Corporate Leadership in the Stakeholder Era

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The rise of environmental, social, and governance (ESG) investing and stakeholder capitalism – both accelerated by a global pandemic and racial inequality – have forever transformed the demands on boards and CEOs. For boards, the principle that only the interests of shareholders matter has given way to expectations that the interests of all stakeholders be considered. In addition, investors expect boards to oversee a growing number of ESG issues that help promote sustainable financial growth over the long-term. As for CEOs, they are increasingly expected to not only manage the interests of all stakeholders, but to articulate the company's values and provide vocal leadership on issues affecting society.

To succeed in this new environment, both groups must acknowledge this tremendous shift and reassess their strategy. For example, does the current board have the right skillset to manage ESG issues? Does each member have enough time to address this expanding list of duties? CEOs must plan for the long-term and manage relationships with multiple constituencies who sometimes have competing interests. Further, both groups must understand their respective roles and responsibilities, collaborate seamlessly, and communicate effectively to meet the challenges of this new era of stakeholder capitalism.

Background of ESG and Stakeholder Capitalism

"Stakeholder capitalism" can be defined as an investment philosophy asserting that the best way to create and preserve long-term value is to consider the interests of all stakeholders (including employees and the environment). Over the past year, stakeholder capitalism has been broadly endorsed by major companies and investors from around the world. In 2019, over 180 public company CEOs signed a revised Business Roundtable corporate purpose statement outlining a fundamental commitment to all stakeholders. Earlier in 2020, BlackRock also emphasized this "fundamental reshaping of finance" towards sustainability in its annual letter to CEOs.

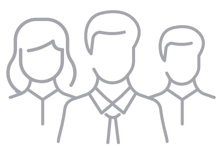
The 2020 proxy season began with rising acceptance of stakeholder capitalism and investors' heightened focus on ESG concerns. The impacts of the COVID-19 pandemic and social unrest related to racial inequality on the governance landscape accelerated discussions on ESG issues. The early weeks of the pandemic saw hundreds of voluntary and, at times, required pay reductions[1] for top executives and non-employee directors. Market turmoil eroded the value of outstanding equity awards and rendered some incentive goals unrealistic and potentially demotivating. In addition, as a result of the tremendous momentum behind the Black Lives Matter movement, investors and stakeholders have pushed companies to move beyond diversity statements and towards concrete actions to increase their racial/ethnic profiles as well as transparent disclosure of data and progress.

The crises faced in 2020 will not only result in a continuance of the stakeholder capitalism movement, but an acceleration of it in 2021. Politicians have already been pressuring companies on their response to the crises in the context of stakeholder capitalism, and the investment community is beginning to do the same. Some examples include:

- BlackRock commented it would not be easing up on its sustainability priorities, including a mandate that companies disclose to the SASB and TCFD frameworks by year end;
- A group of over 200 institutional investors published a set of expectations of all companies during the coronavirus crisis, including fair treatment of employees and limits on executive compensation;

[1] Per the Senate Stimulus Bill (H.R. 748, Sec. 4116), companies receiving loans under the CARES Act*, were required to freeze pay and cap severance for employees making more than $425,000 and reduce pay for those earning more than $3,000,000.

- U.S. proxy advisor Glass Lewis recently advised that all governance issues will be impacted, indicating that there is no better way to observe the effectiveness of governance than in a crisis;
- JUST Capital announced a Coronavirus Corporate Response Tracker - a rating of how well companies are managing their stakeholders throughout this crisis; and
- ESG ratings firms have signaled that a company's response to a crisis will materially impact their ESG rating.



200+ Institutional Investors

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Investor scrutiny will be in sharp focus across many ESG issues. Compensation committees of boards will be challenged with not only aligning pay and performance during a period of tremendous volatility, but also with the company's employee experience. Governance committees will be reminded of any lack of diversity in the boardroom. Despite the prevalence of diversity statements and policies at U.S. companies, racial minorities in C-suites and boardrooms remain few and far between. While board gender diversity has been a key investor priority in recent years, comparatively little attention has been paid to racial and ethnic diversity. CEOs and their executive teams are faced with challenges of cash flow and liquidity, along with resetting strategy for a new reality and demonstrating good corporate responsibility. Sustainability reports that lack robust EGS data and transparent ESG goals will no longer be sufficient. ESG rating, rankings, indexes, and disclosure frameworks will increase in importance, aiding investors and other stakeholders to determine a company's sustainability profile. Expect investors to call for companies to make progress on issues relating to employee health & safety, diversity & inclusion, climate change, and pay equity.

With the endless amount of possible ESG issues, where should boards and CEOs focus to be ready for the increasing expectations from all stakeholders?

Expansion of Board Mandates in ESG

Boards are the overseers of risk in a corporation and have an important and expanded role in assessing risks and opportunities of ESG – both in how environmental and social changes impact the company and in how the company impacts its stakeholders. Connecting environmental, social and governance issues to business operations, strategy, and long-term value are key to creating a sustainable business strategy.

