Examining the Impact of SEC Guidance Changes on CEO Succession Planning

By Edward Ferris and Justus O’Brien

In an October 2009 release, the United States Securities and Exchange Commission effectively removed the ordinary business exclusion defense used by companies reluctant to disclose their CEO succession process to shareholders. The policy change allows for a new wave of corporate governance scrutiny, as regulators and shareholders increasingly focus on CEO succession practices. Companies and boards would do well to prepare.

Reports from the last few proxy seasons have been showing an increasing interest by institutional investors and activist shareholders in enhanced disclosure on succession planning, including a more detailed corporate policy on how leadership transitions will be handled as well as a description of allocated resources.\(^1\) Previously, though, aside from a few sporadic cases in which a company voluntarily agreed to meet some of its investors’ demands, the SEC had been dismissing these proposals based on “rule 14a-8(i)(7), as relating to [the company’s] ordinary business operations (i.e., the termination, hiring, or promotion of employees).”\(^2\) On this ground, corporations have been excluding the proposals from proxy statements.\(^3\)

On October 27, 2009, a Staff Bulletin (SLB 14E) announced that, in principle, the commission no longer allows companies to exclude these types of proposals based on such arguments.\(^4\) In reversing its position, the SEC acknowledged that poor CEO succession planning constitutes a significant business risk and raises a policy issue on the governance of the corporation that transcends the day-to-day business of managing the workforce.

The change indicates that regulators have reframed CEO succession as a risk management issue and placed its responsibility firmly in the boardroom. Succession planning responsibilities are redefined as “a key board function” and “a significant policy
(and governance) issue … so that a company is not adversely affected by a vacancy in leadership."5 Details are sparse, but the implications seem clear: boards will have to set more specific standards and requirements for CEO succession, take responsibility for results, and exercise discernable independence in the process.

Against this backdrop, this report seeks to answer three questions:

• What is the likely impact of this policy reversal?
• How will it practically affect the board?
• What should shareholders know about CEO succession plans, and why?

What Is the Likely Impact of This Policy Reversal?
Traditionally, changes in the leadership of U.S. public companies have been led by senior management—the chief human resources officer and the CEO, with the latter taking specific ownership of the CEO succession process. Boards generally play a role, but it is often limited to meeting candidates brought to their attention by senior executives—for example, through staged business briefings and field trips. If external candidates are being pursued or considered, the role of board members typically consists of briefing executive search firms on the job description and expected qualifications and participating in pre-selection and selection. Even though it is the board that makes the final decision on who gets appointed, such decisions tend to take place within a framework determined by senior executives.

In many cases this process works well. But because it is management-led, critics maintain that it does not have sufficient checks and balances to assure shareholders of its objectivity and effectiveness in identifying the best candidate. The Laborers’ International Union of North America (LIUNA)—longtime advocates of greater disclosure on succession plans to companies such as Whole Foods, Black and Decker, EBay, and Citigroup6—call it an issue of “corporate accountability and reform” and view the SEC guidance change as “another tool [for shareholders] to hold Wall Street corporations accountable.”7 (See also “A Case in Point” on page 3).

Author Recommendations: Seven Reasons Why Shareholders Should Care about CEO Succession Planning

1 Studies show that externally hired new CEOs are often paid significantly more than internally groomed ones.a Hiring externally may be more prevalent in companies without, or with poor, succession planning processes.
2 Poor CEO selection leads to turnover that is costly and disruptive.
3 Having effective executive development and succession processes in place is a prerequisite for grooming CEO candidates internally.
4 Gaps in leadership brought about by emergency situations or unplanned change are detrimental to reputation, performance, and value.
5 Good CEOs bring long-term value—therefore it’s important to have the best possible CEO in place. Effective succession planning helps companies to find him or her.b
6 CEOs tend to achieve more in the first half of their tenure; boards that manage succession well can prevent scenarios where CEOs stay in place past their peak effectiveness.c
7 Ensuring independent oversight and an effective process for such a strategic policy and risk matter is just good governance.

