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THE MULTI-STAKEHOLDER BUSINESS MODEL: REVOLUTIONIZING COMPENSATION AND BENEFITS

The primary focus of business has always been to make a profit. Yet, a new school of thought has recently emerged: What if corporations could also play a role in making positive changes to society and the environment? This question has increasingly gained the attention of investors – so much so, in fact, that a radical new idea has been born. Not only do companies have the ability to enact positive change, but they actually have a corporate responsibility to do so.

Based on the momentum this idea is gaining, forward-thinking business leaders are wondering if perhaps the idea isn't so radical after all. Investors are now more focused than ever on ensuring corporate pay practices reflect the full spectrum of stakeholder interests, and this multi-stakeholder business model is prompting HR and compensation teams to adopt a new framework for plan design. How should you prepare to factor in environmental, social, and governance criteria into your future compensation and benefit plans and policies?

We'll explore this question and more in the coming pages, including:

- A background on corporate social responsibility
- CSR: what it means and who cares about it
- A brief guide to Conscious Compensation®
- What is likely to change in compensation
- How to address inertia and prepare for momentum

First, let's take a look at some of the factors that have brought us to this new era of business.

A Background on Corporate Social Responsibility

According to an HRsoft webinar survey, just over half of HR and compensation professionals polled have read their company's social responsibility report. More than a third - 38% - of participants don't know whether their company has one.

If your company is public, it's highly likely that it does indeed have a social responsibility report. Many private companies do as well. Yet, until recently, corporate social responsibility (CSR) has been considered a "fringe" topic, with only a handful of business leaders talking about it openly. That's all beginning to change. In part, it likely has something to do with the concerns surrounding major corporations' ethical practices, which have made their way into headlines within recent years.

Have You Seen These Headlines?

Many businesses have fallen under scrutiny for questionable pay practices – and, chances are you didn't have to turn to HR journals to see the following headlines:

- Volkswagen caps executive pay after emissions scandal
- Regulators fined Wells Fargo a record $185 million… pressure put on workers to meet inflated sales goals… claws back millions from CEO
- Mylan CEO's pay rose over 600% as EpiPen price rose 400%
- Why Stanford students turn down $150,000 entry-level salaries
- Got Millennials? Workplace perks that attract the next generation of bright workers
- Companies reveal gigantic CEO-to-work pay ratios
- Don't buy into the gender pay gap myth

Indeed, the conversation about HR issues is no longer confined to trade publications. Now, we're seeing these topics featured in front-page headlines – but why? It turns out, these issues have been making their way to the forefront for quite some time. Let's look at some of the historical factors that have gotten us here.

Old Ideas & Newer Debates

In 1970, economist Milton Friedman wrote an opinion piece which was published in *New York Times*. The article's main argument is summed up in its title, "The Social Responsibility of Business Is to Increase Its Profits." This straightforward notion – that the purpose of business is to make a profit and increase shareholder value – was embraced by many companies until very recently.

In the next decade, Dr. F. Edward Freeman issued a rebuttal to Friedman's shareholder theory with his stakeholder theory. He posits that shareholders are only one of many stakeholders in a company, and that the overall stakeholder ecosystem also comprises employees, banks, unions, and other groups. Lynn Stout argued a similar point of view in her book, *The Shareholder Value Myth*. She emphasized that a company's board of directors is not legally required to *only* increase profits; rather, they can maximize any stakeholder group's value.

We truly began to see this shift gaining momentum when prominent CEOs started to share their perspectives on the matter. Paul Polman, CEO of Unilever, shared his thoughts in 2012, stating "I don't think our fiduciary duty is to put shareholders first." The controversial argument was taken a step further when Virgin Group CEO Sir Richard Branson added his two cents, saying, "…if you can put staff first, your customer second and shareholders third, effectively, in the end, the shareholders do well, the customers do better, and you yourself are happy."

Of course, these were unpopular opinions at the time – these statements certainly don't fall under things CEOs are "supposed to" say. Thus, the debate was still largely perceived as a fringe topic until January 2018, when BlackRock CEO Laurence Fink joined the conversation. With over $6 trillion in investments managed, BlackRock is the largest asset manager in the world. Fink issued a letter to CEOs, encompassing the following points:

- "Society is demanding that companies, both public and private, serve a social purpose…"
- "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."

Later that month, BlackRock Vice-Chair Philipp Hildebrand echoed the CEO's sentiments on a panel with Al Gore for the World Economic Forum, saying simply, "We have to change capitalism." Gore agreed, saying that "companies that integrate ESG factors into their business plans perform better."

