COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Positioning the company for long-term success

Appointing the right CEO and aligning incentives with long-term strategy help position a company for long-term success. Accomplishing this in the face of short-term pressure from markets and external observers is a common challenge for boards. In recent conversations and at a June 22-23 meeting, Compensation Committee Leadership Network members discussed how boards address these issues.[1]

Synthesizing these discussions, this *ViewPoints* focuses on three important questions: [2]

- What challenges must a board address when selecting the next CEO?
- How can compensation committees best align pay and long-term performance?
- How does ISS develop and apply its executive compensation policies?

What challenges must a board address when selecting the next CEO?

Success starts with the right CEO. In a wide-ranging discussion about CEO selection, compensation committee chairs addressed several common challenges in getting the right person in the role:

- Agreeing on the skills necessary for long-term success
- Comparing internal and external candidates
- Engaging the departing CEO appropriately
- Maximizing value from external advisers
- Leveraging in-person interviews
- Negotiating employment terms

Agreeing on the skills necessary for long-term success

Members emphasized that a CEO search must be focused on candidates with the skills to match the company's long-term goals. This process is often shaped by the company's strategic plans at the time of the CEO search. One member said, *"Once you converge on the long-term strategy you are more able to identify what it will take to make the next CEO successful. A board that does not agree on strategy is likely to have divergent views on CEO candidates."* Members expressed that the speed of change across industries makes the focus on the future more important than ever before. One member said, *"The notion of having an adequate amount of peripheral vision to see where the company and the world might go is critical. The board needs a clear view of how candidates will perform in this changing world."*

[1] For a list of participants in the June 22-23 meeting, see the Appendix on page 10.

[2] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

Some members contended that while it is important to consider the company's strategic direction when selecting a new CEO, it is also important to maintain enough flexibility to allow the incoming CEO to shape strategy. One member described a company in which *"we went and got a CEO who was good at transformation, because that is what we knew we needed. It was better to pick someone who could transform the company, and develop the strategy along the way, than to give the new CEO a fully-baked strategy."*

It is also essential for a board to consider how a new CEO will sustain or create the necessary culture, because this is often at least as important as its strategy. This can be particularly challenging with the departure of a founder or long-tenured CEO. One member said, *"A company can be hugely successful, but for it to stand and continue to grow, you may need a CEO who can develop a common value set independent of the personality of the founder."*

Comparing internal and external candidates

Network members extolled the value of having a broad pool of CEO candidates. One explained that a thorough search provides the board comfort that they can find the best candidate: *"Before selecting a CEO, you should make sure there is a very rigorous evaluation of the internal candidates against the best of whatever can be delivered from the outside world."* One recent survey of S&P 500 companies found that about 80% of new CEOs in 2015 were corporate insiders, a 20% increase from 2012.[3] However, another study of 2,500 global companies found that 22% of CEO picks in recent years have come from outside the company, up from 14% a decade ago.[4]

Comparing internal candidates, whom board members know very well, with external candidates who may be less familiar to them, complicates the process of finding the best candidate. One member stressed the importance of having informal conversations with outside contacts to bridge this information gap: *"On a well-connected board, it is amazing how frequently we can find contacts that know the candidates. The advantage of that is people are more willing to speak candidly in an informal setting than we may be able to extract otherwise."*

The decision to hire a new CEO from inside or outside the company is often situational. In a high-performing company, members said they were less likely to consider an outsider, absent extenuating circumstances. One member said, *"A good rule, generally, is that if things are going well, the cultural harmony exceeds the disruption of taking on an external candidate."* Most members said, however, that they were more likely to appoint someone from the outside when the company needed major changes. One member noted, *"There is pressure from shareholder and other constituents to consider outside candidates, especially when you replace a CEO for performance."*

Members added that many boards, when considering external candidates, are less focused on industry expertise than they have been in the past. One member said, *"Especially in industries with technological disruption, you might consider a broader slate of external candidates. If you talk about future threats and*

[3] Joann S. Lublin, "More CEO Jobs Are Going to Inside Candidates," *Wall Street Journal*, March 8, 2016.

