

Compensation Committee Leadership Network

January 2018

CCLN

VIEWPOINTS

Board oversight of talent

Directors and senior managers often say that their companies' most valuable assets are their people, and boards typically take the lead in the selection and development of the CEO and other top executives. Today that role is challenging boards more than ever, as they face shortages of executive talent and shifting strategic priorities requiring different executive skills. In addition, boards are looking more broadly at the issue of talent, spending more time ensuring that their companies are taking steps to recruit, retain, and retrain the best employees at all levels of the organization. The responsibilities and skill requirements of the chief human resources officer (CHRO)¹ and the human resources (HR) function are evolving, and directors are working more closely with both the CHRO and the HR staff.

On November 30 and December 1, 2017, Compensation Committee Leadership Network (CCLN) members met in New York to discuss the evolving role of boards in talent management. For the session on December 1, members were joined by two guests with extensive experience as CHROs: Larry Costello, former CHRO at Tyco, and Kevin Cox, CHRO at American Express.

Management development and succession planning

Ensuring that a company has the best possible leaders in the C-suite has long been one of the board's most important responsibilities, and it is not getting any easier. The growing complexity and dynamism of today's business environment—characterized by globalization, technological disruption, and policy uncertainty—make choosing and developing the right individuals not only more critical but also more challenging.

A recent survey of over 1,000 directors and executives found that 58% of directors consider improving CEO succession planning to be a critical priority for 2018, a jump from 47% of respondents in 2016.² Meanwhile, a Stanford University survey of 113 directors of Fortune 250 companies found that, on average, directors believe that fewer than four people, either inside or outside the company, could run the company as well as the current CEO.³

The compensation committee often plays a large role in CEO succession, sometimes in conjunction with another committee or the full board. At the meeting in New York, CCLN members identified several ways their companies might improve development and succession practices, focusing on the roles of both the board and the incumbent CEO.

Start the conversation with a job description

Members said that the essential succession question is not about the specific candidates so much as the qualifications. One explained, *“Business models are changing. It’s not the same business going forward, and a different profile may be required. The internal pipeline might not have it naturally because of a tendency for the CEO to develop leaders in his or her own image.”*

A board needs to be confident in the strategy and in the skills required to execute it. *“We need to link the processes for strategy and CEO succession,”* one member said. Another member suggested that the board create a job description for the CEO of the future, focusing on the skills they will need in five years. Reflecting on the practice, the member said that the board is using that description to make sure the entire leadership team is developing the skills needed to succeed in the future.

The focus on long-term strategy makes CEO succession planning distinct from the emergency succession plan in place at most companies. Before the meeting, one member said, *“The hit-by-the-bus succession plan is not the CEO succession plan. In all those kinds of cases, the person selected is someone very experienced in the company—very wise, too old to be the successor, but very stable. They just serve as the emergency step-in CEO while we figure out what we’ll do.”*

Be clear about the board’s and the CEO’s respective responsibilities in the process

While the board must ultimately control the process, boards seek the active participation of the sitting CEO in identifying and developing his or her successor. *“We made a portion of the CEO’s compensation contingent on the CEO coming up with a good plan and presenting it to the board,”* one CCLN member explained. Another added, *“I’ve told our CEO that we need to keep developing candidates. We have three of them. We ought to be training them and working on their weaknesses. The CEO is getting used to this.”*

Members emphasized the need to keep the CEO’s views in perspective, acknowledging that it can be difficult for CEOs to appreciate the need for a successor with a different skill set or profile than his or her own. *“You want the CEO, as the most knowledgeable but also the least objective person involved in the process, to weigh in. Then you have to decide how objective they are,”* a member said. In some cases, as another member explained, this might mean a more direct role for the board: *“After asking for more in the way of succession planning, we were presented with only one credible succession candidate. We took the process away from the CEO.”*

An ongoing routine with agreed-upon rules can help the succession process go smoothly. *“If the discussion of succession has gone on for some time, it becomes a regular thing. It should always be an open exchange of ideas on who should take over, and the CEO should make*

their case. The board has an open discussion where the ground rules are set. The CEO will be involved, but there's also a rigorous process of looking externally," a member said.