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a For a discussion of internal/external CEO compensation comparisons, see Tonello et al., “CEO Succession Planning,” in Tonello, The Role of the Board in Turbulent Times p. 32.
c Claudio Fernández-Aráoz, Managing CEO Succession, Egon Zehnder International, (“Returns to shareholders…are significantly lower in the second half of CEO tenure regardless of whether the CEO was forced to leave or whether it was a regular transition, where the CEO retired or left for another job”), citing data by Booz Allen Hamilton.
A Case in Point: Whole Foods Markets

In recent years, LIUNA has filed multiple proxy requests for major corporations to disclose their succession planning process. They were all systematically excluded from shareholder vote by senior management invoking Rule 14a-8 under the Exchange Act. Since the announced change in SEC guidance on the rule, a new wave of proxy requests is in the works; some have already been filed. The recent exchange among LIUNA, Whole Foods Markets, and SEC staff illustrates the types of implications that the policy reversal is expected to produce on a larger scale, beginning with the 2010 proxy season.

In late September 2009, LIUNA filed a proxy proposal on succession planning at Whole Foods “in order to promote a governance system at the Company that enables the Board and senior management to manage the Company for the long-term” and requested that the company “adopt and disclose a written and detailed succession planning policy, including the following specific features:

- The Board of Directors will review the plan annually;
- The Board will develop criteria for the CEO position which will reflect the Company’s business strategy and will use a formal assessment process to evaluate candidates;
- The Board will identify and develop internal candidates;
- The Board will begin non-emergency CEO succession planning at least three years before an expected transition and will maintain an emergency succession plan that is reviewed annually;
- The Board will annually produce a report on its succession plan to shareholders.”

LIUNA supported its request by citing a best practices study by the National Association of Corporate Directors (NACD) on CEO succession and a report by the Hay Group on board governance and effective human capital management.

On October 5, 2009, Whole Foods asked the SEC to concur in your view that WFM may exclude the proposal under rule 14a-8(i)(7). In arriving at this position, we note that the proposal focuses on the significant policy issue of CEO succession planning. Accordingly, we do not believe that WFM may omit the proposal from its proxy materials in reliance on rule 14a-8(i)(7).

On March 8, 2010, a LIUNA proposal on CEO succession planning adoption and disclosure received almost 30 percent support from Whole Foods’ shareholders. Although the measure was defeated, this was a significant level of support for a first-time ballot proposal.

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b See, for example, Beverly Behan, “Shareholder Activists Target Succession Planning,” Business Week, January 15, 2010.

c To follow the correspondence, visit the SEC website (www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/centrallaborers11009-14a8.pdf).


The disastrous consequences of poor succession planning cannot be overstated. Business literature contains many examples of companies that destroyed shareholder value through their inability to manage leadership transitions. Indeed, in one recent study, of 22 identified areas where companies have faced “a crisis,” the majority were associated with CEO succession/resignation.

In the October 2009 bulletin, the SEC explained the decision to revisit its policy on this matter by stating that “recent events have underscored the importance of [CEO succession planning] to the governance of the corporation,” without specifically identifying which situations prompted its reconsideration. In the last few months alone, business commentators have reported on:

- the intense scrutiny of the succession processes at Bank of America, GM, Marks and Spencer, and ITV;
- concerns over Steve Jobs’ health at Apple;
- the departure of potential successors at McDonalds and Avon for health and career reasons, respectively;
- the emergency transition at Lazard; and
- speculation over Jamie Dimon’s future.

As the following statistics indicate, boards of U.S. public companies still have a long way to go when it comes to proper oversight of CEO succession:

- Forty-two percent of companies have no CEO succession plan.
- Forty-six percent of successions in 2008 were unplanned.
- Forty percent of companies are not prepared for an emergency succession.
- Forty-eight percent of directors currently see CEO succession as the sole responsibility of the CEO.
- More than 60 percent of companies report that the CEO recommends his/her successor.
- Fifty-seven percent of directors say that they do not know when their CEO plans to step down.
- Only 16 percent of directors believe their board is effective at CEO succession planning.

The most recent developments in SEC guidance fully elevate CEO succession to the status of a core board responsibility, along with audit, governance, executive compensation, and other traditional board functions. Given the empirical data illustrated above, for most companies this will require structural, process, and disclosure changes even in the best of circumstances. While it is likely that the actual operation of succession planning will remain managed by company executives, the involvement and oversight role of the board will intensify.