Society is demanding that companies start paying attention to ESG (environmental, social, and governance) factors. And, if it hasn't already happened in your company, at some point someone will ask how you're integrating ESG factors into your HR strategy. By familiarizing yourself with the subject now, you can prepare to have that conversation when the time comes. Part of your preparedness will also depend on your ability to understand the different names and meanings for corporate social responsibility, which brings us to our next point.

CSR: What It Means & Who Cares About It

CSR is a frequently-used umbrella term, but there are many variations you may hear. ESG is one we've discussed already, but here are some other words or phrases you may encounter when the subject is approached:

- Sustainability
- Corporate responsibility
- Triple bottom line
- Creating shared value
- Corporate accountability
- Responsible investment
- Responsible business
- Corporate sustainability
- Corporate citizenship

Your company could even have its own name for its CSR report, but more importantly, its contents should reflect all of the beneficial ways it impacts society. In some companies, the report may be just a few pages, while in others it could be 100 pages or more. Yet, having something in place to showcase the company's societal contributions is becoming increasingly important, as a number of groups are developing an interest in it.

Who Cares About CSR?

Shareholders are beginning to put CSR-related proposals on the ballot in an attempt to link sustainability to executive pay. Nonetheless, most of these proposals currently get voted down and receive 20% approval on average. CSR therefore has yet to be considered mainstream when it comes to shareholder resolutions, and we continue to see boards recommending to vote against these proposals.

While it's true that the percentage of companies integrating CSR into their pay practices may still be in the single digits, the trajectory we see suggests that this could change dramatically in the coming years.

In fact, while there has been a growing emphasis on talking about conscious capitalism – including the book by that title written by Whole Foods CEO John Mackey – there has been little focus on how CSR affects compensation. If you're going to incorporate CSR into your organization, will you pay people consistently with these principles? This question is in part what led to the development of Conscious Compensation®.

What is Conscious Compensation®?

Conscious Compensation® helps companies move from the traditional, capitalist approach to compensation towards practices that are more socially responsible. For decades, traditional capitalist compensation has been characterized by the following:

- Base wage or salary
- Merit-based salary increases
- Annual incentives
- Primarily financial metrics
- Stock-based compensation focused on executives
- Graded annual vesting
- Increasing cost to employees for benefits
- Primarily self-funded retirement; 401(k) with match
- Executive supplemental benefits and perks
- Top-down performance review

Yet, many of these characteristics are at odds with the emerging demand for a more socially and politically correct approach to compensation, which encompasses:

- CEO pay caps at a multiple of the lowest-paid worker
- Living wage levels
- Employer payment of all benefits costs
- Employer-funded pension
- Employee profit-sharing
- All-employee equity participation
- Employee ownership
- Length of service/seniority as basis for pay increases

To bridge the gap, Conscious Compensation® invites companies to explore the ways in which they could improve their pay practices without sacrificing profits and without overreacting to perceived societal trends and short-term political hiccups. For instance, it encourages periodic distributions instead of annual incentives, because even though annual financial statements are required for businesses, compensation doesn't have to operate within the same time frame. It could also encompass 360-degree performance reviews instead of reviews that are exclusively top-down, the same benefits and perks for all employees, stock-based compensation for all employees, and stakeholder-driven metrics, among other design elements.

The following 12 ideas act as the foundation for Conscious Compensation®:

- Based on multi-stakeholder value creation
- Scalable and sustainable across organization growth cycles
- Easy to understand for all stakeholders
- Not a transaction-dependent or exit-dependent
- A balance between organization need and worker preferences
- Not driven by accounting's calendar-based cycles
- Equitable, but not always equal
- Affordable but generous
- Team-based by individualized
- Transparent but confidential
- Efficient to administer
- Linked to information, education, and empowerment processes

While these 12 ideas are the factors on which a robust and conscious compensation plan can be developed, the overarching principles can be summed up into three key points:

Organization Sustainability

If the organization is providing societal value, it has to continue to operate to exist to provide that value. This holds true even if the company is acquired or any other significant changes take shape; it must still deliver benefits to society. A key concern when a conscious company is acquired by a larger company is whether the acquired company will be allowed to pursue its original mission. This was exemplified by Ben & Jerry's acquisition by Unilever in 2001. In 2018, the same questions are being raised by Amazon's acquisition of Whole Foods Market.

Employee Primacy

Employees deliver the value to the business, even as developments in machine learning, robotics, and artificial intelligence are made. To drive this point home, consider asking yourself: If no employees showed up to work, could the company still function? This is viewed by some as being in direct conflict with the emphasis on shareholder value while other companies believe that by putting employees first, increases in shareholder value naturally follows.

Performance-Based Outcomes

A company must perform well financially, especially in a global market. Yet, performance is broadly-defined and does not just refer to total shareholder return. The myth that "as long as the share price is good, everyone is happy" should be confronted. It will become increasingly important that companies also perform well socially and environmentally.