The board's involvement in management succession extends below the CEO, but members said that for those roles the CEO should have the final decision. In a 2014 survey of 159 directors, just over half reported understanding the strengths and weaknesses of senior executives "extremely well" or "very well."⁴ A member noted, *"We can only look at so many levels, but I can insist that there is a process."* Members addressed this issue in advance of the meeting as well. One member said, *"The board has to be informed, but the final decision is the CEO's job. The board makes sure there's a good process, but it should not be the one deciding who the executive team is."*

Identify and address functional gaps early

It is rare to find a potential CEO who has all the skills in a job description. This is especially true with internal candidates because they don't typically have experience running a public company. Companies are doing more to help their internal candidates develop necessary skills before ascending to the role, members said. One member noted that operational leaders often have gaps with external relations: *"Some candidates don't have the experience with external swordfights that the CEO might have. We look for circumstances to give them that exposure ... to make sure candidates have the presence and skill to engage with outsiders like investors and regulators."* Another member described how one board tried to address this challenge by creating *"a detailed plan of exposures"* for succession candidates, including *"financial, regulatory, and policy"* competencies, as well as *"how to meet the expectations."*

Before and after the meeting, members brought up the use of external resources in assessing and developing candidates. One member mentioned a board getting an outside psychological evaluation of a candidate to better understand their strengths and weaknesses. Another said the board hired an expert to come up with an *"in-depth development plan."* A 2016 Conference Board survey of executive coaching practices found that "development-focused coaching" was the most common type of external coaching at organizations of all sizes.⁵ However, a member also mentioned the limitations of coaching: *"It's like coaches say, you can't coach height and speed."*

Insist on a clean break when the incumbent leaves

Once a new CEO has been appointed, boards must ensure a smooth transition. In any given year, about 10% of boards face this challenge,⁶ in which critical knowledge must be transferred with minimal disruption and confusion as to who is in charge. A common approach is to keep the outgoing CEO in a formal role, such as executive chair; according to a recent study of S&P 500 companies, 60% of outgoing CEOs stayed on as the chair of the board in 2016.⁷

Yet several CCLN members questioned this practice. *"It's a bad idea for the outgoing CEO to continue on the board. The new CEO has to have a clean slate. They need space, not the old*

CEO hovering,” one member said. Another drew on personal experience to advise against the practice: “When I took over, my predecessor stayed on the board. But whenever I had to present, the other board members would still look to him for validation.”

Instead of keeping the outgoing CEO closely involved after his or her departure, members suggested that the knowledge transfer could be enabled by having the incoming CEO work in a role reporting to the CEO, such as president or chief operating officer, before stepping up to the CEO role. Such an arrangement can also be tricky, however, as a member noted in a pre-meeting conversation: *“Sometimes there’s the issue of how much authority the [incoming CEO] is given. At one board, the CEO kept strategy and HR and gave the president everything else ... You don’t want a dead man walking, but you want the successor to have some authority.”*

A dialogue with chief human resources officers

In their discussion with Mr. Costello and Mr. Cox, CCLN members touched on several significant HR developments, which are in turn having implications for the board’s oversight of HR and its relationship with the CHRO.