Suddenly undertaking such new responsibility could be problematic. Corporate board duties have changed significantly since the passage of the Sarbanes-Oxley Act of 2002, which...
resulted in a significant expansion of the scope and intensity of directors’ workload. After the Sarbanes-Oxley Act, the New York Stock Exchange and other self-regulatory organizations have adopted rules assigning to the nominating and governance committee formal responsibilities with respect to the evaluation of management. However, the fact remains that most boards have been performing an ancillary role in succession planning and will now face the need to expand their involvement and stamp their authority on the process, and not only on the outcome.

Some commentators suggest that we are at an inflection point in the evolution of corporate governance and that boards of directors will increasingly be required to demonstrate that they are integrating governance decisions with business strategy, sustainable economic performance, and long-term value creation. Discussion and disclosure of CEO succession is part of this transformation. Boards should welcome the opportunity to explain to shareholders how their decisions advance strategy and pursue long-term growth.

In this new context, companies that set the benchmark are likely to become the benchmark. Those that seize the opportunity to engage shareholders and reassure them that the company has a process to properly manage CEO succession will build confidence and deepen relationships. Those that hold the view that shareholders need to back off and let the managers manage may be storing up longer-term antagonism that will become problematic.

Staff Legal Bulletin No. 14E (SLB 14E) is a relatively gentle way to raise awareness of the importance of board oversight of CEO succession. Much like majority voting and “say-on-pay,” it could rapidly evolve into a set of mainstream practices. (See “Mainstreaming: The Recent Adoption of Majority Vote Provisions and Executive ‘Say-on-Pay’ Policies” on page 6.) Companies should prepare themselves for this eventuality.

It seems inevitable that boards will need to be more deeply involved in the way CEO succession planning is managed by the corporation to ensure, independently and objectively, that candidates emerging through the pipeline are being effectively prepared for and are ready to assume the top job. No longer will it be sufficient to conduct an annual review (a.k.a. management presentation of viable candidates) or gear up a year in advance of a planned transition. Instead, board succession planning responsibilities will necessarily become an ongoing process of oversight and accountability. This is not only because of the SEC guidance reversal but because of the context that underpins the change, including recent CEO underperformance, consistently high levels of executive derailment, increasing shareholder scrutiny of CEO succession practice, and growing governance concerns about inadequate process and lack of independence oversight. All these considerations combine to suggest that CEO succession has been reframed as a business risk issue and that its process oversight will become an increasingly important board responsibility in the future.

While a broader purview will therefore likely emerge, these new accountabilities should, discharged judiciously, enable the board to effectively oversee the corporate succession process to a degree that should satisfy shareholders and improve the quality and independence of the process. Companies and boards would do well to acknowledge the winds of change and, over time and without shareholder confrontation, begin to enhance succession planning practices and disclosure. In this way, they are controlling the communication process rather than reacting to it. Those companies without a robust process should set about building one. Those with a robust process should enhance independent director oversight and proactively share a summation of their process with shareholders.

How Will SLB 14E Practically Affect the Board?

Best-practice CEO succession planning is a combination of process and substance. To ensure that succession planning produces its desired outcome, board members should not only establish a well-designed process but also make sure that the substance of that process focuses on the right issues with sufficient depth and rigor. This consideration applies, in particular, to such critical areas as defining role requirements, executive development practices, candidate assessment, and external benchmarking. Boards that work with management to conscientiously address the substance of the process, rather than perfunctorily checking off its steps, will insulate themselves from charges of laxness in CEO succession planning. Most important, they make sure that the board’s most critical decision—choosing the chief executive—is successful.
Mainstreaming: The Recent Adoption of Majority Vote Provisions and Executive “Say-on-Pay” Policies

Shareholder proposals relating to the annual disclosure of a company’s CEO succession plan may gain more and more support from shareholders, ultimately resulting in the widespread adoption of the practice by many corporations. Here’s a look at two other hot issues promoted by shareholder advocacy groups over the past few years. What happened with them provides a precedent for the potential evolution of SLB14E into a common practice.