Of course, the transition to Conscious Compensation® isn't going to happen overnight. In the following section, we'll discuss some of the changes that will take shape in compensation as more and more organizations begin to embrace the multi-stakeholder business model.

What Has to Change?

To accommodate the changing landscape of compensation, it's likely we will begin to witness some significant casualties over the next few years. Keep in mind that these are only predictions. With that said, being mindful of the possible shifts you could face in advance will give you the time needed to prepare and be agile in making any necessary updates to your compensation plan.

Possible Compensation Casualties

- **3-year TSR "long-term" plans**
  Most investors do not have a timeframe of three years, and in fact, high-frequency investors typically hold shares of stock for less than a minute. More than half of stock market trades are conducted this way. Conversely, pension funds and insurance companies my need to have a 30-year timeframe, so three years is a very artificial time frame.
- **Actuary-designed Long-Term Incentive (LTI) plans**
  LTI plans that require actuaries to design wind up being incredibly complex. Oftentimes, executives don't understand them, and employees certainly don't either. It will therefore be of no surprise if companies begin to move away from these types of plans as simplicity and transparency increase in importance and more stakeholder groups scrutinize the plans.
- **Change-in-control provisions**
  When everything is vested right away upon a company being acquired, there is a greater incentive to sell companies. Thus, change-in-control provisions may be addressed to reduce the incentive to single-mindedly focus on selling the company instead of operating an ongoing concern pursuing a social or environmental mission. We have already seen the beginnings of this as some companies have implemented change-in-control provisions that do not vest 100% of outstanding grants but only a portion.
- **Survey data-driven decisions**
  Surveys are backward-looking and therefore don't fit modern, future-focused compensation practices. They tell us what companies did a year ago but not what they're doing now, which is important considering how rapidly compensation is changing. Survey data can be a form of inertia – if few or no companies engage in a practice, the decision may be not to pursue that practice as it is not the "market norm" though it may be fast becoming such.

- **Annual executive incentive plans**
  Annual executive incentive plans have become a big part of executive pay, but contribute to "short-termism." They also make may encourage companies to manipulate financial results. Given that the rationale for substantial long-term incentives for executives is their effect on the long-term success of the company, annual incentives should be drawn into question.
- **Salary ranges that are +/- 20%**
  Research shows that the most productive workers are five to ten times more productive than average workers. Why, then, are we only paying them 20% or 40% more? Already, we are seeing these salary ranges change, and it's likely they will continue to do so.
- **Survey-based target and max incentives**
  Similar to the point mentioned above, what happens to employees who increase their output beyond maximum incentive performance levels? Companies may move away from survey-based target and maximum concepts to address these issues.
- **Individual merit salary increases**
  Of the casualties on this list, individual merit salary increases are likely to die soonest. Spending weeks or months deciding how to allocate 3% merit increases – especially if a large percentage of the workplace gets promoted and receives a significant increase thereafter – is no longer an effective practice.
- **CEO pay ratio disclosure**
  While there is a current focus on this at the moment, the media will soon find something else on which to focus their attention. We've seen that the most correlated factor in significant pay ratios is the size of the company in terms of the number of employees. Thus, larger enterprises will inevitably have higher CEO pay ratios than smaller companies. Already we have seen media attention switch from the pay ratio itself to the median pay level against which CEO pay is compared. In 2018 we saw articles comparing the median pay at companies such as Alphabet, Netflix, and Twitter with those at Intel, Tesla, and IBM. This is not meaningful, but feeds into the current sociopolitical dynamic of pay equality.

- **Over-engineered sales incentive plans**
  Compensation professionals tend to have no power over the incentive plans designed by line managers and sales groups. Yet, without compensation experience, these parties tend to over-engineer plans. To facilitate simplicity, more companies will likely force out complex sales incentive plans. One technology company has a lawsuit pending that began in 2009 because the sales incentive plans are so complex the company is unable to calculate employee commissions.
- **"Employee communications"**
  Employee communication is a broad topic in compensation. If we're only communicating *to* them, we're not doing anything to truly educate and empower our employees. Generation Z and Millennial workers want to be empowered and educated on how the business works. To get messages across, information must appear on the first screen on a phone, as most audiences won't scroll down. TLDR ("too long, didn't read") is a common response to employee communications that are wordy and top-down.

While it's probable that at least some of these changes will begin to occur soon, like many forms of change, they will be met with a certain degree of inertia at first.

Inertia & Momentum

ESG is a topic that continues to be on investors' radar worldwide. The companies who will be the first to respond are those who have fallen under direct scrutiny on safety and environmental issues. Yet, there are still many business leaders who do not perceive it as a top-level priority. Thus, they may approach it simply as the next box to be checked, squeezing ESG metrics into plan designs with their existing TSR and profit focus. Moreover, most HR and compensation people haven't yet heard about ESG and researchers are concluding that it's not prevalent.

