Stakeholder Voices in the Boardroom

Today's boards must ensure that stakeholder interests are factored into decision-making

POINT *of* VIEW

SpencerStuart

The idea that corporations should be accountable not just to their shareholders but to a wider universe of stakeholders has rapidly gained traction. The global pandemic has amplified the need for businesses to secure a strong social license to operate. The confluence of an unprecedented health and economic crisis, the looming threat of climate change, and demands for business to address inequality and social injustice have catapulted stakeholder engagement to the top of the board agenda.

Stakeholder capitalism, the term used to describe this broadening remit for business, goes hand in hand with the environmental, social and governance (ESG) movement that is transforming the entire business landscape, let alone the fund management industry. A growing number of investors are taking an intense interest in how companies are dealing with the medium- to long-term risks posed by climate change and environmental degradation throughout the value chain, while joining calls for investee companies to play their part in building a more stable and just society. Diversity, equity and inclusion, workforce engagement, decarbonization, responsible sourcing and supply chain management — investors are scrutinizing these and other risk factors as they prioritize sustainability planning over short-termism; they also recognize that they are not the only stakeholders who matter. As BlackRock CEO Larry Fink wrote in his 2020 letter to CEOs, "a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders."

> **Stakeholder capitalism is transforming the entire business landscape.**

The change is here to stay, given the trajectory of climate change and the social upheaval and disparities exposed by the pandemic. Boards recognize that their businesses have to be viewed as part of the broader social and environmental fabric. While trust in governmental and supranational institutions has faltered, the expectations of business leaders have soared — from employees, customers, suppliers, local communities, politicians and regulators. Activism is no longer the preserve of an aggressive minority of investors; it is everywhere, including inside organizations as emboldened employees seek to hold their leaders to account. It is incumbent upon every board to ensure that leaders understand the needs of all their stakeholders and manage them well.

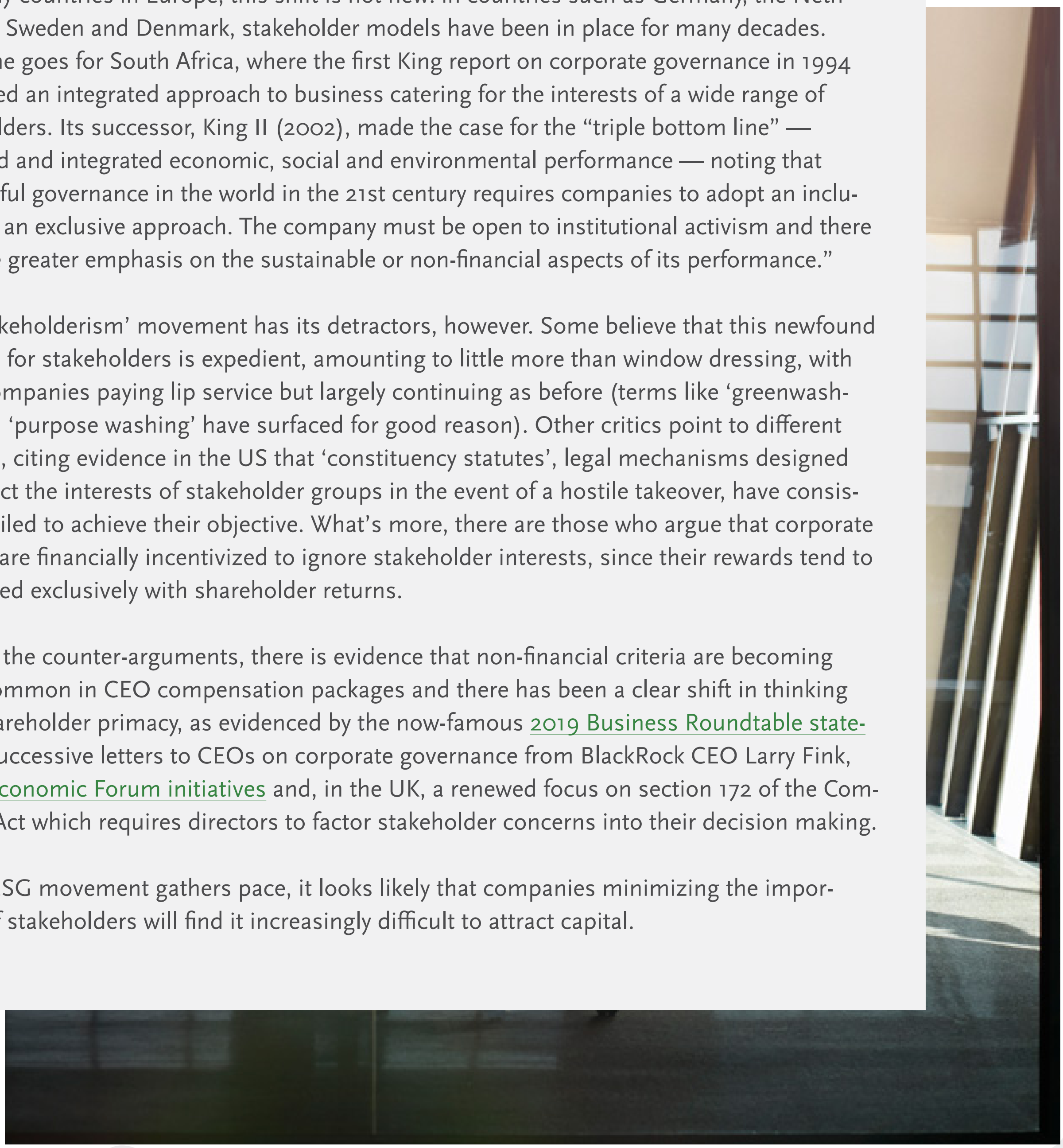
The shift towards stakeholder capitalism