Majority vote provisions
Since Pfizer first announced its groundbreaking change to a plurality-plus-resignation policy in 2005 and Intel Corporation adopted a majority vote by law in 2006, there has been a significant trend in this direction. That translates into an increase in the number of shareholder proposals requesting boards adopt a bylaw provision requiring directors to submit their resignation if they are unable to obtain a minimum of 50 percent of the votes cast for them.

Before 2005, most directors of U.S. public companies were elected by a plurality of votes cast. Based on the system of plurality voting—the default method under Delaware law—the election is won by those nominees who receive the highest number of affirmative votes. The plurality voting system permits a director nominee to be elected with only one affirmative vote, even if several million withheld their votes. In companies that have adopted the majority vote requirement for directors, nominees are instead typically required to receive the affirmative vote of at least 50 percent of votes cast to remain in office for another term. Today, majority voting for the election of directors has become the prevailing standard by large companies, with more than 50 percent of the companies in the S&P 500 adopting some form of the policy.

Executive say-on-pay policies
“Say-on-Pay” is the term used by proponents of a policy enabling shareholders to have the right to an annual vote on the remuneration of executives. In 2006, the American Federation of State, County and Municipal Employees (AFSCME) sponsored several shareholder proposals calling on boards to adopt a policy providing an annual advisory vote on the issue. Since then, there has been a strong national trend toward the corporate adoption of say-on-pay policies, underpinned by unprecedented support from both the U.S. government and shareholder rights advocates.

Say-on-pay proposals averaged about 39 percent favorable votes in 2007 and passed at Verizon (48 percent for, 47 percent against), Motorola (52 percent for, 44 percent against) and Ingersoll Rand (55 percent for, 42 percent against). In 2009, an average 43 percent of shareholders voted favorably for the proposals at 67 companies and 16 of those businesses received a majority of votes requesting that they adopt the policy.

Table 1
Majority Vote Proposals Submitted by Shareholders Since 2005

<table>
<thead>
<tr>
<th>2005</th>
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<th>2007</th>
<th>2008</th>
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<td>127</td>
<td>80</td>
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<td>Shareholder proposals “withdrawn”*</td>
<td>24</td>
<td>48</td>
<td>90</td>
<td>56</td>
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<tr>
<td>Shareholder proposals voted</td>
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<td>87</td>
<td>37</td>
<td>24</td>
</tr>
<tr>
<td>Shareholders voting “for”</td>
<td>43%</td>
<td>47%</td>
<td>49%</td>
<td>50%</td>
</tr>
<tr>
<td>Shareholders voting “against”</td>
<td>55%</td>
<td>51%</td>
<td>49%</td>
<td>50%</td>
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* Shareholder proposals are typically “withdrawn” when the company agrees to include the proposal in their proxy materials.
Source: Georgeson, December 2009.

Table 2
“Say-on-Pay” Proposals

<table>
<thead>
<tr>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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</thead>
<tbody>
<tr>
<td>Shareholder proposals submitted</td>
<td>61</td>
<td>79</td>
</tr>
<tr>
<td>Shareholder proposals “withdrawn”*</td>
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<td>Shareholders voting “for”</td>
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<td>39%</td>
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<td>Shareholders voting “against”</td>
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Source: Georgeson, December 2009

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b For references to legislative initiatives and voting policies by major shareholder groups, see Mattiello, Corporate Governance Handbook: Legal Standards and Board Practices, The Conference Board, Research Report 1450, p. 76.
**Dedicated board committee**

The board should begin by establishing a succession planning charter that details core responsibilities and process and integrates them into the board’s calendar and agenda. The lead director and the members of the governance committee should then determine the composition of a dedicated succession planning committee that will oversee the process. Directors who are given these responsibilities should have experience and competencies in executive development and selection or be provided with sufficient training in those areas. The board may also consider engaging external advisors who can monitor the executive development and succession process on its behalf. This will ensure that those with the talent to lead the company get the developmental opportunities and experiences necessary to prepare them for the role. It will also guarantee that job specification, external talent market mapping, and candidate assessment processes are undertaken with rigor and expertise.

