

CSUITE

INSIGHT

SUCCESSION PLANNING

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THE ART OF SUCCESSION PLANNING



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THE ART OF SUCCESSION PLANNING

There are fundamental principles involved with succession planning. Even so, addressing the succession-planning challenge can be more art than science.



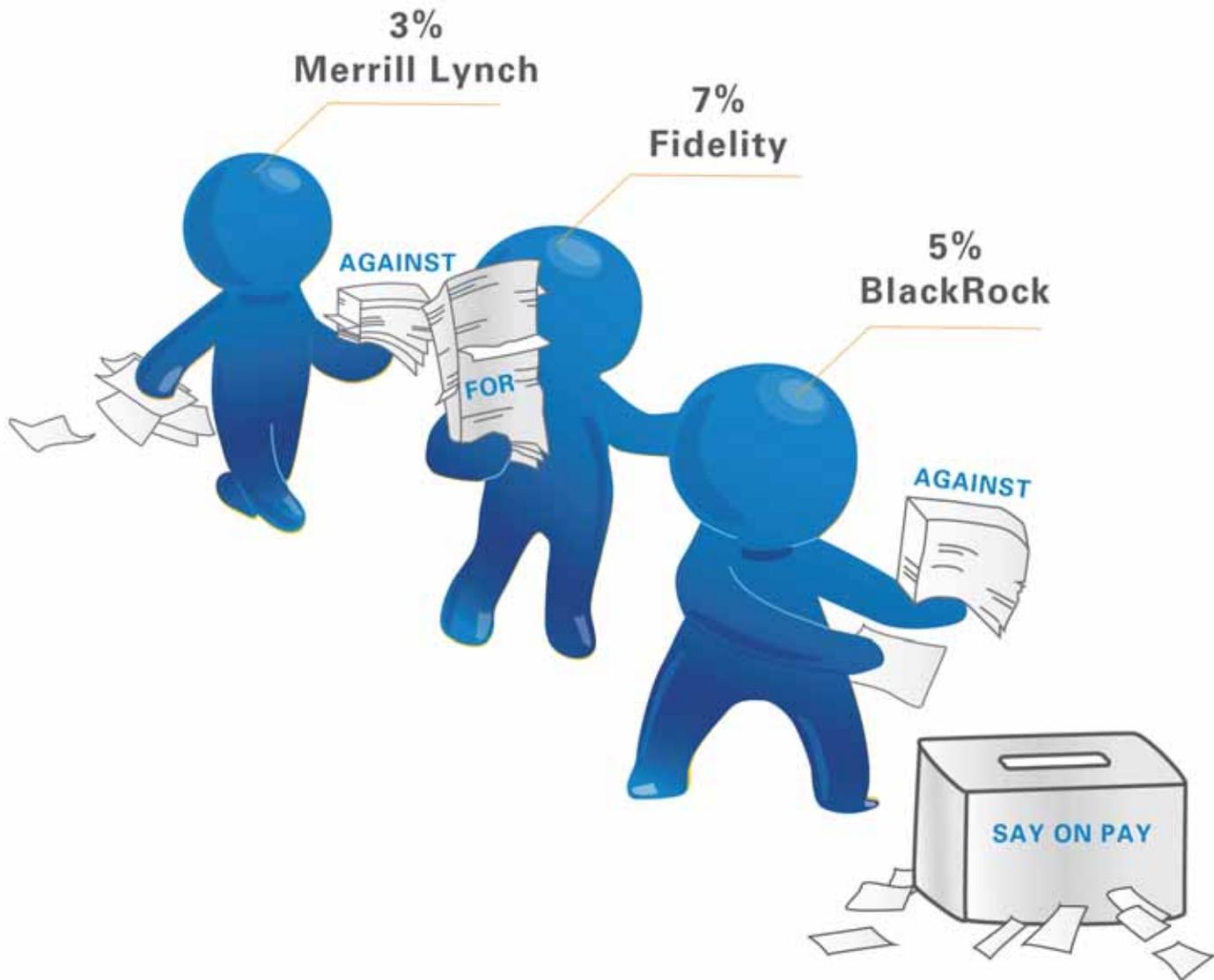
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David has led Equilar from a pure start-up since its inception in 2000 to one of the most respected and trusted names in the executive compensation industry.

PLANNING FOR SUCCESSION SUCCESS

SUCCESION PLANNING IS ONE of the most important tasks boards can undertake, but it is often assigned a lower priority than it deserves. The current issue of *C-Suite Insight* is dedicated to this essential, yet often neglected, topic. Many companies are famous for top-to-bottom, institutionalized succession-planning programs, while others clearly struggle with it.

To begin the conversation, we devoted two features in this issue to the processes that are necessary for solid succession planning. We also interviewed one of the country's leading succession-planning experts, Joe Griesedieck, who serves as Vice Chairman and Managing Director, Board & CEO Services, at Korn/Ferry International.

But succession planning isn't the only topic on our minds. This issue of *C-Suite Insight* marks an expansion in our distribution model to encompass our new Equilar Atlas product, which is designed to assist business development professionals for navigating the C-suite. You don't want to miss our special interview with Sterling Shea, Managing Director and Head of Advisor Programs at Barron's.

This issue also features the voices of institutional investors and academics, including the conclusion of our interview with Anne Simpson from CalPERS, and a discussion with Dave Larcker and Brian Tayan from Stanford University about their book *Corporate Governance Matters*.

As always, I hope you enjoy the magazine, and encourage you to contact me with any questions or suggestions. ■

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The Art of Succession Planning

BY ROGER STRUKHOFF

Stock markets rise and fall, recessions come and go. CEOs, other C-suite executives, and boards struggle to create long-term value while fretting over short-term performance. Markets change, evolve, and disappear. Competitors emerge, fade, get bought out, and sometimes buy others out.

In this daily thrum and chaos of the business world, a very important task often gets forgotten: choosing a successor. The old saying about forgetting that you were hired to drain the swamp is doubly resonant when it comes to succession planning: you also forget that someday, you'll need to hire someone else to drain the swamp.

FUNDAMENTAL PRINCIPLES

Succession-planning discussions are often focused on the CEO, particularly in the case of a charismatic company founder (like Steve Jobs, Fred Smith, or Herb Kelleher) or iconic miracle worker (like Lee Iacocca, Jack Welch, or Lou Gerstner). But the importance of succession planning also extends all the way down an organization. Companies that require all managers to have a plan for a successor are also the ones that will have less trouble replacing key people at the top of the organization chart.

There are some fundamental steps to the succession-planning process in every organization: defining what experience (and possibly education) will be required to fill a role, what internal performance factors are important, where the talent might be located internally (a big challenge in a multinational company), and what training and development programs might be needed for managers on the way up.

This type of process can serve as a sifting mechanism over time, creating a smallish pool of strong candidates for the top jobs. It can be effective, even at the top levels of the organization, for most jobs:

- Consider that all Chief Counsels will be lawyers.
- All CFOs seem, to the untrained eye, to be the same.
- The CTO will, no doubt, be a highly educated engineer.
- The CIO may have more of a business orientation, but will be very well-versed in leading and emerging technologies.
- Although it can be a challenge for a top salesperson to become a top sales manager, the head of sales in an organization will be, in fact, a salesperson.
- Even the COO (whether specifically titled as such or not) will typically be an operations-oriented executive who has risen through the ranks as a floor manager, facility boss, and/or division leader.

A METHOD TO THE MADNESS

A number of competing books, theories, methodologies, and consultants are available, yet no single approach to succession planning has been proven superior to the others over time.

This platitude might be true as far as finding the right CEO is concerned, but is perhaps less true across an organization. Successful CEO succession planning might be likened to the entertainment business, in which a few big hits compensate for a number of less-successful efforts.

The charismatic leader is a staple personality in the business world, and defines most of the superstar CEOs who emerge over time. But this staple can also be a stereotype. A succession of CEOs at Intel over the years have been uncharismatic, yet persuasive, public speakers. Who remembers the great performances of Ray Kroc, or going back further, of Alfred Sloan or Tom Watson Sr. or Jr.? Today, it's tough to imagine a more diffident speaker than Google CEO Larry Page—but who's to say he won't keep the company on its highly successful path?

THE NEED FOR LEADERS

Below the pinnacle, decisions about who should be promoted through the managerial ranks can be systematically driven and codified based on past success. As in the military, most businesses have a very good idea of which lieutenants will make good captains and which captains will make good majors.

One of the most sought-after skills for an executive is the ability to make decisions in the face of contradictory input from equally influential sources. This can be a particular challenge in organizations with any sort of matrix management in place, in which a



manager might be taking specific direction from more than one boss or more than one committee of bosses.

Managers must become leaders if they are to be considered for the C-suite and other top jobs. Leadership can be difficult to define, but it's easy to identify. A good corporate manager will successfully negotiate a "trial by fire" (or several), eventually proving themselves capable of effectively leading teams through difficult challenges.

THEN THERE'S THE CEO

But when it comes to the CEO, the ideal choice can be anyone's guess. No process can be automated to the degree of picking the right candidate from among many, especially for the CEO job. There is simply a screaming uniqueness about that top spot.

Business is not war—even for modern executives who are regularly seen toting copies of Sun Tzu. But a business does have a strong command-and-control aspect to its management structure, along the lines of a military organization. Succession planning is inherent to the military's "up or out" leadership culture, in which only two percent of its top officers are nominated to be generals and admirals.

Even in the tightly controlled environment of the military, however, choosing a top leader is as much art as science. Specific personalities can be the perfect fit one year, and the wrong fit the next. One day, a highly technical background is preferred. The next, sharp political instincts and elbows. The next, a classic warrior.

The same holds true for business. It's easy enough to mock the huge mistakes certain companies have made over the years in choosing their CEOs. It's tougher to be in the position of making this sort of decision. Savvier boards of directors act quickly when it becomes apparent they've put the wrong person in place, even if it's usually because the market is loudly telling them they've made a mistake.

In the wake of the disastrous market crash that brought on the Great Recession, the federal government decided to poke its nose into the issue—or rather, allow shareholders to poke their noses in, in the form of SEC Bulletin 14E (see the related story on page 21). Some of the wording in this regulation opens the door for shareholders, even very small shareholders, to place CEO candidates into consideration.

This sounds like vocal sports fans having a real say in picking the quarterback of the local NFL franchise—a policy of which many sports fans would, no doubt, approve. Just as sports fans provide the revenues for NFL teams, shareholders provide the equity for public corporations to function. Furthermore, picking a winning quarterback can be as perilous and uncertain a task as picking a winning CEO. So why not?

IT'S THE MORALITY, STUPID

Though picking and retaining the optimal CEO attracts the most scrutiny, the most important aspect of choosing a top executive should be ethics and morality, not performance. A bad fit or a surprisingly lackluster

performance from a new CEO is one thing. Criminality is another. It is the stuff of nightmares.

Public companies have been rocked by several large scandals involving criminal behavior during the course of the first decade of the 21st century. Such behavior will no doubt rear its ugly head again somewhere, and sooner rather than later.

To combat this, the federal government instituted two major (and controversial) pieces of legislation over the past decade: Sarbanes-Oxley (SOX), and more recently, the Dodd-Frank Act. *C-Suite Insight* readers are as well-steeped in this legislation as any group of people. It's not a secret that they often find the legislation to be burdensome.