It has always been an imperative to have a high-performance board, best-in-class governance, and a way of working together that supports the CEO and ultimately the company and its shareholders. The events of this year highlight the need for high performing, effective boards. The best practice corporate board structure is composed primarily of independent directors, who have no ties to management. These directors take on part-time roles with full-time fiduciary duties. They are expected to proactively and continuously reevaluate their board structure and resources, and plan for succession, in order to be in the best position to provide thoughtful, best in-class governance and a way of working together that supports the chief executive officer and ultimately the company.

ESG Topics on the Board Agenda

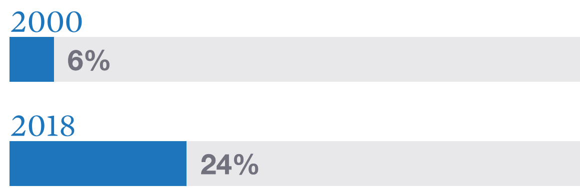
ESG topics are finding their way more frequently on to the agendas of board meetings. The ability of a board to carry out its fiduciary duties depends not only on a clear articulation of expectations, but an understanding of risks and how the risk priorities change. Operational risk, reputational risk, financial risk, activism risk, and cyber risk have all been impacted by the events this past summer.

Stakeholder capitalism, however, can be a challenge to manage for boards. The varying groups and interests can make it difficult for a board to interpret the appropriate course of action to represent the company and its diverse shareholders and stakeholders. They need a highly skilled team around the boardroom table, with robust processes to support their decision-making. It is imperative for directors to ensure that they receive accurate and updated information to help manage the evolving expectations of shareholders and stakeholders.

As boards attempt to meet the expectations of a vast array of interests, they are also faced with the common problem of balancing short-term and long-term interests. ESG takes a long-term perspective, while hedge fund activism is often viewed as short-term. Boards must oversee strategy and monitor business risks, while engaging with and understanding a diverse global ownership base. Along with diverse owners, diverse risks have also emerged.

The increase in ESG topics considered by investors, as measured by shareholder proposals, has been on the rise for decades. In 2000, median support for E&S proposals was approximately 6%. By 2018, that had increased to about 24%. E&S proposals increasingly focus on disclosure, risk assessment, and oversight. Proposals receiving at least 30% support have been on the rise: in 2000, none met that threshold; in 2018 over one-third were above 30% support.

Median Support for E&S Shareholder Proposals



During the pandemic and protests over racial injustice, boards responded by overseeing sweeping changes in the way companies work and articulating statements in support of racial equality. Board attention will be expected on a range of issues, including the company’s culture, its management of human capital, the safety and well-being of employees, and the pursuit of diversity and inclusion, as well as the rising issues around climate risks.

Diversity and Inclusion

Boards’ mandates on diversity and inclusion have expanded greatly in the wake of the protests over social injustice and the Black Lives Matter movement. Shareholder proposals requesting companies to disclose diversity data (some asking for publication of EEO data) were well received in 2020. Seven proposals were voted this year, with four receiving majority support. As these proposals would have been filed in 2019, there will likely be more diversity-themed proposals on ballots in 2021.

How boards oversee diversity and inclusion topics varies across companies. Currently only a few companies in the S&P 500 have separate Diversity and Inclusion committees of the board. More prevalent is that other committees have diversity and inclusion as part of their charters – nominating and governance committees, corporate responsibility committees, sustainability committees, and ESG committees.

Proactively managing the challenges of stakeholder capitalism and increasing focus on ESG can help with oversight of the risks and opportunities. A few actions that boards can take to navigate the current landscape include:

- Understand the ESG investing ecosystem of ESG ratings, rankings, indexes, and disclosure frameworks;
- Understand how the company is being rated on its sustainability initiatives by the primary ESG ratings firms and understand the impact such ratings are having on access to capital and the AGM;
- Review whether the company is aligned with the primary ESG disclosure frameworks promoted by major investors and identify any gaps in your company's current disclosure;
- Understand which ESG issues your top investors are most focused on, as well as any formal proxy voting policies related to such issues;
- Interface with management – request an ESG assessment and prioritize risks;
- Rethink board succession and different matrix skills needed;
- Benchmark policies and practices;
- Ensure appropriate disclosures and communicate effectively;
- Work to integrate sustainability with strategy; and
- Incorporate ESG metrics in executive incentive plans to provide a clear signal to stakeholders that sustainability is essential to corporate strategy. Currently, more than half of the S&P 500 incorporate ESG measures or considerations in executive incentives, most often in the annual incentive plan. Despite the long horizon of environmental and social measures, these are rare in long-term incentive plans, although some leaders in the space have begun to adopt multi-year sustainability incentive measures.

C-Suite Leadership in the New Reality

CEOs and by extension, their executive leadership teams, have had to quickly pivot to a multitude of changing demands and priorities over the course of 2020. At the same time, there is an increasing call from their investors to rethink or transform their social license to operate. While many CEOs adopted the Business Roundtable view of stakeholder capitalism in 2019, the concepts were put to the test in 2020.