For many countries in Europe, this shift is not new: in countries such as Germany, the Netherlands, Sweden and Denmark, stakeholder models have been in place for many decades. The same goes for South Africa, where the first King report on corporate governance in 1994 promoted an integrated approach to business catering for the interests of a wide range of stakeholders. Its successor, King II (2002), made the case for the "triple bottom line" — balanced and integrated economic, social and environmental performance — noting that "successful governance in the world in the 21st century requires companies to adopt an inclusive not an exclusive approach. The company must be open to institutional activism and there must be greater emphasis on the sustainable or non-financial aspects of its performance."

The 'stakeholderism' movement has its detractors, however. Some believe that this newfound concern for stakeholders is expedient, amounting to little more than window dressing, with most companies paying lip service but largely continuing as before (terms like 'greenwashing' and 'purpose washing' have surfaced for good reason). Other critics point to different dangers, citing evidence in the US that 'constituency statutes', legal mechanisms designed to protect the interests of stakeholder groups in the event of a hostile takeover, have consistently failed to achieve their objective. What's more, there are those who argue that corporate leaders are financially incentivized to ignore stakeholder interests, since their rewards tend to be aligned exclusively with shareholder returns.

Despite the counter-arguments, there is evidence that non-financial criteria are becoming more common in CEO compensation packages and there has been a clear shift in thinking over shareholder primacy, as evidenced by the now-famous 2019 Business Roundtable statement, successive letters to CEOs on corporate governance from BlackRock CEO Larry Fink, World Economic Forum initiatives and, in the UK, a renewed focus on section 172 of the Companies Act which requires directors to factor stakeholder concerns into their decision making.

As the ESG movement gathers pace, it looks likely that companies minimizing the importance of stakeholders will find it increasingly difficult to attract capital.



Stakeholder engagement is a question of purpose

More and more companies are actively pursuing policies of broad stakeholder engagement. The pandemic has highlighted the interdependence between businesses and their stakeholders as well as the kudos to be gained from treating stakeholders well. Unilever's decision early in the crisis to provide cash flow relief to smaller suppliers was a powerful example (followed by others) of a business offering support to stakeholders to preserve the stability of its ecosystem.

COVID-19 has contributed to a shift in the mindset of boards and executive leadership teams, impelling leaders to engage with stakeholders as never before and to acknowledge that businesses do not exist in isolation from the communities in which they operate. Hubert Joly, the former chairman and CEO of Best Buy, calls this "the end of zero-sum leadership". Profits do not need to come at the expense of others.