But just as SOX has encouraged board members to pay closer attention to major decisions, Dodd-Frank is encouraging board members to pay closer attention to their CEOs.

A recent Equilar survey, for example, found that 84% of companies in the Fortune 100 now have clawback provisions in place. We can imagine that these policies will be enacted among public companies of all sizes in the near to moderate term. An ugly word for an unpleasant process, clawbacks are intended to reimburse companies and their shareholders for financial restatements, ethical misconduct, and even criminal activity—not simply incompetence or bad luck.

BOTTOM LINE: DOES IT WORK?

There are very few other criteria that board members can apply to their CEOs. One immutable business reality is that a CEO and compliant management team can run a company right off a metaphorical cliff. That's the essence of the risk investors take when they buy stock.

But looking at the very long haul shows that the system works. The United States and other Western nations have built tremendous wealth since the end of World War II. Today, emerging nations from every region of the globe are getting into the game, through the time-tested combination of stable government and capitalism.

There are fits and starts and terrifying moments, of course. One recent example is Thailand, where a period of political upheaval was followed just a few months later by a World Bank upgrade of the country's economy to the middle-income tier.

Meanwhile, the Great Recession and its aftermath seem to have shaken the U.S. to the core. Criticism of what goes on in Washington and on Wall Street is in a steep crescendo at the present moment. The U.S. appears headed for an historic election next year, one in which the issues are clearly defined and in which truly different visions of the future are being presented.

“Succession planning” in the world of politics is a top-of-mind issue for many American voters heading into 2012. As in the military and corporate worlds, this process has a methodology in its early stages, but the final selection is typically more imprecise art than rigorous science. ■



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Should I STAY or Should I GO?

A Look at
Different Types of
Succession-Planning
Challenges

by Roger Strukhoff



Charismatic Founder (Senior Division)

The Challenge: How to replace the face of the company.

Three Stories

Warren Buffett, Berkshire Hathaway

The Oracle of Omaha writes long, amusing, incisive letters. He creates value by buying things and putting the right people in charge of them. He lives in a modest house for a business titan. He's not modest so much as smart, and has been smart enough to pool a lot of candidates to replace him. Plus, he's always had Charlie Munger. The real question is, who will replace Charlie?

Fred Smith, FedEx

Fred allegedly went to Las Vegas to win the money to launch his empire. He used a hub-and-spoke system in the black-swan location of Memphis to optimize the delivery process. Then he improved upon it. He failed with a fax service, but killed it so quickly people forgot about it. Above all, he's an operations meister. His successor's challenge will be to innovate in ways we can't conceive of today.

Larry Ellison, Oracle

The Oracle of Oracle sails boats, flies planes, and buys companies. He's said San Jose will turn into Detroit some day. He's said good blogs are nice, but good products and services are better. He's brutal. Not liked, but respected by some and feared by all. His strongest people always leave. He's not leaving until he's at least 102.

Charismatic Founder (Junior Division)

The Challenge: Same as to the left — but with more time to worry about it.

Three Stories

Larry Page, Google

This Larry is quite different from the one in Redwood Shores. A classic brilliant, shy geek. Modest enough and green enough early on to bring in adult supervision to run the company. But now he's in charge. He's not going to want to leave this job. He's a bad public speaker and would probably prefer to be nose-down into his Droid phone when meeting the President of the United States. But you know, there are a lot of smart geeks around, many with passable social skills. Google will find someone when it's time.

Jeff Bezos, Amazon

One of the World Wide Web's transformational companies, even if the big secret behind the curtain is that Amazon moves a lot of weight over the course of each day. He's stated from the beginning that he wants Amazon to ship everything — and do everything. So now he's selling access to his company's IT power. He smiles a lot and is personable enough, but is maniacal about the business. Who else is this, uh, intense?

Mark Zuckerberg, Facebook

Seriously? He still looks like a teenager and he's in this discussion? Well, what if he burns out? What if he wakes up one morning, suddenly becomes aware of the trappings of the good life, and gets bored? Or what if the government suddenly decides it really needs to get some control over this company? What if a new kid on the block impresses his 750 million users and renders his company the latest casualty of the flavor-of-the-month club? This board had better be seriously, seriously engaged in thinking these questions all the way through.



The Steady Hand

The Challenge: The CEO has kept the ship upright in rough waters — who else can do this job?

Three Stories

Lloyd Blankfein, Goldman Sachs

The most hated man in business today, Blankfein has a penchant for saying brutally true things in a brutally impolitic way. Who else could've stood in the middle of the unceasing storm of the past three years without flinching? He's made it look easy, as if he simply doesn't sweat either the small stuff or the big stuff. Plenty of people have the ego to succeed him; who has the toughness and skill?

Alan Mulally, Ford Motor Company

His name is not in the company logo. His industry has been besieged for more than three decades now. Yet somehow he managed to keep Ford out of the same doom-saying headlines as GM and Chrysler. The challenges never end in one of the most complex of businesses, and a continuing recession will hit his company harder than most. He's not going to make it up selling cars to China and Brazil. Has he had any time to think about who might replace him? Has Ford's board?

James Skinner, McDonald's

The legend of Ray Kroc lives on. But this is not your father's McDonald's. The company's systematized operations and management training have kept it rolling worldwide through numerous recessions and unceasing competitive pressure. Now it's embarking on its latest effort to offer healthier food (to keep activists and the government off its back) while still growing and remaining profitable (to keep shareholders off its back). Tough guy to replace.



Changing of the Guard

The Challenge: An enormous company is facing the future while breaking with its past.

Three Stories

Steve Ballmer, Microsoft

Steve and Microsoft are becoming the Jackie Gleason and Dean Martin of our age. Yesterday's story. The leviathan has \$60 billion in revenue, but who would argue its best days are ahead of it? Its venture into the smartphone market with Nokia hasn't gotten anyone too excited just yet, although things may change if HTC and Samsung get nervous about Google's acquisition of Motorola Mobility.

John Chambers, Cisco

Just what was that Flip video cam fiasco all about, John? You bought a cool, successful product that absolutely didn't fit your mission, then you killed it when it didn't fit your mission? Egad. Cisco has been in the doldrums since its glory days as one of the world's most valuable companies at the height of the dot-com boom. Those days are long gone, even as the company remains strong in its core business and could be a star in the emerging cloud based IT business. John Chambers is often seen as the face of the company, but not as clearly as Larry Ellison and many others. What is his succession plan? If anybody could enhance his legacy by finding the perfect successor, it's him.

Mike Duke, Walmart

Though he's been with the company "only" since 1995, Mike and his job serve as the perfect example of a company that successfully faced up to the challenge of changing the guard. It's also Exhibit A with respect to the trade deficit with China and with how well it takes care of its employees. But we've been hearing the same complaints about Walmart for 20 years, as a non-Walton CEO continues to take the company to new heights.

Uncertain Future

The Challenge: Oh my, there's no Easy Button to be found here.

Three Stories

Mike McCallister, Humana

CEO Mike McCallister grew up with this company; he's been there more than 30 years. When you have people testifying in Congress that you let people die to save money and you are a target of Michael Moore, perhaps your long-time association with the company is not uniformly a good thing. Past is past, and now the company focuses exclusively on health insurance — which happens to be among the most high-profile, controversial issues in business, particularly as "Obamacare" becomes a centerpiece of the 2012 Presidential election.

George Barrett, Cardinal Health

The health-care industry provides high irony today. It's growing faster than most industries and becoming a major new-employment engine, with good jobs that can't be outsourced. But when you literally hold people's lives in your hands, things are going to get hot. By focusing on equipment and pharmaceuticals, Cardinal avoids much of the direct fire. Its stock price has recovered over the course of 2011, but still lags compared to the levels of a few years ago. This is a classic case of "will it or won't it succeed?" Is the CEO going to make it happen or not? Heads or tails?

Lou D'Ambrosio, Sears

On the surface, a company with more than \$40 billion annual revenue looks good. But this is Sears, the long-fading icon of American merchandising. Its sales are about 10% of Walmart's. Its iconic tower in Chicago is now formally known as the Willis Tower, fer cryin' out loud. Who knows, maybe if the print medium continues its modest comeback, the Sears catalog will be cool and hot again, if in a retro way? What would you do as CEO of Sears? And if you can't turn things around, who would you recommend? Anyone?

Hello, I Must Be Going (With Apologies to Groucho Marx)

The Challenge: Yes, I am the new CEO. Where's the company cafeteria?

Three Stories

Meg Whitman, HP

There have been many changes on the BOD and in the CEO's office in recent years. Now, shareholders are looking to former eBay CEO Meg Whitman to apply a steady hand. A top priority will be to decide whether the PC division -- still the world's largest -- is for sale or is part of HP's future. She also needs to make the Autonomy acquisition work within the company's software strategy. It's easy enough to point out that eBay wasn't a technology company, but it was a fast-growing company under Meg's watch that was a highly sophisticated user of technology. A bigger question is how much influence Executive Chairman Ray Lane will have in making the big strategic decisions that face the company.

Brian Moynihan, Bank of America

He wasn't the guy who made the dumb acquisitions. He wasn't the guy who created a culture of cutting corners and taking care of the company at the expense of its customers. It's not his fault that the company moved from San Francisco to Charlotte years ago and hasn't been the same since. But Brian Moynihan has this job, at least for now. This company may be so unstable that it never recovers.

Howard Schultz, Starbucks

Show me how to whip up one of them lattes, Howard. Thanks, dude. Here is the story of a guy who built a company, made it grow maybe a little too quickly, let go of the reins, then came back in a panic. His CEO 2.0 act has gone as well as it did in the first iteration. Another operational whiz, Howard used to fit into the Charismatic Founder category. Today, the challenge is for a still-youngish CEO to replace himself successfully once and for all.

And Then There's Apple

The Challenge: Replacing Steve.

One Story

Steve Jobs, Apple

First he was young and impetuous, didn't get the top job at his own company, and was fired. Then he came back, no longer young but still impetuous. Made business history. Then he got sick and everybody worried. But he had already put the right people in place. The company ran fine without him. He came back, albeit for a brief time. Now that he is no longer around to drive the company, Tim Cook must find a way to build atop the legacy of Steve Jobs and not in place of it. **C**



INTERVIEW WITH **JOE GRIESEDIECK**

Joe Griesedieck is Vice Chairman and Managing Director, Board & CEO Services, at Korn/Ferry International, which assists organizations in attracting, developing, retaining and sustaining their people in nearly 40 countries.

Joe is based in San Francisco, and focuses primarily on engagements for CEO and director searches across multiple industries, as well as working with boards of directors on CEO succession planning and other related senior-talent-management solutions.

His prior experience includes two terms as global chief executive officer of another international search firm. He also served as co-head of the firm's Strategic Leadership Services practice in North America.

We began our talk with a discussion of succession planning.



“SUCCESSION PLANNING IS MUCH MORE ON THE FRONT BURNER THAN IN THE PAST.”

C-Suite Insight: Everyone says succession planning is important, but to what degree do you think it gets back-burnered in the C-Suite, the boardroom, and the day-to-day world of business?