[4] DeAnne Aguirre, Per-Ola Karlsson, and Gary L. Neilson, "From the Outside In," *strategy+business*, May 2, 2016.

trends, you might realize that knowledge of the industry, historically, is less relevant in a new, disruptive world." Another added, *"One approach is to look at people who have solved similar problems, even if outside the industry. Sometimes it feels like the right problem-solving skills are as important as industry knowledge."*

There are often exceptions to these general principles. For example, one member described a company where *"it would have seemed obvious to appoint an internal candidate, but one kicker was that the way the top executives were managed, to appoint any one of them would create an unmanageable structure for the rest of the team. It was a complicated issue, but the company was better off keeping each of them in their roles."* In some cases, however, appointing an outside CEO may cause too much change all at once for an underperforming company. One member cited the situation of a company in the middle of a major crisis: *"The minimal risk would be to pick the best internal candidate for some transition period, so the board can do all the work you need to do to make sure you are making the right decision for the long haul. Once things have stabilized, you can revisit whether that internal candidate is the right choice."*

Engaging the departing CEO

While members agreed that the independent directors must own the CEO selection process and make the ultimate decision, they also acknowledged the value of a departing CEO's perspectives and opinions. But this acknowledgement came with a caveat, which one member described: *"Even with the best-minded CEO, the harsh reality is that the board's view of the internal candidates is filtered and influenced by the CEO's opinions. At the same time, the CEO has a role as the person with the most insight into the day-to-day performance."* Boards must weigh carefully the incumbent CEO's singular perspective against possible bias, and not give undue weight to his or her perception of potential successors.

Members suggested several strategies for boards seeking to augment the CEO's evaluation of internal candidates. One member said, *"As a board, you should get a well-rounded picture of the candidates. You can use outside resources to do an objective analysis, or get to know them better yourselves, so you are not dependent on the CEO's evaluation."* Another member added that the board should ask the CEO to provide details to back up his or her recommendation: *"It is important to understand not just who the CEO sees as the best successor, but why. They work so closely with these people that it can be hard for them to acknowledge their biases. The board needs to use them as a source of information, not to make the decision."*

Members also noted the benefits of keeping conversations about the outgoing CEO's future role on the board completely separate from the CEO search. One member said, *"I can recall one board that was influenced by the CEO's views to choose a particular internal candidate. A part of the reason for the CEO's endorsement was that the candidate would be happy to have the departing CEO stay on the company's board for a long time."* Another added, *"My strong bias is that the departing CEO's board tenure should be short, if at all, and it should not influence the CEO selection process at all."*

Maximizing value from external advisers

Boards regularly rely on outside advisers to help identify and evaluate CEO candidates. One member said: *"It helps to have an additional, well-informed resource to offer an objective assessment on what is right for the company. It doesn't always have to be a traditional search firm; a whole range of people can play that role, including former chairs and CEOs of companies."* It is important to establish at the outset that external advisers work for the independent directors: *"Whether it is a search firm or someone else, it needs to be the board who selects those third parties, not the CEO,"* another added.

Members also debated when to get outside advisers involved in a search. One member said, *"Well before we start a formal search, we engage a firm to do a desk search. That means that they create a list, without talking to people. We ask for that list to be updated regularly. This helps to define how broad we are willing to go."* One benefit of early engagement is that managers are less likely to view the presence of these advisers as a threat to their future prospects. One member explained, *"By working with firms as part of our long-term talent assessment process, we created an environment where there were always conversations with search firms, so it didn't create a problem."*

Leveraging in-person interviews

Even after background research and reference checks, directors rely heavily on in-person interactions with the candidates. One member explained, *"In an interview, you will start to see their personality and how they plan to run the company."* Another said, *"It is really helpful to hear their approaches to solving problems. A person who has gone through the process of properly preparing for an interview will demonstrate pretty good signals about how they will do once they are on board."*

Members emphasized the importance of having a broad group of board members meet candidates. One said, *"It is helpful to have two or three directors interview the candidate at once. It makes for a dynamic discussion."* Others suggested that finalists meet with the full board.

Negotiating employment terms

The final stage of a CEO selection process includes negotiating compensation terms. This should start relatively early in the hiring process. One member said, *"It is very helpful to give a general sense of what you are thinking about up front, so you are not worlds apart. You want to do that at least before you've eliminated the second-best choice."*

Members expect CEO candidates to come to the negotiations prepared. One opined, *"I would think a candidate would, at a minimum, look at the proxy. How we pay the current CEO says something about the culture of the company, not just compensation."* Candidates also benefit from receiving good advice: *"Search firms can help to coax and coach good candidates to do more research or dampen down the wilder expectations in a way that feels more acceptable to the candidate."*

Negotiations can be more difficult when a candidate is the CEO of another company. Meridian's Annette Leckie explained, *"The expectation is that a non-CEO candidate gets paid a step down from what the predecessor was making. That could still double their pay from what they were making in their prior role.*

If you bring in a sitting CEO, you might have to pay more. Those negotiations are more about what they are leaving behind, rather than the pay of their predecessor."