Fueled by the growing impact investing movement and amplified by social media, pressure is coming from all sides for boards to articulate a thoughtful and authentic purpose for the business. Ideally, a company's purpose statement will serve several functions: inform the strategy; help guide investment and operational decisions; engage and motivate employees; and provide clarity and alignment for investors and other stakeholders. Today, a company's social narrative needs to be as powerful as its financial narrative.

Prioritizing the stakeholders that matter

Helge Lund, chair of both energy giant BP and Novo Nordisk, a global healthcare company which majors on chronic diseases such as diabetes, says that his boards "spend time working with the executive team making sure that we have the right approach to dealing with stakeholders. The executive team naturally drives the stakeholder dialogue on a day-to-day basis, but increasingly board directors engage directly with internal and external stakeholders too."

Tony Hayward, chair of Glencore, agrees: "In our business the social framework really rests with the executive — our role is to make sure it is part of every board meeting agenda. There are circumstances when it is appropriate for the board to engage directly with external stakeholders — at Glencore in the recent past that has been the case with climate change — and I have always followed up on a personal basis with any matters raised by external stakeholders at our AGM."

While the day-to-day management of stakeholders is not the responsibility of the board itself, directors must form a clear picture of which stakeholders are materially affected by its decisions. Not only must the board ensure that the senior executive team has a framework in place and a plan for engaging with those stakeholders, but it should also find a way to have stakeholder voices represented — or at least heard — in the boardroom.

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A 2020 survey of over 400 directors and corporate leaders by the Diligent Institute found that 73% of boards expect to discuss the impact of their decisions on non-shareholder stakeholders at least quarterly in the three years following the COVID-19 outbreak, with 42% anticipating such a discussion at every board meeting.

Mapping an organization's stakeholders could result in a long list, especially if one applies the international standard definition of a stakeholder as an "individual or group that has an interest in any decision or activity of an organization." The larger the organization's footprint, the more extensive its ecosystem and therefore its likely stakeholder base.

Since you can't please all of the people all of the time, prioritization is essential. Each company will have its own unique context to consider. "Boards should focus their attention on the stakeholders that have a significant impact on the long-term sustainability of the business," says Glenn Booraem, principal and former investment stewardship officer at The Vanguard Group. "That varies company by company, it certainly varies industry by industry."

Shareholders, in particular those that identify as either ESG or impact investors, are increasingly aligning themselves with stakeholders. An April 2021 report by Morningstar found that the global sustainable fund universe has risen to almost US$2 trillion, as a growing number of funds allocate capital to companies that pursue long-term value in ways that do not profit from causing ecological or social problems.

> **"As shareholder and stakeholder interests converge, directors may have to represent, and listen to, a far wider set of perspectives.**

Typically, stakeholders with the greatest impact on operations and performance will appear at the top of the list — for example, employees, contractors, customers, suppliers, capital investors and, in some sectors, regulators. However, as shareholder and stakeholder interests converge, directors may have to represent, and listen to, a far wider set of perspectives. The range of stakeholders who might be materially affected by a business' decisions can be very broad, including NGOs, local governments, pension scheme participants, special interest groups, media and the community — the latter defined either geographically (as in the case of people in close proximity to a mine or chemical plant) or in more universal societal terms (where corporate actions are increasingly viewed through the lens of social justice, equality and race relations).

Missteps in dealing with stakeholder concerns can reverberate around the world and cause lasting reputational damage. There is a growing case for boards to set up a dedicated risk committee, something that is still mainly confined to the financial services sector.

Listening to the voices that matter

In this era of ESG activism, it is self-evident that directors' fiduciary duties go well beyond the financial. It has been estimated that up to 85% of the value of S&P 500 companies can be attributed to intangible assets, of which trust is a major component. All directors are guardians of those assets, which are often stakeholder-dependent.

There are different tolerance levels for stakeholder representation in the boardroom, ranging from the US, where the shareholder has traditionally been king, to European social market economies, where employee representation on supervisory boards (co-determination) is prescribed by law — for example in Germany, the Netherlands, parts of Scandinavia and Poland.

Boards operating in one-tier (unitary) governance systems are looking at innovative ways of ensuring that they are exposed to a wide range of voices well beyond those of shareholders. These include: the creation of a 'shadow board' made up of, say, high-potential employees offering a different perspective on key issues; seeking insight from regional or advisory boards; designating directors to understand stakeholder concerns; and appointing directors with specific stakeholder-related expertise.