Joe Griesedieck: I don't think it's getting back-burnered to the extent that it might have been two or three years ago, or maybe even a year ago. There's been so much written about it, and now SEC Bulletin 14E has made all board members aware that this is really one of their primary responsibilities.

So the issue today is along the lines of "Are we doing this the right way?" versus "Are we doing this?"

CSI: How many companies are doing it the right way?

JG: We did a survey that found that a lot of boards felt they didn't have a good succession plan in place. The way I translate this is that they feel they don't have a succession plan that they think is defensible in terms of shareholder reactions or ISS reactions. Are they confident that they're going through the right steps? Can they competently say they've

done a thorough job in assessing both internal and external candidates?

Overall, though, I would say succession planning is much more on the front burner than in the past.

CSI: Is this a widespread belief?

JG: McKinsey did a study a year or two ago that looked at the top five priorities that boards have today. Number three was talent development and succession planning, something that did not even appear four or five years ago.

So it's clearly on the agenda of all boards, and it's certainly been a part of all the discussions I've had with board roundtables. They're all aware that it's their responsibility. They obviously want to do it in concert with the current CEO, if that's appropriate, but they realize that at the end of the day, they have to make a decision.

CSI: As far as best practices, does this mean there's sort of a steep learning curve for board members? They have to come up to speed rather quickly, right?

JG: Well, they do. A lot of them will say, "We think we have a pretty good plan in place." But then the question is, how good is it? How does it compare to what we would consider to be best in class, if you will, or best standards?

CSI: And do you have a process to help them with this?

JG: First of all, you have to understand what the strategy of the company is—not just today, but what it's going to look like three years, five years out. Because it could change.

One of the competencies that you're looking for is being in sync with that. People who have done a great job in the company up until now may not be the right people to lead in the future, because [a board may require] different experiences and different competencies.

So the board needs to do a very thorough job of making sure that they're aligned with what the strategy. This becomes the roadmap for the specs or the criteria they're going to look for in the next CEO.



THE BOARD COMPETENCIES AND EXPERIENCE THAT THE BOARD HAS DETERMINED ARE CRITICAL FOR THE COMPANY'S FUTURE GROWTH AND SUCCESS.

CSI: Do you mean boards need to look externally?

JG: No, they should look internally. And if boards today are really doing their jobs, they should not only be looking at CEO succession, but at the whole C-suite and below.

There's a limit to how far boards themselves can go, but they need to make sure the CEO and the Head of Human Resources or Talent Development are really looking at people developing within the organization.

You don't want to go outside if you don't have to. It's always riskier, culturally and otherwise.

CSI: So finding the right successors may not be a linear, straight-down process, but there should be good candidates in the organization.

JG: Yes, and if you're a big company, you should have the luxury of having multiple candidates. If you're a smaller company, it's harder, of course.

But as boards assess internal candidates, they should also do what we call a "talent benchmarking." This is not a search, but rather, just a look outside

to see who would be best in class according to the board's specs. They can make that comparison, at least.

CSI: If they're just taking a look, what's the advantage to them?

JG: They can come back to any constituent or shareholder group and say they've done a very thorough job of vetting, not only the internal candidates but looking at who would be good from the outside.

This is an ongoing process that boards should be doing anyway, because it helps them if there's an emergency, which would put them into a different succession-planning scenario altogether.

CSI: To what degree does the board have a responsibility to work with HR to institute policies that develop careers all the way down the line, so that those internal candidates

are there as they move up through the organization and into the top spots?

JG: I think this is a growing responsibility, and I would say that many boards today are not as engaged in that as they should be. They're thinking about CEO succession planning, sure, but a lot of them haven't yet started to think about much broader succession planning and executive development.

Succession planning is not really an event; it should be an ongoing process. It's really about growth and innovation, and it takes people to bring that about.

CSI: You find a lot of very strong-willed individuals in the top spots, so one way of looking at succession planning is you're saying to people, "Well, OK, you've got the job. But now we have to know who's going to replace you." How does that fly?

JG: Well, good corporate governance today would tell

you that the day the CEO is appointed is the day the board should start planning for his or her succession. It's not meant to be a threatening thing, and the board should be doing it in sync with the CEO.

Now the fact is, too many boards rely on the CEO's recommendations. Granted, the CEO knows these people probably better than many of the board members, but it's only one person's point of view. I think boards have to have a broader, independent point of view, about not only internal executives but also, potentially, external executives.

CSI: We've heard you and others talk about "learning agility," that is, how some executives have a general talent that can be applied to corporate leadership.

JG: Yes, there are "A players," people who you can drop anywhere in the world under any circumstances and they will find a way to succeed. I think it has to do with learning agility. This is a very important characteristic, along with the integrity and high ethics that lead to success. It can be more important than experience.

CSI: More important than experience?

JG: Experience is terrific, too, and obviously overall success depends on the industry and the situation. If you're hiring a turnaround CEO, for example, you're going to look for much different skills than you are if you're bringing someone in to take the company through its next series of growth.

So finding the right person can be situational, depend-

ing on where the company is, but I think you'll find high degrees of integrity, high ethics, and learning agility in all the great leaders.

CSI: Can you summarize leadership in a few sentences?

JG: Beyond what I've already mentioned, there is what I call "intellectual toughness." This is the ability to make difficult decisions in a logical, yet compassionate way. You have to have a very strong sense for people and teams and people development.

It's just too difficult for a single CEO to run a company today, particularly a global company. So an important aspect of leadership is about building teams, and about having the courage to make the right decisions on who should be on those teams and who shouldn't.

YOU HAVE TO HAVE A VERY STRONG SENSE FOR PEOPLE AND TEAMS AND PEOPLE DEVELOPMENT.



CSI: How do you decide who's on the team?

JG: Obviously, in any given situation, industry knowledge and customer knowledge are both very important. And global perspective is almost a must these days, because if you're not selling globally, you're dealing with somebody who is.

[Add to that] the softer qualities about learning agility, which is really the ability to adapt to situations and know which way to go.

Beyond those basics, you have to be a superb communicator, and be willing to communicate openly and transparently. You have to be able to do this not only with your people—which is where you star—but also with your board, with your shareholders, and with Wall Street, the media, and all the rest of it. 

What is SEC Bulletin 14E, and Why Does It Matter?

In the accompanying interview, Korn/Ferry Vice Chairman Joe Griesedieck refers to SEC Bulletin 14E. A sub-section of this bulletin has the potential to drive HR professionals as well as C-suite executives and board members slightly mad, by increasing the burden of compliance on them in the wake of Great Recession reforms.

Specifically, Rule 14a-8 in this bulletin “provides an opportunity for a shareholder owning a relatively small amount of a company's securities to have his or her proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote at an annual or special meeting of shareholders,” according to the SEC.

Further embedded is 14a-8(i)(7), which simply refers to “a matter relating to the company's ordinary business operations.”

This may all sound innocuous enough, but it has opened the door to shareholder proposals regarding succession planning—which is now considered a part of ordinary business operations.

Background

The SEC reported in 2009 that it had received “a number of no-action requests from companies” regarding shareholder proposals in this area: that is, the companies had requested that they be allowed to exclude these proposals.

The SEC had previously agreed with the companies, citing a 1998 ruling [Exchange Act Release No. 40018] in which it took the position that these proposals could be excluded because they “related to the termination, hiring, or promotion of employees.”

However, the Commission has since reversed course, treating succession planning as part of governance. Noting that one of a board's “key functions is to provide for succession planning so that the company is not adversely affected due to a vacancy in leadership,” the SEC refers to the Great Recession when it states that “recent events [that] have underscored the board function to governance.” Therefore, the SEC now “[takes] the view that a company generally may not rely on Rule 14a-8(i)(7) to exclude a proposal that focuses on CEO succession planning.”

In other words, companies must consider shareholder proposals related to succession planning. This increases their obligation to have thorough, defensible plans in place, as Joe discusses in his *C-Suite Insight* interview.

THE LEADER IN
EXECUTIVE
— AND —
DIRECTOR
COMPENSATION
BENCHMARKING

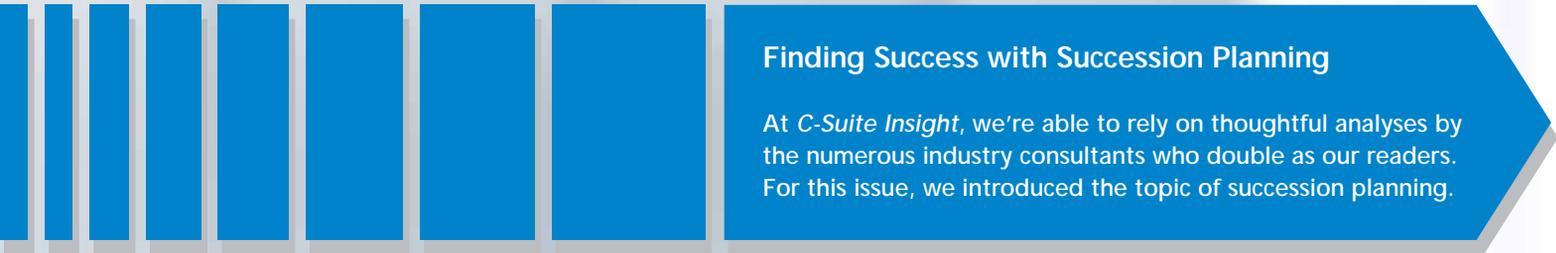
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CONSULTANT'S CORNER



Finding Success with Succession Planning

At *C-Suite Insight*, we're able to rely on thoughtful analyses by the numerous industry consultants who double as our readers. For this issue, we introduced the topic of succession planning.

See next page...

To: Consultant's Corner Participants

What are the key ingredients or best practices, in your opinion, when it comes to succession planning?

From: Jannice L. Koors, Managing Director, Pearl Meyer & Partners, Chicago

Pearl Meyer & Partners just completed a survey on CEO succession planning. While the survey focused on the CEO position, the succession planning implications can certainly cascade throughout an organization. One of the biggest concerns expressed by the respondents was that internal candidates not selected might leave the company. Such a talent drain can weaken the company's management ranks and cause further succession challenges. Yet these concerns can be mitigated with proactive planning.

First, boards should make realistic individual assessments of the "also-rans." Are they all equally critical for retention? Do their individual career aspirations preclude a continued productive role in the company?

Once retention priorities are determined, the company can then consider several effective compensation tools, such as additional equity grants with back-loaded vesting or cash-based retention awards with clawback provisions. Care should be taken to avoid too much emphasis on base salary adjustments, as these can create problems with internal equity and future senior executive recruitment. Compensation isn't the only important factor; the company can consider organizational changes to provide new or expanded responsibilities to the runners-up as a visible, public sign of their continued value to the organization.

Pearl Meyer & Partners
Comprehensive Compensation®

From: Daniel J. Ryterband, President, Frederic W. Cook & Co., Inc., New York

Succession planning, particularly for the CEO position, is among the most important corporate governance functions. Developing internal candidates reduces the risk of failure and the disruption that often accompanies the integration of externally sourced talent. In addition, internal promotion is almost always less expensive.

Having a supply of internal candidates for critical leadership roles requires an outstanding management development program and a compensation system that functions to retain key talent. Interestingly, companies recognized for their management development capabilities often face an intensified risk of undesired attrition, which magnifies the importance of effective compensation design.