Nonetheless, the force of momentum surrounding ESG factors is growing stronger, and it's only a matter of time before it reaches your company. Attention to these factors among investors has moved from a nice practice to a majority practice – it gets the attention of the Board of Directors and there is a growth in number of shareholder proposals. Proxy advisers have incorporated these concepts into their criteria, and companies will begin to add low-weighted ESG metrics to annual and long-term plans, rapidly changing the "prevalence" data. And, like investors, employees are also looking for these factors and including them in their assessment of the value of employers.

It will take many years to integrate broader plan design changes, but because there is convergence with other corporate governance concerns, these shifts may happen than we think. Income inequality and diversity are increasingly being added to ESG criteria and add a socio-political aspect. Thus, ESG is no longer just a fun, buzz-worthy topic, but one that is very real and demands attention from HR.

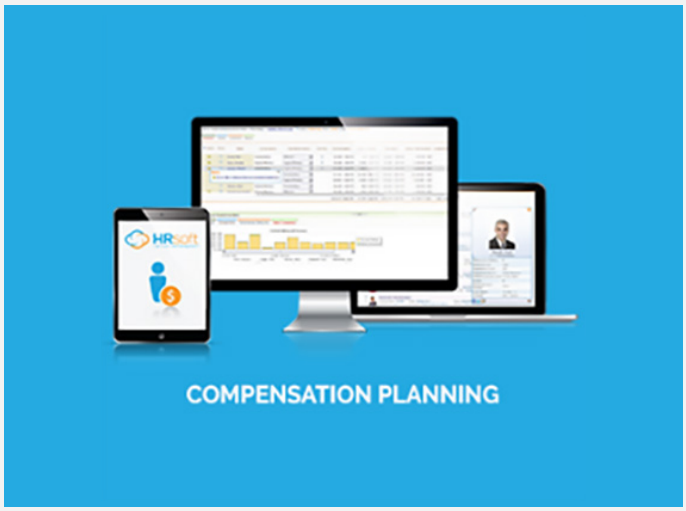
Summary

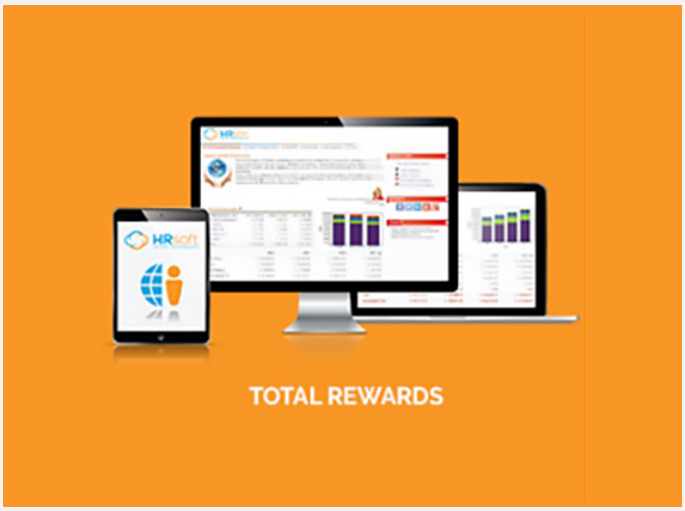
While the multi-stakeholder business model is still new, significant change is on the horizon. Thus, the companies that stay ahead of this change will fare best in terms of meeting the expectations of employees, investors, and other stakeholders.

To review some of the points discussed in this guide, here is a brief summary of key takeaways:

- While the focus on ESG topics may seem radical and new, we have been moving towards the multi-stakeholder business model for quite some time. Recent headlines have sparked conversations on how capitalism could improve to become more socially and environmentally responsible.
- There are many names for CSR/ESG, but no matter what you call it, your company should have a report that details the ways in which it's contributing to society. Shareholders are beginning to take an interest in CSR, as are employees.
- Conscious Compensation® helps companies adopt pay practices that are more socially and politically correct. It is based on organization sustainability, employee primacy, and performance-based outcomes.
- In order for CSR factors to emerge in business, some compensation casualties must occur. In general, compensation will take a more future-focused approach, complex incentives are likely to disappear, and employee communication strategies will be refined to empower and educate the workforce.

Finally, although there is widespread inertia at the moment, it is just the calm before the storm. ESG factors are converging with corporate governance, and companies must be ready to adjust their compensation plans to reflect these new demands for attention to socio-political and environmental concerns. It will likely take years for these changes to be fully realized, but gearing up for change is what will set your company up for success in the new multi-stakeholder business landscape.





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