**Job specifications: experience, competencies, and personal characteristics**

Through interviews with key stakeholders, including all of the members of the board, the company should detail the specifications for the next CEO, taking into account alternative transition time horizons. Those time horizons should include anticipated transitions as well as emergency situations, so that the board can maintain an emergency CEO succession plan that can be implemented immediately and minimize disruption. The CEO specification should include the competencies that the company’s strategy will require, the critical experiences the next CEO should have, and the personal characteristics that the CEO will need in order to succeed.

The strategy and business challenges will of course differ from industry to industry, company to company, and within companies, depending on the time frame of the transition. Because the permutations of strategy, especially relative to differing time horizons, can be nearly inexhaustible, it is all the more important that the board reach agreement on precisely what their company’s strategy is likely to be in various time frames.

**Experience** With aligned views of the company’s future in hand, the board can then determine what experiences are likely to make a candidate the right person for the job. Is international experience—such as global P&L responsibility or building markets in Asia—required? What industry sector experiences and functional experiences are necessary in a candidate? What business challenges handled by the candidate will prove important for the challenges ahead? These could include: driving performance improvement, leading a substantial change program, pursuing a growth agenda, leading a large division or company, building organizational capability, and numerous others, again depending on the company’s projected circumstances.

**Competencies** Experience—what someone has done—is only part of the specification. Leadership competencies—what someone is capable of doing as a leader, as demonstrated by past accomplishments and results—are equally important. The board should clearly determine what leadership competencies are most important for the company’s needs as well as the proficiency level required for each competency.

**Personal characteristics** The specification should also include desirable personal characteristics of the next CEO that will fit with the culture of the enterprise and/or be required to lead the company in pursuit of future strategies and business goals. Does the company need someone who is inspirational? Risk-taking or risk-averse? Decisive? Collegial? Some characteristics, like integrity and energy, will be important in any leader. Others will depend on specific company needs as the board sees them. At the conclusion of this part of the process, the board, the succession planning committee, and the external advisors should have a clear, detailed, and comprehensive profile of the company’s next leader.

By systematically exploring and developing the specifications in each of the above categories, the board can:

- achieve all-important alignment around what the next CEO should look like;
- assure a more orderly process;
- make it easier to reach a final decision when the time comes; and
- create the basis for emerging-candidate gap analyses, executive development, and recruitment strategy and action.
Candidate assessment
Once the full board has agreed on a CEO profile, the succession planning committee and its advisors can establish methodologies to evaluate candidates. These methodologies, which should also include gap analyses, should aim at testing the candidates’ fitness with respect to each dimension of the CEO role. Based on those predetermined methodologies, members of the committee can assess all viable successors, determining each individual’s potential and vulnerabilities. In addition to a recommendation regarding the candidate’s likely preparedness, the assessment process should produce required development actions for each prospect.

Benchmarking
Internal candidates should also be benchmarked against the external market for top executive talent. As part of an ongoing succession planning process, benchmarking does not mean conducting interviews; it means developing a confidential map of external talent and assessing it against the same CEO specifications that have been used to evaluate internal talent. Such benchmarking can:
- tell the board what reasonable expectation it might have of finding candidates who fulfill the requirements;
- uncover gaps in the competencies of the internal candidates that might otherwise have escaped close scrutiny;
- reveal that an internal candidate is as good as, or superior to, the external talent and enable the company to concentrate on retaining that individual;
- inject more universal, objective standards into the process and thereby defuse some of the emotions that are involved when succession planning is restricted to internal candidates;
- provide the board with a means of driving the succession planning process without being contentious; and
- give the board a significant head start when confronted with an unplanned succession or the need for recruiting an external candidate.

Pipeline management
As an ongoing process, best-practice succession planning requires significant talent management and developmental programs to help ensure a pipeline of potential CEO candidates. As part of that effort, the board should work with management to:
- determine competency and experience gaps in emerging candidates and ensure that substantive developmental opportunities are orchestrated to add and test required future capabilities, including unblocking key stepping-stone positions if necessary;
- establish a program of emerging candidate board exposure, performance review, and potential/capability assessment over a multi-year time frame in advance of an expected transition event;
- make sure that executive retention strategies are enacted and sufficient to preserve executive talent that is critical to the succession pipeline;
- determine executive search needs to fill gaps when development will not surface a sufficient slate of qualified candidates in the required timeframe, and/or to benchmark external candidates for capability comparison; and
- directly involve the board in external candidate assessment and selection when hiring executives for whom CEO succession potential is part of the appointment criteria.