The compensation systems that are most effective in supporting retention typically share two common attributes. The first is the ability (and willingness) to differentiate compensation to reflect performance. The second is the ability to balance compensation between short-term payouts and long-term wealth creation.

Programs overly focused on the short-term tend to create a free-agency mindset, which can foster turnover when operational performance slips or the stock price depreciates. Conversely, balanced programs ensure that wealth-creation opportunity is dependent on a combination of short-term payouts, longer-term changes in shareholder value, and career employment.

F R E D E R I C W . C O O K & C O . , I N C .

BALANCE
DIFFERENTIATE



From: Doug Friske, Managing Principal, Towers Watson, Chicago

Best practices in succession planning, and broader talent mobility, include rigor and thoughtfulness around four key elements:

Identification: This requires being clear on who you will treat as talent (Only senior leaders? Individuals early on in their careers?) and how you will identify talent (Traditional performance and potential, or broader elements like learning agility, critical competencies, ambition?).

Development: This involves using assignment management to build leaders through experiential learning, including providing cross-functional and cross-border opportunities and being mindful of the types of role changes (scope, specialty, and location), to mitigate transition risk.

Deployment: This is about building the right infrastructure and process to be able to move the right skills to the right place at the right time. Specific activities include defining and communicating career paths and role profiles, building a talent “ecosystem,” and making room for emerging talent by creating organizational gaps.

Track Plans & Measure: Analytics and planning help identify and shape appropriate talent-management solutions. Best practice succession planning has the right metrics in place to help determine the real value and impact of your organization’s programs.

From: Joseph M. Yaffe, Partner, Skadden, Palo Alto

It sounds simple, but the first step in developing an effective succession plan is to recognize the need to focus on CEO and senior-executive succession plans in advance—not after the fact or when the plan has failed.

An untimely (or no) succession plan subjects the board of directors to reputational risk and the company to a potential loss in market value. The absence of a succession plan places stress on a process that is best implemented on a “clear day,” not when the board is under direct scrutiny from shareholders regarding CEO or senior executive succession.

Best practices for developing a succession plan include: (1) clear articulation of who is responsible for the process, including participation by the CEO and external advisors; (2) a commitment to at least annually review the plan; and (3) the identification of multiple candidates, depending on the succession scenario being addressed.

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IDENTIFICATION DEPLOYMENT
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& MEASURE

To: Consultant's Corner Participants

What are the key ingredients or best practices, in your opinion, when it comes to succession planning?

From: Lorraine Stomski, Ph.D., Senior Vice President,
Aon Hewitt, New York

In Aon Hewitt's global research study, *Top Companies for Leaders*, we examined the best practices of top-performing companies and their leadership practices, including succession planning. Through our research, we've found the following trends in successful firms:

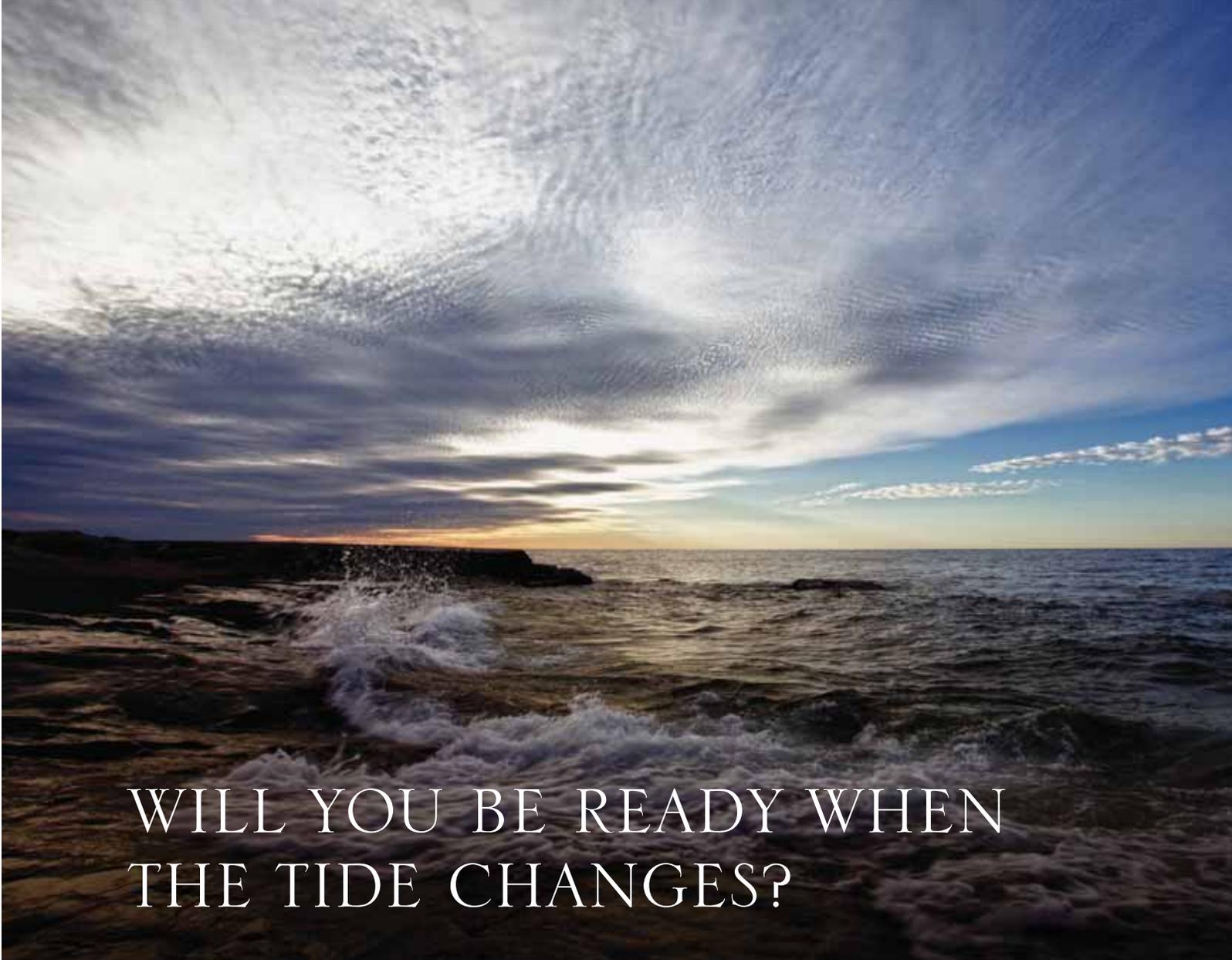
- Senior leaders take active ownership of the leadership/people agenda—including succession planning.
- Succession plans are clearly driven by business strategy.
- Talent is more often built than bought (75% internal, 25% external).
- Succession plans are used to fill 90% of vacant leadership positions.
- Succession readiness is an honest and accurate evaluation (not a “stretch”).
- Companies focus on multiple levels in the organization and identify pivotal roles.
- Two to three years after a role is filled by a successor, organizations will measure the effectiveness of his or her selection, and whether their original assessment of that candidate's capabilities was correct.
- An emergency succession plan has been developed for the top one or two jobs.

Additionally, as we emerge from the recession, there are some competencies and attributes that are becoming more critical than ever to assess for and monitor as part of the succession planning process:

- The ability to lead through rapid and complex change
- Optimism and resiliency — the ability to overcome challenges and obstacles and help others do so as well
- Learning agility — the ability to learn from experience and apply those lessons moving forward



THE ABILITY TO LEAD
THROUGH RAPID AND
COMPLEX CHANGE



WILL YOU BE READY WHEN THE TIDE CHANGES?

WITH GREATER SHAREHOLDER SCRUTINY FOCUSED ON EXECUTIVE COMPENSATION, IT'S MORE IMPORTANT THAN EVER TO BE PREPARED.

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INTERVIEW WITH **DAVE LARCKER & BRIAN TAYAN**



DAVE LARCKER is James Irvin Miller Professor of Accounting at the Stanford Graduate School of Business. He directs the Corporate Governance Research Program at the Stanford Graduate School of Business and is senior faculty of the Arthur and Toni Rembe Rock Center for Corporate Governance at Stanford University. Previously, he was professor of accounting at the Wharton School of the University of Pennsylvania and professor of accounting and information systems at the Kellogg Graduate School of Management at Northwestern University. He received his PhD in business from the University of Kansas and his BS and MS in engineering from the University of Missouri – Rolla.

BRIAN TAYAN is a researcher with the Corporate Governance Research Program at the Stanford Graduate School of Business. He received his MBA from the Stanford Graduate School of Business and his BA from Princeton University.



THE STANFORD GRADUATE SCHOOL OF BUSINESS

launched the Corporate Governance Research Program (CGRP) in 2006 to generate new insights, and advance the intellectual understanding and teaching of corporate governance around the world. The CGRP further seeks to bridge the gap between theory and practice of corporate governance by engaging academics, regulators, and professionals who can apply this knowledge to both classrooms and organizations around the world. Located in the heart of California's Silicon Valley, the Stanford Graduate School of Business has built an international reputation based on its innovative programs, which include the two-year MBA, one-year Sloan Master's Program, PhD, executive education, and faculty research.



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ON BOARD RESPONSIBILITIES

C-Suite Insight: We'd like to explore some of the themes in your book, *Corporate Governance Matters*. Let's start with your view of board members and their roles.

What are their primary duties, really?

Dave Larcker: The standard answer is they're there to evaluate, vet, and approve corporate strategy. The second thing is, they're there to assess whether the company has the right senior executives in place.

Thirdly, they're there to think about risk management. Is the company taking on the appropriate amount of risk? Are there risks that are unmitigated? If so, what impact can those have on the strategy?

CSI: That's it?

DL: It's important to keep in mind that boards are supposed to do board things, and managers are supposed to do management things. The board is not meant to manage the organization.

People tend to forget that boards have an advisory role and an oversight role.

When boards are criticized by the public, it's usually for failing in some of that oversight role. But we need to keep in mind that they have very important duties from an advisory perspective as well.

CSI: But how do you square that circle when a crisis breaks out and a board is expected to react quickly and make decisions? That's really more of a direct management role.

DL: There's no question that this happens. They have a duty to shareholders and a duty to maintain a viable organization. So if there's a crisis where there's some malfeasance or something like that, it's not uncommon for the lead director or an outside director to be appointed to the internal management.

Brian Tayan: On an interim basis.

Dave: Yes, on an interim basis. Even so, you hope you have the processes in place such that there is a realistic transition path when those things happen. But in most circumstances, the board should not be trying to manage the company.

ON EXTERNAL INFLUENCES

CSI: Let's look at institutional investors who represent big retirement funds and the like. They could be emboldened now to push harder on say on pay, and even push for the removal of certain board members. To what degree do you think they will be so emboldened?

DL: I'm not sure that the average institutional investor gets overly worked up about pay levels. The people that we've talked to say they can vote with their feet if they find something unacceptable. If they're holding something like 120 stocks, they switch into something else. It's not worth it to them to mount a huge campaign about something that they view as egregious.