Expanding CHRO responsibilities and skills

The role of HR and the CHRO is undergoing significant changes, though these changes are taking place in different ways across companies. Unlike other senior management functions, it is not always clear where a CHRO’s responsibilities begin and end. Mr. Cox shared some ideas about how to clarify the role: *“The model of a world-class CHRO involves many components, with the goal of driving business results. It involves being the architect of people strategy, an organizational-change leader, the steward of a company’s culture and purpose, a trusted advisor, and a functional leader of the HR organization.”* However, he added, *“The CEO owns culture. I’m the property manager; they own the building.”*

Mr. Costello also saw the emergence of new responsibilities, noting that HR has an opportunity to become a driver of value for the business rather than just a cost center. He highlighted the challenges posed by this shift: *“If you want to be a relevant HR function, it requires different skills. You have to comprehend the broader profile of where the business is going.”* Mr. Cox provided advice for interviewing and assessing prospective CHROs: *“You ask them how expansively they view the role. You ask them to give an example of the last time they participated in the development of business strategy. If they say, ‘I’m downstream from that,’ that’s not a good sign.”*

The escalating demands may already be influencing CHRO compensation. Equilar’s 2017 report on compensation for HR executives found that pay has recently increased at companies in all size ranges except the largest (over \$15 billion in revenue); at companies with revenues between \$5 billion and \$15 billion, pay for HR executives jumped 9.2% from 2015 to 2016.⁸

Members agreed that with such a broad mandate, it can be challenging for CHROs to set priorities. One commented that different CHROs have different strengths, and a CHRO’s skills

should align with the company's needs. *"There are at least two mindsets, one focused on tactical issues like compensation and benefits, and the other on strategy. You shouldn't try to make the CHRO a Renaissance man,"* the member said.

Given the changing nature of the role and the increasing need to understand the business, members were interested in whether the CHRO needed a traditional HR background. A 2015 study that interviewed 45 CHROs across 10 industries found that 53% had spent most of their careers outside HR, coming instead from various other business functions and consulting.⁹ Mr. Cox confirmed that effective CHROs can come from a number of different backgrounds, but he noted that, irrespective of their background (HR or other), business acumen is increasingly relevant to their success in the role.

A stronger team

One way that effective CHROs complement their own skills is by building a strong team around them. Mr. Cox said, *"The skill requirements of HR professionals are changing. World-class HR leaders need to think about upping their game in predictive analytics and third-party relationship management to focus on the fusion of business strategy and culture."* Members acknowledged the need for technologically skilled workers in HR, but noted that the demand for data scientists and others with experience in analytics makes it challenging for CHROs at some companies to attract this kind of talent.

Mr. Costello added that as HR leaders build out their teams, the focus on the needs of the business again comes into play. *"I always want people on my team to create value, not just be viewed as an expense. No matter what they are doing, someone in HR needs to have a business mindset in their work,"* he said.

Members said that as HR enhances its capabilities, it is important to demonstrate those capabilities to senior management. One member wondered what the CHRO should do if the CEO has not fully realized the potential of HR. Mr. Costello said effective CHROs must find ways to demonstrate their ability to influence change: *"They could pick something relevant in the business and create a solution or do a diagnostic. CEOs need to see examples. If you have a large sales group, for example, find ways to determine if their programs are getting the intended result. HR's relevance becomes obvious through education."*

Mr. Costello struck a note of optimism about CEOs' receptivity to new contributions from HR: *"The good news is that an enabling characteristic in many CEOs is that they want HR to transform themselves. CEO expectations are getting greater. They like a holistic point of view on the influence of human capital on the enterprise."*

Changing work landscape

A key driver of the evolution in CHRO responsibilities and skills is the changing landscape of work. The proliferation of social media and mobile technologies, the emergence of new technologies such as robotic process automation and artificial intelligence, and the entry of

millennials into the workforce are all having an impact. CCLN members highlighted several trends they are seeing and hearing about from experts:

- **The required skill set is changing.** Members pointed to a host of essential skills and competencies that employees across their organizations will require to a greater degree in the future. Companies will need to focus on both finding employees with these skills and training existing employees. These efforts will themselves require new skills and technologies. One member emphasized the need to utilize social media to attract and retain employees: *“If an executive team doesn’t know how to use social media, then they won’t be able to recruit and retain a big part of the workforce. Leading companies need to have executive teams well versed in those communication channels.”*
- **Automation is changing the nature of work.** Some members highlighted that automation does not solely eliminate jobs but can also shift resources toward other work by removing the focus on non-complex repetitive activities. One member said, *“We’ve brought down labor over time with automation. There is a lot of concern about those that are displaced, but I find that for every job that is displaced, we need to hire another technical person. It’s not so much a labor reduction, but a shift in the workforce.”*
- **New technologies are allowing greater flexibility.** Several members also noted that technological advances will result in greater flexibility in the way work is accomplished. This may include more remote working, role sharing, and freelancing. Telecommuting, in particular, can reduce costs while helping to attract and retain talent. One member said, *“We have eliminated offices for the entire salesforce.”* Another member said, *“There is certainly a higher degree of work being done outside of the formal office environment, but it’s probably not as dramatic as what’s happening in other industries since so much of what the company does is a creative team process.”*

Deepening relations between the board and the CHRO

The new demands on HR and the CHRO pose a challenge for board oversight. How can the board be sure that the HR function and the CHRO are successfully handling the complex issues they are facing? Mr. Cox remarked, *“Given the very limited access directors have, understanding a company can be akin to watching a ‘baseball game through a hole in the fence.’ Having been a director, the only real leverage you have is the questions you ask.”*

Members discussed how boards and CHROs can best help each other. One said, *“The audit committee can summon the chief audit executive, but the compensation committee doesn’t have that same relationship with the CHRO. What should it be?”* Mr. Cox recommended that members spend time with their CHROs in executive sessions or outside of board meetings to ensure coordination on the company’s people strategy. Mr. Costello added, *“In many cases, you need triangulation with the CEO, CHRO, and the board. The CEO is in the best position to prompt engagement between the CHRO and the board.”*

Members were also interested in when the CHRO might work with the board or compensation committee without the CEO's involvement. One member said, *"The CHRO reports to the CEO, until he or she doesn't. There are times when the CHRO must be accountable directly to the board. The board needs to be clear that if you see a particular risk, you have that kind of relationship."* Mr. Costello added, *"I tried to forge a great relationship with the compensation committee chair. I got enough 'surround sound' to understand what was on the board's mind, especially when I had the opportunity to be in the board meeting."*

Regarding how the CHRO should communicate issues to the board, Mr. Cox said, *"I can imagine picking up the phone, but for the most part, I do it through the meeting agenda. The best approach is to contribute to how the agenda is constructed, but with appropriate care."*

As boards focus more closely on talent strategy and the HR function, they also consider their own capabilities in HR. A Heidrick & Struggles analysis of board appointments to Fortune 500 companies found that "between 2009 and 2013 about two-thirds of the newly appointed directors were sitting or former CEOs and CFOs. While such board members are comfortable diving into the minutia of strategy and finance, without an HR background they are often reluctant to delve into talent issues."¹⁰ As workforce strategy becomes an increasingly important focus of board oversight, boards may seek more training in this area and more directors with experience in HR and other workforce-related functions.

How can the CHRO help the board with CEO succession?

CCLN members and guests said that an effective CHRO can be an invaluable contributor to the CEO succession process. Experts on CEO succession planning note that the CHRO can help in several ways: ensuring that the process is effective, objective, and stays on track; serving as counsel to the outgoing CEO; helping to retain internal candidates who are not selected for the top job; and positioning the new CEO for success.¹¹ Other more specific steps might include helping the board develop specifications for the new CEO, creating development plans for candidates, and keeping the board up to date.¹²

One member said that involving the CHRO initially created some friction, partly because the board had taken control of the process away from the CEO, to whom the CHRO felt allegiance. Ultimately, though, it proved valuable as the CHRO came to understand her responsibilities to the board. Mr. Cox described his own experience working on a CEO transition: *"I spent a lot of time, but I viewed my role as the showrunner, not the kingmaker."* Mr. Costello also noted the potential contributions of the CHRO, but confirmed that involvement can put the CHRO in an uncomfortable position and *"not all CHROs get a chance to play that role."*