Finally, the board should conduct a periodic risk assessment that pertains specifically to CEO succession planning, and implement changes to process and practice to minimize risk exposures.

On-boarding
Following the selection of a new CEO, the board’s oversight and involvement should extend through an extended period of assimilation into the new role—often a period of 12-18 months. “On-boarding” should include stakeholder relationship development, cultural integration, performance expectation-setting, and evaluation. A formal and structured process supported by a director-mentor provides the best approach.
Disclosure
Once directors have agreed to a process, the board should discuss with management the most appropriate disclosure to assure stakeholders that effective CEO succession planning practices and checks and balances are in place. In determining the scope of the disclosure, directors should balance two opposing needs: the need to be transparent and open to engagement with shareholders on critical issues of leadership development and transition and the need to be sensitive to the potential loss of competitive advantage that may result from disclosure.

While these responsibilities and activities will add workload, the costs and potential consequences of continuity gaps and poor transition are sufficient to justify this level of engagement. Once established and managed appropriately, CEO succession planning oversight will find its appropriate workload level in line with other major board responsibilities and accountabilities currently in place.

CEO: A Job Like No Other
Preparation for the unique position of CEO takes careful and personalized developmental action, primarily involving subordinate P&L responsibility and often international assignment and/or span of control, plus specific preparatory experiences—such as board, investor relations, and media exposure experiences that are peculiar to the office of the CEO (few new CEOs emerge from functional roles).

To find, nurture, and develop a person with the capability to lead a company into the future is no small task. It is a major project requiring effective succession planning and executive development over many years. Just like world-class R&D process, succession planning extends from managing an array of possibilities (i.e., multiple talented, ambitious people permeating the executive ranks) through to managing a filtered pipeline of viable candidates in anticipation of a transition event or in readiness for an emergency situation that needs immediate intervention. While the board has no role in the operating aspects of succession planning, it has clear responsibility for assessing the quality and quantity of viable candidates emerging through the pipeline, so as to ensure that leadership continuity risks are mitigated and that the company will have a choice of capable and suitably experienced CEO successors when it needs them.

Moreover, while the current median CEO tenure is eight years, which suggests a reasonable degree of stability, CEO turnover is still 14.4 percent per year, with 46 percent of successions being unplanned. Derailment statistics are alarming—40 percent of CEOs are fired or “retired” within the first 18 months and 64 percent never make it to their fourth anniversary. Considering that, in some markets, the leader effect can account for up to 40 percent of the variance in performance or value, it is little wonder that the current level of board involvement in CEO succession processes is considered inadequate and that shareholder groups are lobbying for better process and more transparency.

\[a\] In 2008, 65.6 percent of new CEOs had previously run a business (18.9 percent of them as CEO of another company, whereas 52 percent had international business experience). See Per-Ola Karlsson and Gary L. Neilson, “CEO Succession 2008: Stability in the Storm,” strategy-business, Issue 55, Summer 2009.

[b] Karlsson and Neilson, “CEO Succession 2008,” which reports that only 15.2 percent had been promoted from a career that culminated in functional leadership, including the CFO position.

[c] Ibid.


[g] In addition to the LIUNA proposals previously referenced, Walden Asset Management has recently filed a resolution that requests Intel’s Board of Directors to “initiate the appropriate process to include in the Company’s Corporate Governance guidelines and policies a written and detailed succession planning policy.”
What Should Shareholders Know about CEO Succession Plans, and Why?

For those companies that discuss CEO succession practices in public disclosure documents, most provide generic boiler-plate language indicating that the process is in place and that the board reviews it on a regular basis. When a CEO transition occurs, a news release typically announces the ensuing change and praises the soundness and effectiveness of the internal process. Rarely do shareholders have the opportunity to understand in more detail how the process works and make an informed judgment on its rigor and effectiveness.