Activist funds have an objective that is probably purer, in the sense of "Here are some wrongs that need to be corrected." They're going to try to create value. What's unknown is whether these models that they have in mind—about pay levels, how the board should be structured, who's a good person or bad person for the board—are the right ones.

IT'S NOT CLEAR THAT YOU CAN TAKE A UNIFORM STANDARD FOR EVALUATING PAY, APPLY IT TO ALL COMPANIES, AND EXPECT THAT TO CREATE A LEVEL PLAYING FIELD.

CSI: What are some things that boards can do to head problems like this off at the pass, especially with activist investors?

BT: There's a reputational element that didn't exist before, to the extent that companies don't want to be in the limelight when it comes to say on pay or proxy access or any of these activist things.

So a lot of companies are increasing their communication in order to forestall that. A lot of this is finding out the rational concerns of your investor base—and some of it is also finding out the somewhat irrational concerns of either an activist investor base or a proxy-advisory firm

that stand to have a large influence over the vote.

DL: A lot of people have said that one of the positive outcomes of say on pay is that it caused an increase in dialogue. On the other hand, what are you actually talking about in that dialogue? How much dialogue can a company have with an activist fund? How many other investors do they have to have that dialogue with, given the thousands of companies in their portfolio?

But I think reaching out and getting a grip on the requirements and demands of your institutional shareholders is an important thing.

ON PROXY ADVICE

CSI: To what degree do "apples-to-oranges" comparisons come into play in the conversations proxy-advisory firms are having with their clients?

DL: Proxy advisory firms use a single standard that they apply to all companies, regardless of their industry, their specific size, their situation, or anything else.

Say you're looking at one- and three-year total shareholder return and how that compares to your peers,

and whether your CEO's pay went up or down over the period—then they make an automatic recommendation based on that.

If you're in, say, an oil-production company, your time cycle is so much longer than one to three years. You're making investments that may look horrible for that time period. So you may have poor share-price performance in the medium term.

But in order for the company to succeed long-term, those investments need to be made. It's not clear that you can take a uniform standard for evaluating pay, apply it to all companies, and expect that to create a level playing field.

BT: Companies also differ based on the CEO and the quality of that individual, in terms of ability to do the job, personality, and how that person manages and leads. Companies are also different in terms of the board—whether they have a board that's actually strongly engaged from an advisory and oversight standpoint, or a board that's just punching the clock so they can get their paychecks.

Many companies differ in terms of not just their

organizational structure, but in terms of the culture of the firm itself. All of those things influence the governance system of the firm. All of those things need to be taken into account when you're looking at governance quality.

CSI: So how many boards are just punching the clock these days, compared to five or ten years ago?

DL: I don't know if we can answer that, but I think boards in general are clearly taking things much more seriously these days. The days of board meetings starting and you hear the FedEx envelopes just opening for the first time—those days are over.

But I think the true weakness in boards is the board evaluation process. How do you evaluate individual board members, and how do you get bad board members to leave? It's a very difficult task to do these evaluations in a constructive and effective way. But obviously it's a good idea, and in fact, it's required.

ON GOVERNANCE RATINGS

CSI: Getting board member evaluations right is not

something that emerges from numbers, right?

BT: Yes. Look at governance ratings and similar things, and it's apparent that a lot of these best practices ignore the fact that companies are organizational settings. As such, they're subject to human dynamics. You can't just take a straight economic view and hope that it works across every company.

CSI: But to what degree can governance ratings cause boards to sort of pull their punches, or maybe try to get to a rating without thinking about what's best for the company?

DL: The research we've done suggests these ratings are not very informative about anything. They don't predict governance failures or restatements or lawsuits regarding performance, or anything like that.

But I think board members do pay attention to these things. Somebody comes up and says, "Gee, you're in the bottom 10% of the governance rankings." This sucks up board meeting time, so we have to ask, "Is that a reasonable yardstick to hold a company to?"

CSI: And?

DL: Our research, so far, hasn't indicated that these things are all that useful.

CSI: Is there any correlation between them and stock price, or according to the investment segment?

DL: No.

Brian: There's no "one size fits all" for corporate strategy, so why would you expect that there's a "one size fits all" in corporate governance?

ON SUCCESSION PLANNING

CSI: You've mentioned before that boards spend fewer than two hours per year on succession planning. Can this be right?

DL: Yes.

CSI: So are boards focusing on the right things?

DL: Since Sarbanes-Oxley was enacted, boards have spent a considerable amount of time on compliance, particularly accounting and audit. So one of the things that's lacking is they're not spending enough time on succession planning, evaluating internal

talent development, and that type of thing.

We have survey data that backs this up. One of the things that was frightening was that 38 percent of the several hundred companies we surveyed didn't have a single internal candidate that was ready to take the CEO role if it came open today.

BT: If you want to do CEO succession right, it really has to do with internal talent development. How familiar are board members with the people in the C-suite, or with the people one level below, and even two levels below? And are they making a comparison of those people against the general external market?

This takes a lot of time. Jack Welch once said he spent 50 percent of his time on people issues. Now, the board doesn't have to do this directly, but it has to make sure that it's being done. Board members need to have a sense, over time,

about who is a potential permanent replacement, and what to do in the event of an emergency. This is a substantial issue.

CSI: What about those cases where the CEO is the "face of the corporation?"

BT: It's better to think of it in terms of an entrenched CEO. A couple of indicators of an entrenched CEO are when there is no viable succession plan, and when there's tremendous turnover of good talent in the level right below him or her. In this case the board has to actively get involved to make sure talent is being developed.

On the other hand, I can't think of a company who's more identified with their CEO than Berkshire Hathaway, but the company has a wealth of valid successors in its plan, and the plan is kind of quasi-public. That's a case where the importance of succession planning has

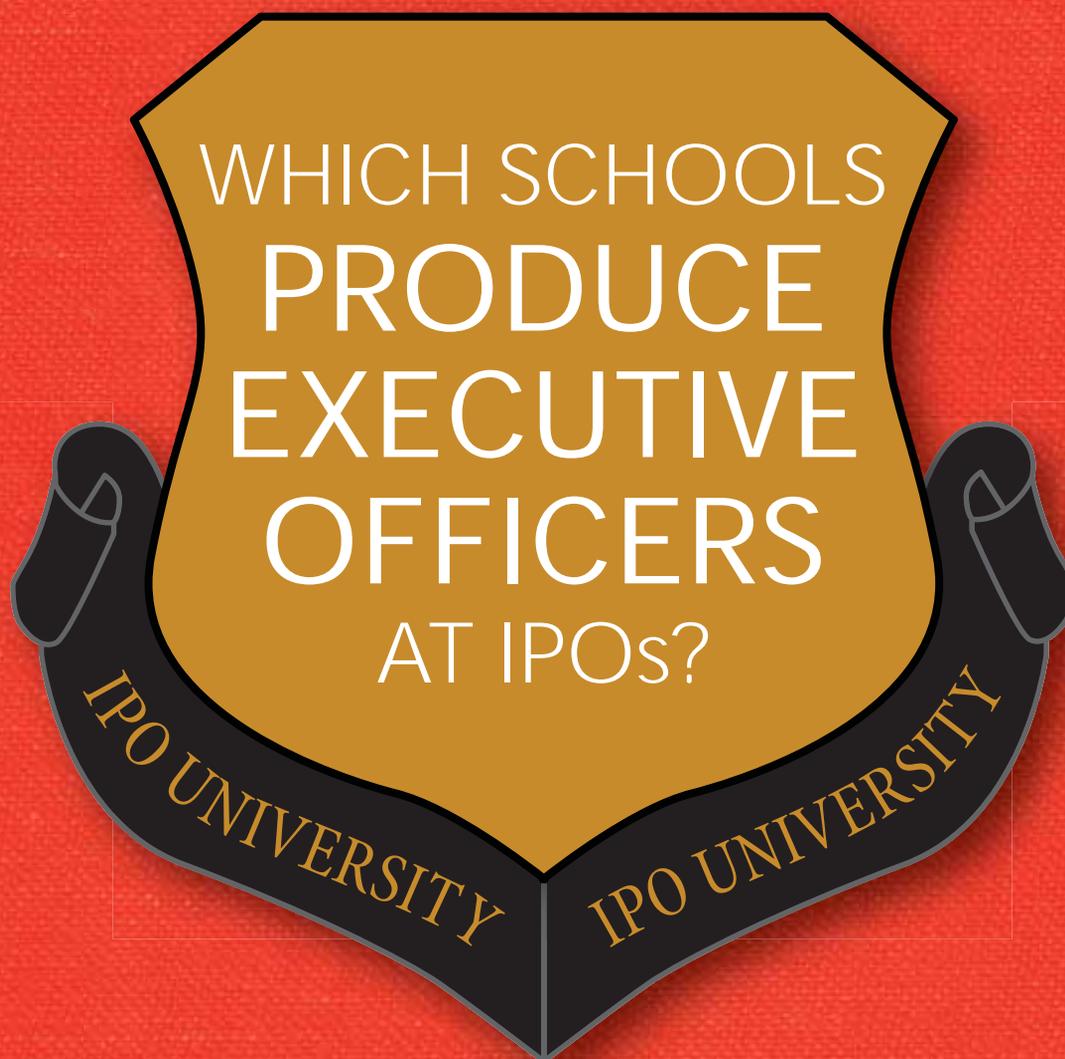
not been lost on Buffett or the board.

CSI: Not every company is so fortunate.

BT: A board must recognize what type of CEO personality it's dealing with. There are CEOs who are facilitators of this, which makes it easier for the board to work in that setting. But even if you have an obstructionist CEO or a passive-aggressive CEO, the board still has the responsibility to develop a plan, and follow through to see that it's in place for the company.

DL: We've come up with some archetypes or names for these people. The one that we've seen a lot of is the Hopeful Savior. This is the type of CEO who says, "Yeah, I'm going to retire." But in truth, this type really wants to lead the company forever. The other candidates aren't as good as him or her, you know, that kind of thing. ■

THE BOARD STILL HAS THE RESPONSIBILITY TO DEVELOP A PLAN, AND FOLLOW THROUGH TO SEE THAT IT'S IN PLACE FOR THE COMPANY.



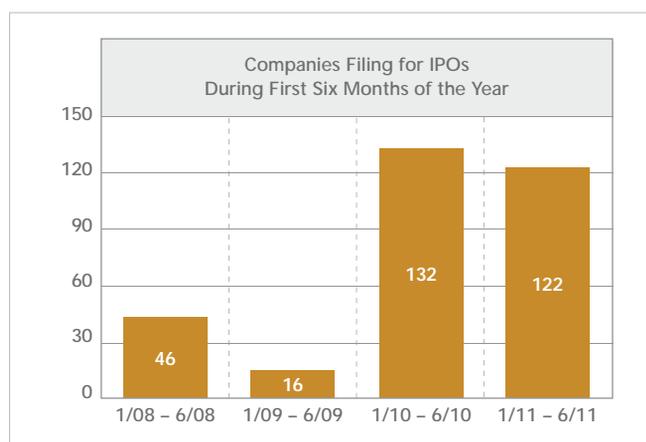
The initial public offering (IPO) market, like the general economy, has rebounded over the past several years. Typically, the IPO market declines during a recession, as companies considering going public fear a poor share valuation. When markets recover, however, firms choosing to go public can greatly benefit from raising new capital and affording their employees the opportunity to realize wealth on their equity holdings.