After the pandemic hit, many companies and their leadership found themselves navigating multiple challenges – complete shutdown, liquidity, cash flow, employee health and safety, plans for reopening, etc. Some companies needed to pivot to rethink their business strategy. Along with this is the need to collaborate on strategy setting with boards and communicating effectively with shareholders and all stakeholders.

Executive Compensation

As the 2020 proxy season wound down, the potential impacts of COVID-19 on executive compensation were only beginning to be seen. The first weeks of the pandemic saw hundreds of voluntary and, at times, required[2] pay reductions for top executives and non-employee directors. Extraordinary stock market volatility has affected the value of outstanding equity awards, while some incentive goals have been rendered unrealistic and potentially demotivating. At the same time, proxy advisors and large institutional investors have indicated that they will continue to hold companies to higher environmental, social and governance (ESG) standards throughout the crisis and have not become more lenient in their policies. Compensation committees now face the difficult task of motivating executives while not aggravating their investors and employees.

Positive adjustments to executive pay against the backdrop of illness, layoffs, furloughs, and extreme stock price volatility draw greater scrutiny from investors and the public at large. Companies with poor records on diversity and inclusion face additional scrutiny, as the recent protests have highlighted pay and income disparity as an issue of racial justice. The complex ESG environment and enhanced level of shareholder scrutiny necessitates a

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clear view of stakeholder perspectives and a full understanding of how any action will be viewed.

Key investor concerns in compensation that will play out as engagement discussions in the latter part of 2020 and at the ballot box in 2021 include:

- Offsetting executive salary cuts with discretionary awards or payouts;
- Granting significantly more shares of stock or options at historically low prices;
- Poor disclosure on incentive metric or goal modifications or the use of discretion;
- Replacing at-risk incentives with time-based awards;
- Failure to consider ESG performance metrics;
- Above-target relative-TSR-based payouts during periods of negative stock price movement;
- Problematic stock option repricing;
- Overuse of discretionary retention awards;
- Excessive focus on top-level employees; and
- Failing to engage with shareholders regarding COVID-19 related pay actions.

Looking ahead, the coronavirus crisis, like the 2008 economic crisis, has the potential to change the executive pay landscape. First, clear and robust disclosure will become even more crucial. Many investors and proxy advisors have indicated that they are more accepting of discretion or pay modifications, but they will expect robust disclosure of the rationale for any changes. As such, companies and compensation committees will be challenged to elucidate the thinking behind their pay decisions beyond standard pay for performance statements. Second, paying for performance takes a new meaning during extraordinary market volatility. Corporate resilience, rather than financial growth, has become a key focus for many companies. The shift could be reflected in new incentive metrics, such as free cash flow or ESG measures like diversity or employee health and safety. Lastly, investors increasingly expect that executive pay is aligned not only with shareholders' experiences, but also with broad-based employee experiences. Recent events have led stakeholders to view pay and income disparity through the lens of racial and social justice. Companies with high pay packages but lackluster records on diversity and inclusion will be particularly vulnerable to criticism, as will those who laid off or furloughed employees during the pandemic.

While some companies have put in place supplemental plans to incentivize and retain top employees for the balance of the year, other companies are taking a wait and see approach when it comes to coronavirus-related pay decisions. The true impact of the crisis will not be fully disclosed until the 2021 proxy season at the earliest. Shareholder and public scrutiny of pay decisions is unlikely to lessen and some companies will see a degree of pushback on changes. Careful consideration of investor views, public perception, and employee experiences, along with robust disclosure and shareholder engagement on any changes will serve boards and management well as they determine the best course of action for their unique circumstances.

Investors are increasingly demanding that companies enhance their ESG disclosure in-line with the following third-party disclosure frameworks:

- **Sustainability Accounting Standards Board (SASB):** The SASB standards are a set of industry-specific ESG disclosures that are believed to have a material impact on a company's financial performance. Large institutional investors are increasingly calling for companies to publish ESG data according to the SASB standards.
- **Task Force on Climate-related Financial Disclosures (TCFD):** TCFD is a disclosure framework that seeks to demonstrate how a company is managing its climate risks. The 2020 proxy season saw several large investors vote against directors on boards at companies that did not disclose according to the TCFD framework.
- **Global Reporting Initiative (GRI):** The GRI is a framework that promotes disclosure about how a company's activities impact its stakeholders (including the environment and communities). It is the oldest and most frequently used ESG disclosure framework.

Continued Focus on Stakeholders and ESG

Important actions that C-suite and board leaders can take to align with the new reality and prepare for 2021 include:

- Transform a separate sustainability strategy to an integrated sustainable business strategy;
- Consider options for disclosure under the various ESG frameworks;
- Track the ESG rankings and ratings, which could influence portfolio construction and access to capital;
- Engage with investors on key ESG topics; and

- Plan and implement an effective communication program around all aspects of ESG that can have a material impact on the business.

In our current environment, shareholders have signaled strongly that they are going to continue to put pressure on companies to meet increasing ESG demands. As the world puts the global pandemic in the rearview mirror, the ESG momentum will continue, and corporate leaders must plan accordingly.

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