exchange Commission (SEC) released the proposed rule: The Enhancement and Standardization of Climate-Related Disclosures for Investors. In 500+ pages, the proposed rule covers climate disclosures in company registration statements and periodic reports. The comment period on the proposed rule will close on Friday, May 20, 2022.

Risk Oversight

Navigating Geopolitical Challenges and Global Risks

In the past two years, the rapid transition of people, businesses, and societies brought awareness to the vulnerabilities and interdependencies of the global economic ecosystem, including fragile supply chains, tight labor markets, and polarized communities. Boards are scrambling to assess a widening array of pandemic-related challenges, looming inflation, and various geopolitical instabilities around the globe.

As a common example, many boards are involved in the oversight of supply chain logistics. Covid-19 disruptions revealed that supply chains are critically important connective tissue within the global economy, so much so that the New York Federal Reserve recently created the Global Supply Chain Pressure Index (GSCPI) to monitor domestic and international factors impacting the global supply chain.[4]

Oversight of enterprise risk management is an evolving discipline in the boardroom. Companies that operate in highly regulated industries, such as financial services, typically utilize sophisticated risk frameworks; however, companies in less regulated industries and in some parts of the world do not. We expect to see companies continuing to mature their risk management assessment practices in the near term, modeling and tracking risk areas such as geopolitical, financial, operational, people, regulatory, and reputational risks.

Board participation in tabletop exercises is a helpful way to illustrate risk scenarios and test response protocols. Since the 2007 financial crisis, chief risk officers (CROs) have become more prevalent, and they often communicate with the board on risk management programs. Many CROs are inviting directors to observe and even participate in tabletop exercises related to cyber breaches, supply chain breaks, mass resignations, geopolitical upheavals, capital crises, and other key risks.

Improving Cyber Literacy

Despite the new and emerging threats, cyber risk remains a top concern for boards. Cyber is a threat to revenue, operations, and reputation. In the digital age, cyber risk has evolved beyond a cybersecurity problem into a business problem.

Investors are increasingly focused on cybersecurity risk management. It is critical that boards move quickly beyond tangential and surface-oriented risk oversight and become cyber literate to enable competent oversight and informed decision-making.

This does not necessarily require a board to add a cyber expert director. Competent oversight may be achieved through close collaboration with the company executives who have domain expertise and by engaging third parties who can pressure test the strength of internal cybersecurity practices and infrastructure. We have observed boards with a firm grasp on cyber risk management employ the following practices:

- Improve cyber literacy by engaging in rigorous and ongoing cyber education outside of board meetings, including frequent sessions with internal technology officers and third-party cyber experts.
- Ensure the board understands the language spoken by technology officers (e.g., CISOs, CIOs, and CTOs) by providing directors with a dictionary of technology-based nomenclature and acronyms.
- Condense cybersecurity reports into data-driven and meaningful dashboards that allow directors to monitor the real-time status of internal and external compromises to networks, systems, software, data, users, and devices.
- Participate in enterprise-wide tabletop exercises that test the company's response and recovery from cyberattacks and technology failures and clarify board and management team roles in the process.
- Encourage management to build a collaborative relationship with regulators and law enforcement before a cyberattack happens.

The Boardroom of the Future

Disruption is impacting every aspect of business, from technology to delivery of goods and services to human capital. Boardroom governance is also facing disruption. Boards grapple with how to meaningfully oversee enterprise risk management (ERM), participate in strategic planning cycles, and assess performance, while also considering the needs of a wide range of stakeholders.

No matter the challenges boards face in the coming year, the duty of curiosity is key, both to meet the constantly evolving landscape of threats and to recognize and seize new opportunities. The boardroom of the future is populated with directors from a variety of disciplines, who have an insatiable appetite for learning and the stamina to remain relevant in a rapidly changing world. As you reflect on your responsibilities as a governance professional, consider the areas discussed above through the lens of enterprise risk and opportunity management. Successful boards often dive deeply into emerging relevant areas, update their governance frameworks to meet the needs of stakeholders, and drive long-term profitability that creates shareholder value.

[1] 2021 Edelman Trust Barometer, Edelman website, January 2021

[2] International Sustainability Standards Board webpage, IFRS website

[3] Investment Stewardship 2022 Policies Updates Summary, BlackRock website

[4] A New Barometer of Global Supply Chain Pressures, Liberty Street Economics, Federal Reserve Bank of New York website, January 4, 2022

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