MANY PEOPLE HOPE TO WORK FOR ONE OF THESE COMPANIES, cash in on skyrocketing share valuations, and strike it rich. Is there a specific personal or educational background that makes someone more likely to realize that dream?

To answer this question, Equilar conducted an analysis of all companies that filed for an IPO with the SEC in the first half of 2011. With the help of the S-1 or 424B (prospectus) filings for these companies, Equilar compiled background information for their executives, with a particular emphasis on education. Which schools have produced the greatest number of leaders at firms aspiring to go public?

IPO ACTIVITY

Market turmoil in 2008 and the first half of 2009 discouraged many companies from offering their stock to the public for the first time. As the market has rebounded over the past couple of years, the SEC has seen a concomitant spike in the number of IPO filings. Though high-profile IPOs for LinkedIn and Groupon have made headlines in 2011, 2010 actually saw the highest number of IPO filers. The chart below shows the number of companies that filed to go public in the first six months of each year, from 2008 to 2011.



MAKE-UP OF EXECUTIVES AT IPOs

Although the story of the college-dropout-turned-IPO-millionaire is great movie material, it is still a rarity among real-life executives. The vast majority of individuals in Equilar's study earned some type of higher degree. In 2011, Equilar tracked 122 companies, encompassing 804 executives. 70 percent of those executives disclosed some type of college degree. This does not mean that the remaining 30 percent did not go to school; their schooling was simply not disclosed in their listed biography.

Further education was also a topic of interest; does an employee require a graduate degree to climb to the top rungs of the corporate ladder? It seems to convey a slight advantage: among executives disclosing a degree, 58 percent disclosed earning a graduate degree (either a master's or doctorate).

Despite the perception that starting new companies and taking them public is a young person's game, the average age of executives included in the study was 49. The youngest person on the list was 29 years of age (Jesse Boyd, VP Resort Operations at Peak Resorts), while the oldest person was 81 (Kelsey Boltz, Executive Chair at Neutron Energy).

LARGEST IPO NETWORK

Listed below are the universities that are associated with the greatest number of graduates serving as executives at companies that filed a prospectus in the first half of 2011. The executives in the study attended a total of 379 different schools. Stanford University (32) had the most individuals citing themselves as alumni/alumnae (undergraduate, master's, and/or doctorate), followed by Harvard University (24), and the University of California, Berkeley (23).

The hotbed for cultivating executives for IPO companies appears to be California, particularly the Silicon Valley area. Seven of the 25 most-cited schools were located in California. Illinois and New York came in second; each had three of the top 25 schools.

Rank	University	# of Grads*
1	Stanford University	32
2	Harvard University	24
3	UC Berkeley	23
4	Northwestern University	19
5	UC Los Angeles	18
6	University of Pennsylvania	16
7	University of Texas	13
T-8	Indiana University	12
T-8	University of Chicago	12
T-10	Duke University	11
T-10	University of Illinois	11
T-12	Brigham Young University	9
T-12	University of Michigan	9
T-12	USC	9
T-15	Columbia University	8
T-15	University of Virginia	8
T-17	UC Santa Barbara	7
T-17	University of Colorado	7
T-17	Dartmouth	7
T-17	Michigan State University	7
T-17	Santa Clara University	7
T-17	Texas A&M University	7
T-23	Cornell University	6
T-23	NYU	6
T-23	San Jose State University	6



THE HOTBED FOR CULTIVATING EXECUTIVES FOR IPO COMPANIES APPEARS TO BE CALIFORNIA, PARTICULARLY THE SILICON VALLEY AREA. SEVEN OF THE 25 MOST-CITED SCHOOLS WERE LOCATED IN CALIFORNIA.

UNDERGRADUATES

Listed to the right are the universities that awarded the greatest number of undergraduate degrees to executives at companies that filed a prospectus in the first half of 2011. The list of individuals with an undergraduate degree encompasses 301 different universities. Among the executives with degrees, Stanford University topped the list, with 18 alums. The University of California, Berkeley and the University of Pennsylvania tied for second place, with 10 alums each.

Rank	University	# of Grads*
1	Stanford University	18
T-2	UC Berkeley	10
T-2	University of Pennsylvania	10
4	Indiana University	9
5	Brigham Young University	8
T-6	UCLA	7
T-6	UC Santa Barbara	7
T-6	University of Colorado	7
T-6	University of Texas	7
10	Michigan State University	6

Rank	University	# of Grads*
1	Harvard University	21
2	Stanford University	17
3	Northwestern University	14
4	UC Berkeley	13
5	University of Chicago	12
6	UCLA	11
7	University of Texas	8
T-8	Columbia University	7
T-8	University of Illinois	7
T-8	University of Pennsylvania	7

GRADUATES WITH ADVANCED DEGREES

Listed to the left are the universities with the greatest number of executives holding advanced degrees. 174 different graduate schools are represented among the 331 individuals with a listed advanced degree. Advanced degrees include both master's and doctorates. Harvard tops the list, with 21 executives with graduate degrees. Stanford is second, with 17, and third place is claimed by Northwestern, with 14.

* Executives with multiple degrees from the same school are only counted once. For example, an individual with both a bachelor's and a master's degree from Stanford University is only counted as one graduate in the total.

INTERVIEW WITH **ANNE SIMPSON**

Anne Simpson is described as “one of the world’s most influential investor activists.” She serves as Senior Portfolio Manager and head of Corporate Governance at the California Public Employees’ Retirement System (CalPERS), the largest public pension fund in the United States.

With more than \$235 billion in market assets, CalPERS provides retirement and health benefits to more than 1.6 million public employees, retirees and their families.

Prior to joining CalPERS in mid 2009, Anne served as Executive Director of the International Corporate Governance Network (ICGN), an organization that represents investors responsible for \$15 trillion in global assets—roughly the value of the entire U.S. or EU economy.

Anne has authored two books on corporate governance, and also serves as a Senior Faculty Fellow and Lecturer at Yale University’s School of Management. She is a graduate of Oxford University, and was a Slater Fellow at Wellesley College.

C-Suite Insight conducted an extensive interview with the London native earlier this year. The first half of our discussion was published in Issue 5, and covered say on pay, as well as the bigger picture of executive compensation, regulation, and institutional investors’ expectations. We now present the second half of the interview, conducted with Anne from her office in Sacramento, CA.



“YOU NEED PEOPLE ON A BOARD WHO CAN REPRESENT OUR INTERESTS.”



SAY ON PAY & MAJORITY VOTING

C-Suite Insight: Let's talk a bit more about how say on pay is, in your opinion, not the blunt instrument that it's sometimes described to be.

Anne Simpson: Oh, absolutely. I mean, as I said, it's as much of a blunt instrument as a feather duster, good grief.

In the United States, if you don't like what's going on, you sell. Hence, much of the regulatory regime is geared up around liquidity and trading. Or you sue, in the grand tradition of litigation in the U.S.

So now, with the say on pay provisions in Dodd-Frank, there's a [new] gentle move. But it's only a gentle move towards shareholder rights, towards giving the owners—the shareholders—back the ability to hold boards accountable for what's going on.

CSI: And you don't think boards are always so accountable. Can you give us an example?

AS: We made a proposal last year—and we've got

one on again this year—for a company in the hospitality business. The proposal last year won 90% of the votes cast, representing 70% of shares outstanding. But the company's board [won't accept it]—the company is still just being stubborn.

If you have somebody who doesn't want to listen to the owners, then majority voting—not just a say on pay—is probably needed. Sometimes you need people on a board who can represent our interests.

CSI: So companies can be screaming bloody murder about this tough new say-on-pay regulation, and politicians can be talking tough. But it doesn't really add that much, even if it can someday lead to what you think needs to be done.

AS: Yes. Majority voting was briefly in the bill in the House, when it was under Rep. Frank, but it didn't make it through in the Senate.

CSI: To your chagrin?

AS: Well, what happened is probably sensible, because it would be very difficult

to implement a federal method of intervening with state [corporate] law.

CSI: So what do you do?

AS: As I said, we just have to go company by company. We write to them, ask for conversations to discuss the issue, write to them again, and in the end, there's still a small number of companies that have defied this sensible advice to introduce majority voting.

So then we'll file a proposal [asking] the board to amend their by-laws. To us, it doesn't matter if a company is reliant on, say, a brilliant founding entrepreneur. There needs to be a way to allow the owners of the company to have a genuine vote on the election of board members.

CSI: But you can't nominate anyone directly.

AS: Of course. Because we don't have proxy access, we can't always put our own candidate forward. So you face an election in which you can only vote yes, and you can only vote for the people the management puts forward. This is not a process

that would merit praise as a model of accountability in any other setting.

CSI: At the end of all this wrangling, what's the result in terms of your ownership? Your ultimate vote is either to buy up shares, hold steady, or sell them.

AS: Well, the good thing about CalPERS is that we are permanent owners—this may be viewed as a bad thing, if you're the company.

We have the biggest pool of [institutional investor] money in the world, so when we make investment decisions, we are buying shares in order to give ourselves an exposure to broad economic activity. Our investments are there for a very long-time liability, which is to pay future pensions and benefits to 1.5 million people in California. We're not here for a quick in and out.

So as far as the government's agenda goes, we have patience, we really do have patience. We have the ability to wait and the ability to not go away.

THE UNFORTUNATE NEED FOR CLAWBACKS

CSI: Clawback legislation is also a key part of Dodd-Frank. What's your view here? Another feather duster?

AS: Let me start by saying that having clawback legislation in place is no more than saying if somebody steals something or takes something they're not entitled to, they must give it back. That's obvious, isn't it?

CSI: Seems like it should be, yes.

AS: I mean, isn't every child told not to take something that doesn't belong to them? It's exactly the same

with these executives. If they're rewarded with perks or whatever it might be, shares, to which they are not entitled, it seems to me that it's not a legal question; it's a question of common sense that it's supposed to be given back.

What's useful in Dodd-Frank is by giving it the holy writ of legislation, you've elevated common sense. It's very sad, in this day and age, that we should require a rule that tells you to give back what you did not earn fairly and squarely.

CSI: But now the Feds can pay you a visit if you violate this rule.

AS: Yes, and I hope this stiffens the spines of board members. Because a lot of them sat by and let this happen—they let executives put their fingers into the cookie jar and take pretty much what they wanted.

WHAT'S USEFUL IN DODD-FRANK IS BY GIVING IT THE HOLY WRIT OF LEGISLATION, YOU'VE ELEVATED COMMON SENSE.



CSI: And some folks got caught...

AS: [At which point] many board members sort of feigned hollering and distress. "Oh, no, oh, no! We have to let them take this because otherwise we won't be able to ever replace them, they're so precious and wonderful and marvelous."

That's not to say that the most lavishly remunerated people aren't the people who have been bettered in the highest-performing companies.

But this is a demonstration of how weak [some] boards have been. If there are no consequences to failing in your duty, don't be surprised if people take a pretty sloppy attitude.

FUND MANAGERS & THE SHORT TERM

CSI: So, irrespective of legislation, what can institutional and fund investors be doing?

AS: We need more of the long-term owners to stand up and have a coordinated and coherent approach to tackling these problems.