As more shareholder groups focus on the CEO succession processes adopted by their portfolio companies, however, generic language will become increasingly insufficient to satisfy this informational need. With the rise of activism, the intensifying scrutiny on corporate governance practices, and the level of confidence in corporate executives having reached what is perhaps an all-time low, more definitive and detailed disclosure on succession planning will be increasingly important to effective corporate-investor relations.

Before SLB 14E, consistent “no-action” rulings from the SEC allowed companies to hide behind an ordinary business exclusion defense when shareholders asked for more information on CEO succession planning. Companies who favored this position would generally underscore the confidential nature of the topic and maintain that information release into the public domain could harm the corporation vis-à-vis its competitors and possibly have negative effects on the motivation of employees and the ability of the firm to attract and retain talent.

Analysis of shareholder proposals, however, shows that sensitive or competitively damaging information, such as files on specific CEO candidates, are not being asked for. Instead, requests have centered on the establishment, under the supervision of the board of directors, of an effective succession process and the production of an (annual) shareholder report on its main features and its execution.

“We are not interested in telling companies who the CEO should be but we are interested in making sure that boards are paying attention and they are doing succession planning.” Richard Metcalf, LIUNA’s director of corporate affairs, told the Financial Times recently.

The purpose of disclosure should be to reassure shareholders about the independence and effectiveness of the CEO succession planning process as well as the rationale for the company’s choice of CEO; specifically, communications on the latter should elaborate on why the decision is important to the success of the enterprise and the long-term share value growth.

Shareholder Concerns

Meredith Miller, assistant treasurer at the $20.2 billion Connecticut Retirement Plans and Trust Funds (CRPTF), argues that inadequate succession planning can result in high levels of compensation granted to external hires. But it may also be indicative of the reticence of many boards to challenge sitting CEOs. The latter can manifest itself through disproportionate CEO pay slice, over-generous change-in-control/severance provisions, and entrenched management.

CRPTF maintains that “an analysis of the board’s role in succession planning would … be useful in enabling investors to understand how the board manages risk. The [SEC] should require [any company] to disclose whether it has approved and maintains a CEO succession plan and, if it has, to describe the key terms of that plan. Also of value to investors would be disclosure about whether CEO succession planning has been delegated to a board committee, and, if so, which one.” It advocates tying succession planning to CEO and board performance metrics, and disclosing these to shareholders.

As another example, the Council of Institutional Investors (CII)—a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion and “a duty to protect the retirement assets of millions of American workers”—recently revised its corporate governance policies to include CEO succession planning. The revised policy states that a “(corporate) board should approve and maintain a detailed CEO succession plan and publicly disclose the essential features.”

The rationale of the revised policy is described as follows:

“Poor CEO succession planning and inadequate internal development of managerial talent could result in a panicked board vastly overpaying a replacement chief executive. Shareowners would be able to assess the strength and appropriateness of CEO succession plans if the essential features of such policies were publicly disclosed.”
The incremental executive compensation cost concern cited by CRPTF’s Miller and inherent to CII’s policy rationale seems to be supported by recent empirical evidence. For example, The Conference Board has documented the increased costs associated with external CEO hiring.43 Similarly, LIUNA has asserted that “[s]tudies show that companies without CEO succession plans spend more on executive compensation for new CEOs than companies with clearly defined transition policies.”44 Discussions with Jennifer O’Dell, LIUNA Corporate Affairs and CII Deputy Director Amy Borrus confirmed that their organization’s initial interest in issues of CEO succession planning was in response to statistics on the costs of external recruitment. However, both added that, upon further examination of the topic, other factors began to resonate, including the risk and cost of poor executive transition generally.

Corporate Implications
If a company is doing a great job of CEO succession planning, then it behooves the board to tell shareholders about it; openness will prevent them from worrying, wondering, or feeling the need to agitate. Conversely, if a company is not where it needs to be with CEO succession planning and process, then now is the time to focus, because the company is exposed and the lack of a good process will be increasingly difficult to hide.

The checklist below details those disclosures that show that a company has a good process in place, and that independent board oversight is real and sufficient to ensure that CEO succession will be well managed. Armed with such knowledge and reassurance, shareholders can rest easy—at least on this issue. A company that actively embraces SLB14E can demonstrate both good governance and smart shareholder relations’ strategy, which, in most cases, are one and the same.