The voice of the employee

One of the most critical stakeholders for any business are its employees. Since the start of the pandemic, more and more boards have taken an active interest in employee engagement levels, which have a significant impact on retention, innovation and unlocking corporate performance. Yet recent research by Kincentric found that only 32% of organizations have a clearly defined employee experience strategy — aligning employee experience with business priorities. In the second year of the pandemic, as fatigue and restlessness sets in, it will be more important than ever for management teams to unite employees around a common purpose and listen to their concerns.

There are various ways to bring the voice of the employee into the boardroom. The least likely to take hold is appointing one or more employees to serve as a board director. Outside those countries where worker representation on the board is enshrined in law, there has been little appetite for what many would see as an extreme measure. Proposals in the US to consider the addition of non-management employee directors have been voted down by shareholders at Walmart, Disney, Starbucks and Citigroup in the past year, for example. Nevertheless, the existence of such proposals indicates a growing desire to bridge the gap between corporate management and the workforce.

In the UK, the 2018 Corporate Governance Code now requires listed companies to adopt one (or a combination) of three mechanisms to ensure the board is actively engaging with its employees:

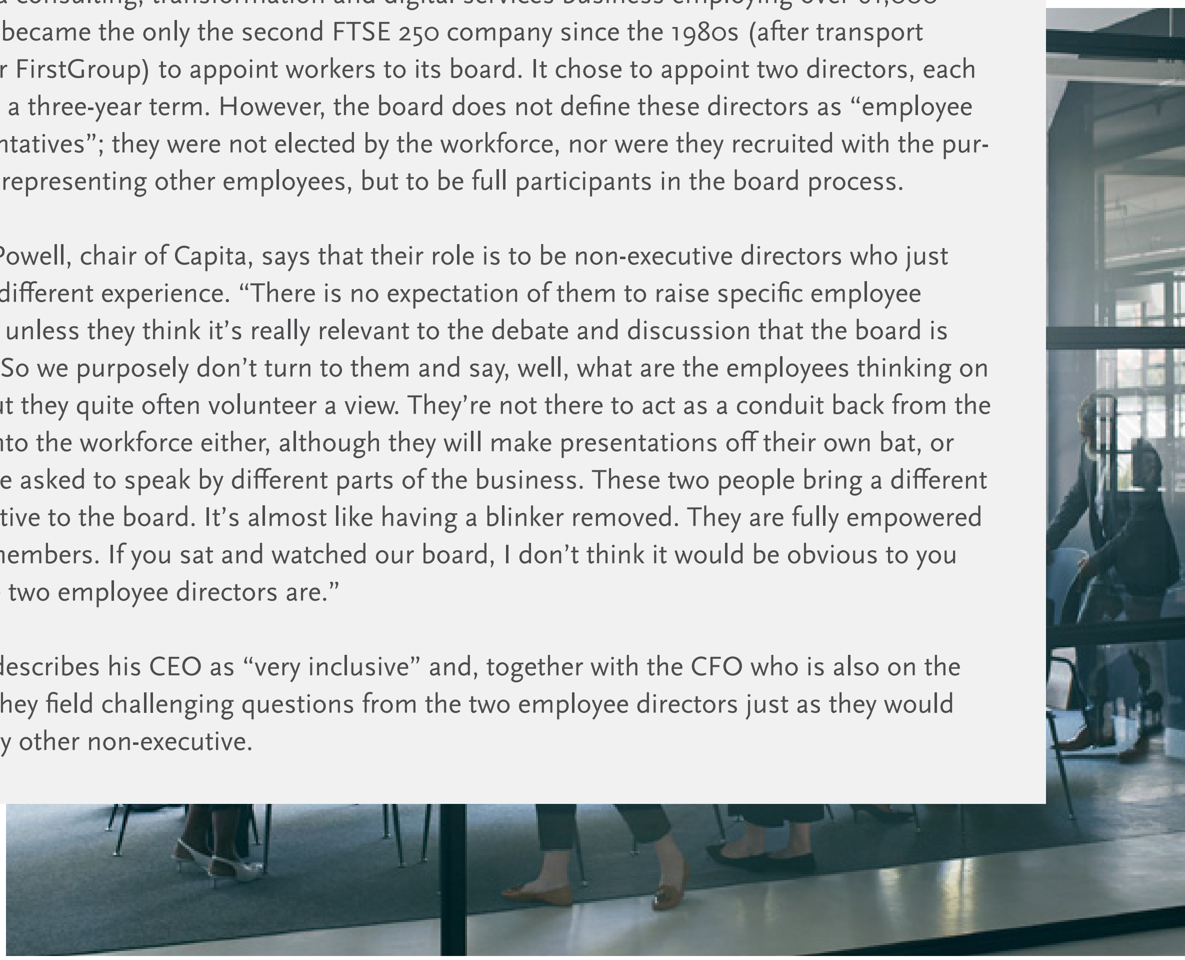
» a director appointed from the workforce
» a formal workforce advisory panel
» a designated non-executive director