Too often, what happens is that pension funds

subcontract the job of investment management to outside fund managers. They think they can delegate their responsibilities, but you know they can abdicate and pass all this onto the fund manager.

And, you know, fund managers are competing on fees. Unlike the liabilities of the underlying owner of the shares, the fund manager is competing for business on the basis of quarterly fees. He or she is in a beauty parade, competing with other fund managers—this has nothing to do with what's really happening in the market.

CSI: So this doesn't sound healthy.

AS: You can find three-quarters of active fund managers on the periphery of the market, and charging you mightily for the privilege of working with them.

How can that happen? It's because we don't have a proper alignment of interests in the fund-management industry. There really needs to be an unbroken chain of accountability for investment professionals—for voting, for making sure that the

THERE REALLY NEEDS TO BE AN UNBROKEN CHAIN OF ACCOUNTABILITY FROM INVESTMENT PROFESSIONALS.

fund managers are all-in for companies.

And we need to make sure that fund managers are rewarded themselves for long-term performance. Otherwise, contagion being what it is, you can be assured that your fund manager will be rewarded on short-term performance. He or she is going to pass that on like a case of head lice, which is then sent onto the board.

CSI: Thus skewing the market.

AS: I think this is where you get the nonsense of quarterly earnings, a tragedy of the commons. It leads to catastrophic results—a lot of very small, short-term decisions mean companies collectively are not putting the time and the effort and the money into training, R&D, reputation, and all the other good stuff on which healthy economies are based. ■

BOARD TURNOVER

AN ANALYSIS OF THE S&P 1500

BY ANNALISA BARRETT

UNLIKE CEO TURNOVER, the departure of a member of the board of directors does not usually impact the performance of the company or cause major disruptions in the company's operations. However, a high level of turnover among board members can be an indication of governance concerns which may lead to performance issues down the road. Certainly, planned board turnover can be healthy for a well-functioning board which intends to integrate fresh ideas into boardroom deliberations and ensure that the composition of the board keeps up with the changing needs of the company. Nonetheless, since conducting a search for a replacement director and providing a new director with the necessary orientation and training is time-consuming and often costly, most companies would prefer to keep board turnover to a minimum.

METHODOLOGY

This study examines board turnover at 1,336 of the S&P 1500 companies for which data was available regarding board composition and departures for the most recent fiscal year.

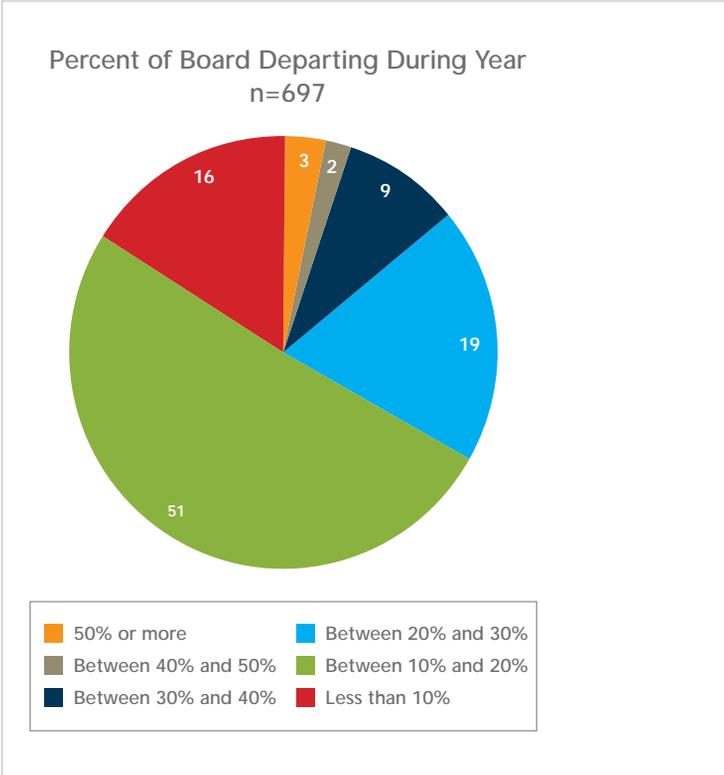
For those boards which did change during the year, the turnover rate was calculated as the number of directors departing from the board during the year divided by the number of directors serving on the board as of the most recent annual meeting.

STUDY FINDINGS

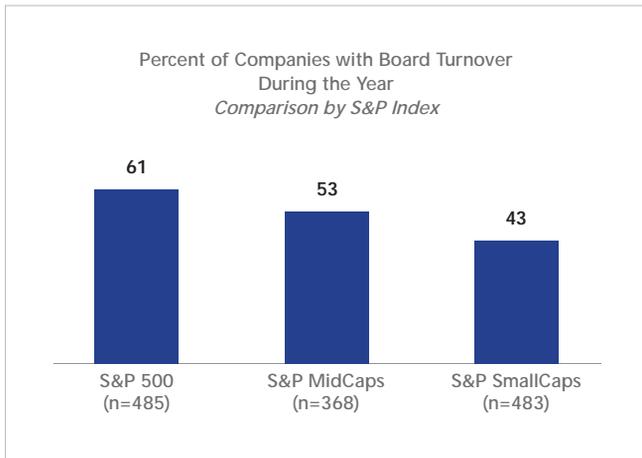
Just over half of the S&P 1500 companies studied (52 percent, or 697 companies) had some level of board turnover during the most recent year. In other words, the composition of the board at just under half of the companies studied (48 percent or 639 companies) did not change during the prior year.

Those companies which had a change in board composition over the last year were examined to determine the board turnover rate. Among the boards which had turnover during the most recent year, the median turnover rate was 14 percent and the average turnover rate was 18 percent.

The most common level of turnover was between ten and twenty percent of the board members, which, for example, would represent one or two directors leaving a 10-person board. Over half (51 percent) of the boards studied fell into this category. While rare, there were some companies which saw more than half of their directors depart during the most recent year. Three percent of the boards studied were in this situation.



(This article is based on a report from Equilar, Inc., entitled "Board Turnover: S&P 1500 Company Analysis.")



ANALYSIS BY COMPANY SIZE

Further analyses were conducted to assess what types of companies had the highest level of turnover during the last year. The larger companies studied were most likely to have had turnover than the smaller companies. More than half (61 percent) of the S&P 500 company boards studied had some level of board turnover, while less than half (43 percent) of the S&P Small Cap company boards studied had turnover during the most recent fiscal year.

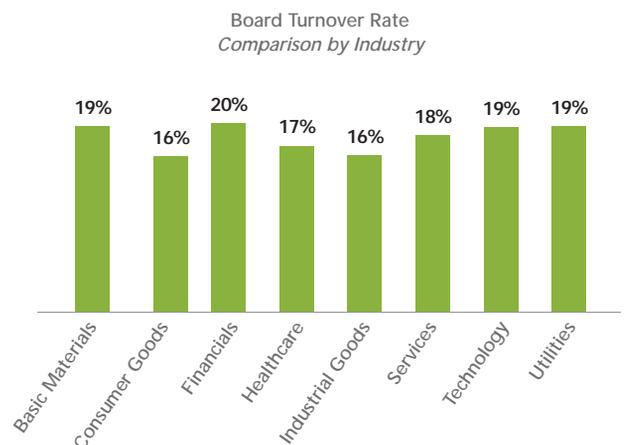
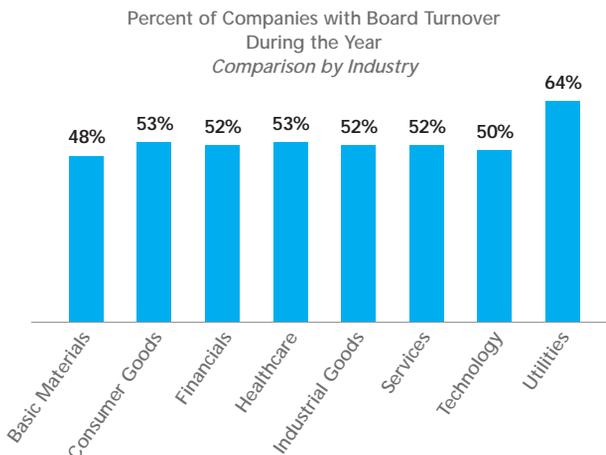
While the boards of the larger companies comprising the S&P 500 index were more likely to have turnover among its board members, the rate of turnover among those boards which had a change was lower than that of the boards of the Small Cap companies studied.

INDUSTRY ANALYSIS

In general, the prevalence of board departures among the companies studied does not vary dramatically based on industry. Just over half of the companies in each industry category had some level of board turnover during the year.

The boards of companies in the Utilities industry were most likely to have some level of turnover during the most recent year. The industry which was least likely to see board turnover was the Basic Materials industry; fewer than half of the companies in this industry had board turnover during the year.

The rate of turnover among those companies which had a change varies slightly based on industry. As shown in the chart below, the companies in the Financials industry had the highest rate of board turnover. The companies with the lowest rate of board turnover were in the Consumer and Industrial Goods industries.



COMPANY PERFORMANCE

It is expected that CEO turnover may increase when company performance is lacking. However, this assumption does not necessarily translate to board turnover. Only in the most extreme circumstances of shareholder discontent would one expect to see the composition of the board change in response to poor company performance.

However, the data shows that companies with the highest levels of one-year total shareholder return (TSR) are less likely to see board turnover than those with lower levels of one-year TSR.

The companies studied were broken into quartiles based on one-year TSR for this analysis. The top quartile of performers had a one-year TSR exceeding 41.4 percent. Companies falling in the next quartile had one-year TSR between 21.6 percent and 41.4 percent.

The third quartile includes companies which had one-year TSR between 6.5 percent and 21.5 percent. The bottom quartile of companies studied had one-year TSR below 6.5 percent. Companies in the quartile with the highest one-year TSR performance were the least likely to have had board turnover during the same one-year period.

However, the companies with the lowest level of one-year TSR performance had the highest rate of board turnover, meaning that a higher proportion of the directors serving on boards of the poorest-performing companies departed during the year.

CONCLUSION

Turnover among board members is an important measure to monitor, both for companies and investors. However, the reasons for the departures are just as important as the prevalence and rate of departures.

Also important are the characteristics (demographics, experience levels, tenures) of the directors who are leaving the boards. As succession planning for the CEO becomes an increasingly important topic for shareholders and investors, the importance of finding the right mix of directors will play a pivotal role in the process. 

Key Findings

- Just over half of the S&P 1500 companies studied (52 percent, or 697 companies) had some level of board turnover during the most recent year.
- Among the S&P 1500 boards studied which had turnover during the most recent year, the median turnover rate was 14 percent and the average turnover rate was 18 percent.
- Larger companies were more likely than smaller companies to see director departures during the most recent fiscal year.
- Boards of companies in the Financials industry had the highest average rate of turnover.
- The quartile which included the companies with the worst one-year TSR performance had the highest average rate of board turnover.



INTERVIEW WITH **STERLING SHEA**

Photo: Chris Casaburi

Sterling Shea is the Managing Director and Head of Advisor Programs at Barron's. Working closely with Barron's editorial group, he has led the development of Barron's series of best-practices conferences for industry-leading financial advisors.