Conclusion

CCLN members and their guests discussed how boards should oversee key aspects of CEO succession and the evolving HR function. They noted the importance of applying a long-term strategic perspective when developing CEO candidates, which may ultimately constrain the role of the incumbent CEO, though his or her input is vital. They also underscored the need to address functional gaps in candidates' experience early, and they noted that the outgoing CEO should not be placed in a position that could undermine the authority of the new CEO.

In their conversation with the CHRO guests, members explored how the CHRO and HR can drive value for the business, a more strategic role that requires greater business acumen as well as strength in data analytics. For boards, this shift entails working more closely with their CHROs—with and without the involvement of the CEO—both to support them and benefit from their expertise and knowledge of the company. Mr. Cox said, *“Be explicit about your expectations of the CHRO. With the right focus and capabilities, you can be the wind beneath their wings.”*

About this document

The views expressed in this document represent those of the Compensation Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, or Tapestry Networks. Please consult your counselors for specific advice.

This material is prepared by Tapestry Networks. It may be reproduced and redistributed in its entirety including all trademarks and legends.

Appendix: Participants

The following CCLN members participated in the meeting:

- Ramani Ayer, XL Group
- Erroll Davis, Union Pacific
- Marianne Harris, Sun Life Financial
- Jim Kennedy, United Continental Group
- Annette Leckie, Meridian Compensation Partners
- Jim Nevels, WestRock
- Laurie Siegel, CenturyLink
- Samme Thompson, American Tower
- Marc Ullman, Meridian

The following members took part in pre- or post-meeting discussions:

- Roxanne Decyk, Orbital ATK
- Kathryn Hill, Moody's Corporation
- William Kerr, Interpublic Group

Endnotes

- ¹ This document uses the abbreviation CHRO to refer to chief human resources officers or any other person charged with leading a company's human resources department or function.
- ² National Association of Corporate Directors, *2017-2018 NACD Public Company Governance Survey: Executive Summary* (Washington, DC: National Association of Corporate Directors, 2017), 6.
- ³ Joann Lublin, "Few Can Fill the CEO's Job, Directors Say," *Wall Street Journal*, October 10, 2017.
- ⁴ David F. Larcker, Scott Saslow, and Brian Tayan, *How Well Do Corporate Directors Know Senior Management?* Director Notes (Conference Board Governance Center, March 2014), 3.
- ⁵ D'Onofrio Consulting Partners, "2016 Trends in Human Capital and Executive Coaching," *Research Briefs* (blog), September 1, 2016.
- ⁶ David F. Larcker and Brian Tayan, *CEO Succession: Data Spotlight*, CGRI Quick Guide Series (Stanford, CA: Corporate Governance Research Initiative, December 2016).
- ⁷ Spencer Stuart, *2016 CEO Transitions*, (Chicago: Spencer Stuart, February 2017), 5.
- ⁸ Equilar, *HR Executive Pay Trends* (Redwood City, CA: Equilar, 2017), 13.
- ⁹ Aon Hewitt, *Developing the Next Generation of CHROs* (London: Aon plc, 2015), 22.
- ¹⁰ Nina Nærby, *The Talent Strategy Questions Every Board Should Ask* (Chicago: Heidrick & Struggles, 2015), 2.
- ¹¹ Claudia Lacy Kelly and Dayton Ogden, *CHRO at the Center: Five Recommendations for Managing an Effective Succession Planning Process* (Spencer Stuart, 2017).
- ¹² For a full list of more specific steps the CHRO can take, see Patrick M. Wright et al., *The Chief HR Officer's Role in CEO Succession: The View from the Board* (Columbia, SC: Center for Executive Succession, Darla Moore School of Business, University of South Carolina).