Capita: a case study

Capita, a consulting, transformation and digital services business employing over 61,000 people, became the only the second FTSE 250 company since the 1980s (after transport operator FirstGroup) to appoint workers to its board. It chose to appoint two directors, each to serve a three-year term. However, the board does not define these directors as “employee representatives”; they were not elected by the workforce, nor were they recruited with the purpose of representing other employees, but to be full participants in the board process.

Sir Ian Powell, chair of Capita, says that their role is to be non-executive directors who just bring a different experience. “There is no expectation of them to raise specific employee matters unless they think it’s really relevant to the debate and discussion that the board is having. So we purposely don’t turn to them and say, well, what are the employees thinking on that? But they quite often volunteer a view. They’re not there to act as a conduit back from the board into the workforce either, although they will make presentations off their own bat, or they’ll be asked to speak by different parts of the business. These two people bring a different perspective to the board. It’s almost like having a blinker removed. They are fully empowered board members. If you sat and watched our board, I don’t think it would be obvious to you who the two employee directors are.”

Powell describes his CEO as “very inclusive” and, together with the CFO who is also on the board, they field challenging questions from the two employee directors just as they would from any other non-executive.



Any company that chooses not to adopt one or more of these methods must explain what alternative arrangements are in place and why it considers that they are effective. By mid-2020, 49% of the top 150 FTSE companies had opted to designate a non-executive director as responsible for representing the employee voice in the boardroom.

Well before the UK Code recommended the idea, Rolls-Royce had appointed non-executive director Irene Dorner as its first 'Employee Champion'. In this role she meets as many cohorts of employees as she can in order to gather a broad range of views and feed these back to the nominations & governance committee on which she sits — *and to the full board*. "It has taken off in such a way that instead of having to invite myself to meetings, we now have to control the flow of what I get invited to, because people now are terribly keen," she says. "It's been a success because I am able to go anywhere I like to meet employees. The CEO and the management team are extremely open to the concept; they are always prepared to deal with any concerns I bring back, whether they are small operational issues or broader observations raised in my annual report to the board."

> **Boards must seek out people with different mindsets who can represent changing views about the role of business in society.**

The most effective route to workforce engagement will depend entirely on the nature and context of each individual business and its context. Employee directors may not be for every company, but better employee engagement certainly is.

Some companies have set up a 'shadow board', giving up-and-coming leadership talent an opportunity to debate issues on the board agenda with the group chair — an effective way of tapping into ideas and concerns circulating well below executive committee level.

Stakeholders benefit from diverse boards

As boards recognize the value of listening to stakeholders — and the risks of not doing so — they are choosing to spend more time with management discussing how to balance shareholder interests with those of other stakeholders. There will be times when these interests collide, leading to uncomfortable trade-offs.

We believe that the more diverse the board, the more thoughtful and effective it will be in weighing competing interests. And there's no question that boards are becoming more diverse. Research for the 2021 *US Spencer Stuart Board Index*, for example, has found that nearly three-quarters of new directors appointed to S&P 500 boards are women and/or belong to a historically underrepresented racial or ethnic group, up from 31% a decade ago. Having a range of backgrounds and experiences around the table is bound to enhance the board's ability to anticipate the financial and non-financial consequences of its decisions. In an era of activism covering everything from racial equity to decarbonization to biodiversity, boards must seek out people with different mindsets who can represent changing views about the role of business in society. But equally important, boards must first ensure that the mechanisms are in place to bring stakeholder voices into boardroom debate.