He recently hosted Barron's Top Advisory Teams Summit, one in a series of the company's Winner's Circle events. *C-Suite Insight* interviewed him shortly after that conference, to see what was on the minds of the world's top wealth-management teams—from financial-advisory-team principals to analysts to business-development officers.

BARRON'S

"HOLISTIC WEALTH MANAGEMENT IS ABOUT HELPING CLIENTS DEFINE AND ACHIEVE LONG-TERM GOALS."

C-Suite Insight: What would you say makes a good wealth manager? What is it that the best ones are doing that make them stand out from the others?

Sterling Shea: A big trend in the industry that we're seeing now is that a lot of great financial advisors are taking a much broader approach to comprehensive wealth management, as opposed to positioning their services as solely investment expertise or brokerage. The best wealth managers are increasingly taking a long-term approach to the preservation of client family wealth, and to helping clients achieve broad financial goals.

Holistic wealth management is about helping wealthy clients define and achieve long-term goals, rather than measuring an advisor's value in terms of short-term investment performance relative to market benchmarks. Many great advisors who are making the transition to a wealth-management orientation are finding ways to get more deeply involved with clients' families. An example of this is an advisor coaching a family through the issues involved with

multi-generational wealth transfer. That's a critical element right now. It's a way that a lot of great financial advisors are differentiating their service and adding value.

CSI: What was the overall outlook among the elite wealth managers who were invited to your recent conference?

SS: There's a fascinating dichotomy here. You have a number of macroeconomic problems that are weighing on the global investment markets and creating volatility — European sovereign debt, domestic unemployment, the sluggish rebound (in the EU and U.S.), and concerns about a slowing of China's growth, to name a few.

Yet many advisors have told us that from their perspective as investors, a lot of great American companies are looking attractive. Their stock is inexpensive relative to earnings, and many companies are sitting on a lot of cash. Advisors think a lot of American companies are lean and profitable. For savvy investors with a long-term view, there seem

to be plenty of opportunities. Advisors are finding lots of promising areas in which to invest, even in a turbulent market.

There's also a new level of diversification available to advisors, thanks to the product innovation of third-party investment managers. New funds and investment products are giving advisors access to unique investment strategies and non-correlated asset classes that they didn't have before.

So, there's optimism about long-term investors finding opportunities to make money and preserve capital in the market. That said, the consensus of the advisors who attended the event seemed to be that in the near term, we're going to continue to see pronounced volatility in the market, and that this turbulence may be with us for some time.

CSI: Do you think that investors are enthusiastic about the fact that all these corporations collectively have trillions of dollars that they're "sitting on," per se? Or is it confidence that at some point the compa-



THE BEST ADVISORS ARE INCREASINGLY TAKING A MORE SOPHISTICATED AND REFINED APPROACH TO ASSET ALLOCATION.

nies are going to do things with their capital—create more employment, more innovation, more value?

SS: I think there's a sense of hope from most advisors that companies will deploy that capital. They believe we'll see corporate spending increase slowly over the next few years, which will fuel growth in the economy, albeit gradually.

A lot of the advisors we talk with think that in the short term, from a valuation standpoint, American companies look poised for growth. Their balance sheets look relatively attractive.

Advisors also feel that in the long term, increased CAPEX spending will be critical to improving the U.S. economy. As that spending increases, it will also help advisors feel more confident about the investments that they're making.

CSI: What types of investments are drawing particular attention?

SS: Most of the advisors at our conference are looking at a wide range of investments, and they believe firmly in diversification and the use

of a broad asset-allocation strategy to achieve long-term investment goals for their clients. Within those parameters, it really depends upon an individual advisor's investment philosophy and the specific risk tolerance of a given client.

There is certainly a lot of discussion right now about fixed-income investments. Refining the approach to bond portfolios, both corporate and municipal, is a hot topic right now. So are alternative investments. A lot of clients come to the conference to hear about different strategies that can give them access to non-correlated asset classes, which help provide leverage to their investment capital.

CSI: What are examples of that?

SS: Beyond traditional long/short domestic equity-alternative strategies, advisors are looking at a range of new alternative strategies covering commodities, emerging and frontier markets, managed futures, derivatives, and MLPs, to name a few. What's become apparent to us is that the

best advisors are increasingly taking a more sophisticated and refined approach to asset allocation, which allows them to diversify and manage risk in ways that were previously unobtainable.

CSI: And maintain momentum through turbulent times.

SS: If you're referring to the health of the financial-services business, then yes. A lot of the firms represented by advisors attending our conference are dependent on the success of the wealth-management component of their broader businesses to pull them through the downturn that we've had over the last couple of years, as well as periods of market instability and volatility that may lie ahead. Most of these firms also have extensive trading and capital-market operations that are quite different and divorced from their core wealth-management business. The profitability of those operations tends to fluctuate dramatically with market cycles. The success of the wealth-management operation, which hinges on the advisors' ability to

protect portfolios, retain clients, and generate referrals, is critically important to the parent firm's overall momentum and success.

CSI: But there are long-term thinkers as well.

SS: Our event brings together the top one percent of financial advisors in the industry. They are all very sophisticated investors. They represent the full spectrum of the financial-advisory business. They come from large firms like Morgan Stanley Smith Barney, Merrill Lynch, Wells Fargo, and UBS; they also come from independent channels, including Registered Investment Advisors and independent broker/dealer networks.

CSI: So, all things considered, how optimistic are they now?

SS: I think that in terms of optimism, it's guarded now. There's a lot of skepticism and concern in the market about the global macroeconomic issues that I mentioned, as well as the lack of positive movement in the U.S. housing market. Those are some of the same issues that are also weighing down consumer confidence.

However, we've had several great advisors tell us that they never underestimate the power of American entrepreneurialism to create growth. Many of the advisors

we speak with believe that there will always be opportunities to find business success in this country. From an investment standpoint, that means that even in volatile and down markets, some companies will find a way to succeed, and that will make for excellent investment opportunities.

CSI: But they must diversify as well, as you mention. So how much are they looking to invest in opportunities that lie outside the U.S.?

SS: Among the advisors attending our conferences, one of the most pronounced investment trends we've seen is an increased awareness of and appetite for global, emerging, and frontier-market investment opportunities. This is being done not just as a way to seek investment return, but also as a way to hedge core bets on domestic stocks and reduce overall portfolio risk.

The percentage of advisors that are actively exploring emerging and frontier investment markets seems to increase every year. It's a clear trend, and I think it's one that's going to continue to grow in the next few years.

CSI: What sort of due diligence do they require for these markets?

SS: The short answer is a lot. The degree of diligence that the advisors we talk

to are taking in regards to their investments in foreign markets is enormous. Most are employing third-party investment managers and fund companies who have specialized resources and expertise for these investments. They put a great deal of scrutiny and diligence into researching and selecting those managers. Many advisors also routinely travel to China themselves, as well as to emerging markets in Asia, South America, and Eastern Europe, for a first-person view of the investment environment.

CSI: Right, they have to see it.

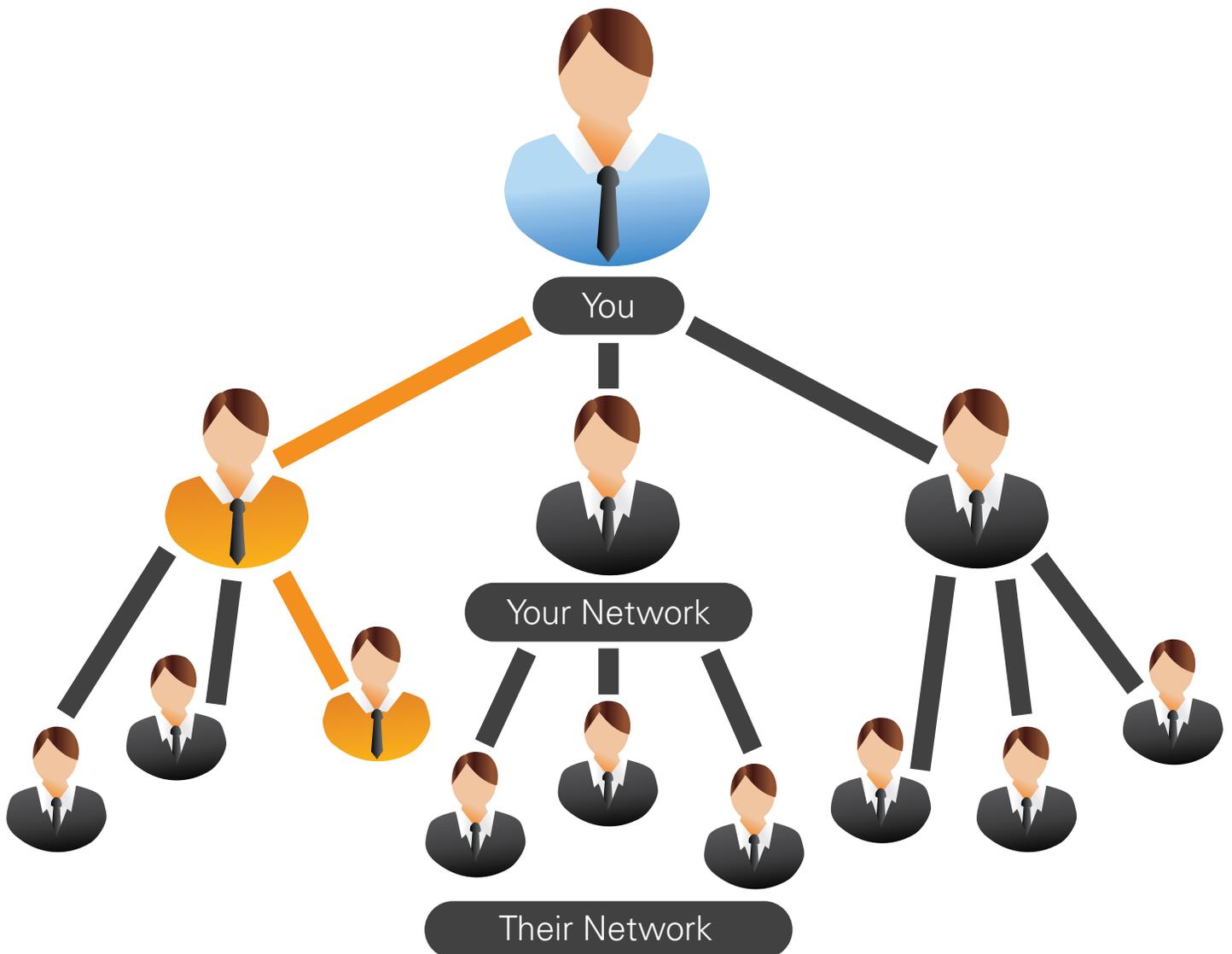
SS: Yes, they want feet-on-the-ground, security-specific research, as well as perspective on the opportunities for the companies and sectors they invest in to deliver the earnings that drive growth. The advisors at the level that we're talking about take this quite seriously.

They're looking at all angles of the equity and debt markets in the related countries that they're studying. For companies based in emerging and frontier markets, there's also a geopolitical factor and a unique global trading position for every country. Both of those factors can have profound ramifications for investment returns, so the need for due diligence can't be underestimated. **c**

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