**Council of Institutional Investors—Best Practice Guidelines for CEO Succession Planning**

1. Discussing CEO succession planning in executive session (that is, without management present) at every board meeting;
2. Dedicating one board meeting per year exclusively to an in-depth discussion of succession plans for the CEO and the top 25 managers, with the discussion based on management-prepared annual reports;
3. Having the top 10 managers make presentations before the board, so that directors can match names with faces and interact with the company’s top talent;
4. Developing and implementing a general philosophy of filling management positions from within;
5. Fostering the development of an internal leadership pipeline by sending promising managers to leadership training courses and by consciously exposing executives to different business sectors and markets;
6. Creating specific committees and processes to provide long-term shareowners an ongoing role in sharing thoughts and concerns on board succession; and
7. Holding an open annual meeting of the nominating and corporate governance committee to gather input from shareowners on succession planning matters.

Ideally, succession planning disclosure should include:

- Assurance that a CEO succession planning process is in place
- Identification of the board committee that is responsible for CEO succession planning, and its charter
- Assurance that the committee members are qualified to oversee the CEO succession planning process
- The frequency with which this committee meets to discuss CEO succession and the process; in general terms, what this review looks like
- The frequency with which the full board discusses CEO succession and reviews the CEO succession plan and process; in general terms what this review consists of
- That the board verifies to shareholders:
  - Assurance that a candidate profile for the next CEO has been developed and approved, and that this profile incorporates qualifications necessary to lead the company’s business strategy in the time frame anticipated
  - That it is satisfied with the quality and effectiveness of the CEO succession planning process, and that a timeframe for CEO succession has been developed and approved
- That viable successor candidates have been identified who are either currently qualified, or who are on customized development programs to gain those experiences and competencies necessary to meet the successor profile criteria within the anticipated time frame; that external searches are underway (or scheduled) to deepen executive bench strength, supplement the CEO succession pipeline, or fill perceived capability gaps, should the board deem it necessary
- That a program of board exposure to succession candidates is in place
- That a CEO selection process has been defined, and that valid measures have been developed to assess and select the next CEO of the company
- That an emergency CEO succession plan has been developed and approved, including the process for immediate appointment and communication of a successor, and how frequently this plan is reviewed and updated

**Endnotes**

2. See, for example, the correspondence between the SEC and Whole Foods Market Inc. with respect to the proposal submitted on September 29, 2008, to the food distribution company by the Central Laborer’s Pension, Welfare and Annuity Fund (www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2008/centrallaborers112508-14a8.pdf).
5. Ibid.

Ibid.

See LIUNA proposal language at Whole Foods, reproduced in “A Case in Point” on p. 3.


See Davis and O’Brien, “Benchmarking: The Misunderstood and Underused Key” (“In some markets, the leadership affect can account for up to 40 percent of the variance in performance or value. For a large US company, the CEO decision has a potential impact on value worth billions of dollars.”)

Lucian A. Bebchuk, Martijn Cremers and Urs Peyer, “Pay Distribution in the Top Executive Team,” Harvard Law and Economics Discussion Paper No. 574, October 2009 (www.ssrn.com/abstract=946303). This study investigates the relationship between the CEO pay slice (CPS)—the fraction of the aggregate compensation of the top-five executive team captured by the CEO—and the value, performance, and behavior of public firms. The CPS “may reflect the relative importance of the CEO as well as the extent to which the CEO is able to extract rents.” The authors’ conclusion is that CPS is negatively associated with firm value. Most particularly that “CPS is correlated with (i) lower (industry-adjusted) accounting profitability, (ii) lower stock returns accompanying acquisitions announced by the firm and higher likelihood of a negative stock return accompanying such announcements, (iii) higher odds of the CEO’s receiving a ‘lucky’ option grant at the lowest price of the month, (iv) greater tendency to reward the CEO for luck due to positive industry-wide shocks, (v) lower performance sensitivity of CEO turnover, (vi) lower firm-specific variability of stock returns over time, and (vii) lower stock market returns accompanying the filing of proxy statements for periods where CPS increases.”


See the Council’s website (www.cii.org/about).


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