How boards can increase engagement with stakeholders

» Understand the respective roles of the board and management vis-à-vis stakeholders.

» Prioritize stakeholders to decide which are the voices the board must hear from regularly.

» Find ways to gain direct exposure to stakeholder groups. Listen with positive intent to deepen board understanding of different perspectives.

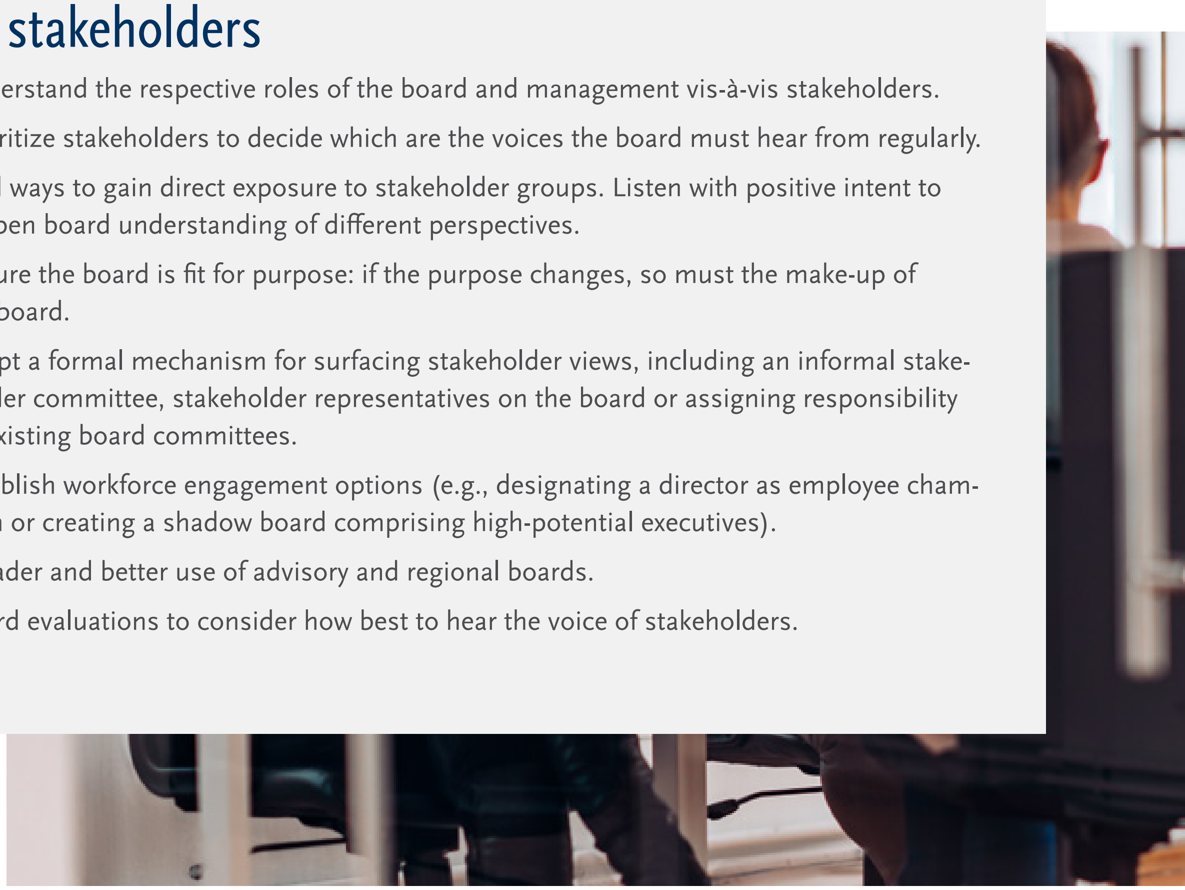
» Ensure the board is fit for purpose: if the purpose changes, so must the make-up of the board.

» Adopt a formal mechanism for surfacing stakeholder views, including an informal stakeholder committee, stakeholder representatives on the board or assigning responsibility to existing board committees.

» Establish workforce engagement options (e.g., designating a director as employee champion or creating a shadow board comprising high-potential executives).

» Broader and better use of advisory and regional boards.

» Board evaluations to consider how best to hear the voice of stakeholders.

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