In rare instances, compensation discussions could cause a board to eliminate a candidate from contention. One member said, *"We identified someone and broadly described the compensation package. During the course of the conversation on specifics, this candidate made demands, including benefits we didn't offer the incumbent. We cut off the conversation as a result. It told us something about the candidate's character."*

Macroeconomic outlook

Mickey Levy, chief US and Asia economist at Berenberg, joined members for a wide-ranging discussion on the global economy. Dr. Levy described an environment where *"growth and international trade are softer, and potential future growth has come down. There is a low probability of a recession in the US, but growth is likely to continue to be disappointing."* He added, *"The Federal Reserve's monetary policy has not stimulated growth. The economy is constrained by non-monetary policies, including government regulation and our corporate tax system."*

Members and Dr. Levy shared concerns about the number of workers in the US who are not succeeding in this economy. One member asked, *"Is there a groundswell towards widespread adoption of an increased minimum wage to address this problem?"* Mr. Levy responded, *"There is a push, in some states, to do that. But the minimum wage addresses the symptoms, rather than the causes of the problems. Skills and education are the only long-run way to fix this problem and raise the living standards of those lesser skilled people."*

Members observed that for many companies, economic uncertainty leads to more difficult investment choices. One said, *"A lot of companies that have cash are being pressured by the investor community to buy back shares or increase dividends, rather than acquire additional widget-making capacity right now. When you factor in the risk, the decision to keep or return cash outweighs investment."* Dr. Levy suggested that some signal of a functional government could stimulate investment: *"If leaders could strike a compromise on corporate tax reform, for example, it would lift a gray cloud off [of] Washington. Factors like tax and regulatory uncertainty are causing companies to add a few percentage points to the rate of return they would need to make an investment."*

How can compensation committees best align pay and long-term performance?

Members also addressed effective practices to motivate and reward management for long-term success. The most common long-term compensation plans feature a three-year performance period where cumulative goals are established at the beginning.[5] Only 1% of S&P 500 companies use a performance period longer

[5] Meridian Compensation Partners, *2016 Trends and Developments in Executive Compensation* (Lake Forest, IL: Meridian Compensation Partners, 2016), 20.

than five years.[6] Discussion focused on the metrics used in long-term plans and the role relative performance plays in the process.

Evaluating the prevalence of long-term metrics

Most compensation committees use more than one metric to assess long-term performance. The most common metric is total shareholder return (TSR), which was used at 59% of major companies in 2016 based on Meridian's recent survey, up from 44% in 2011. Other common long-term metrics in 2016 included earnings per share (22% of companies versus 23% in 2011), return on invested capital (16% of companies versus 13% in 2011), and operating income (14% of companies versus 21% in 2011).[7]

Members were interested in the prevalence of TSR and alternative ways to assess long-term performance. Meridian's Ms. Leckie provided context on the continuing rise of TSR: *"One benefit of using TSR for a long-term plan is that you don't need to set three-year goals. Over a three-year period, it's easier to set relative positioning goals than it is to set absolute goals."* One member said, *"In times of change, TSR is the only way to measure performance."*

But a number of members were concerned about the proliferation of TSR as a metric. One member asserted that the lack of absolute goals in a TSR plan is precisely the problem: *"Using TSR as a metric can be demotivating for a management team. It is hard to achieve performance goals when the factors you will be measured against are unknown."* Members suggested that, based on a company's industry and or current situation, there are usually a handful of other metrics that more accurately reflect management's long-term performance.

Ms. Leckie encouraged members to pay attention to how compensation committees are using TSR: *"One statistic to watch is whether relative TSR is the sole metric in a long-term plan. We don't think the number of companies using TSR will go down, but its role within the plan may shift, with more companies either pairing it with an operational metric or using it as a modifier. There will likely be fewer plans that rely 100% on relative TSR."* One member said, *"TSR's best use is as a threshold. It shouldn't be used to measure performance, but if TSR is below a certain level, management shouldn't receive a large payout."*

Considering relative performance

When assessing long-term performance, boards generally compare the company's results to peer companies or to the market more broadly. This is especially true with TSR plans, which almost always base awards not on absolute returns but on how those returns compare to those at other companies.

Members discussed the challenges in constructing the right peer group for a relative TSR calculation. One member said, *"In an industry with a lot of change and growth, we evaluate and re-evaluate the group regularly. Circumstances change with some companies that mean they are no longer a good part of the*

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[6] "Executive Incentive Plans: How Leading Companies Pay for Performance," Equilar, updated April 6, 2016.

[7] Meridian Compensation Partners, *2016 Trends and Developments in Executive Compensation* (Lake Forest, IL: Meridian Compensation Partners, 2016), 21; Meridian Compensation Partners, *2012 Trends and Developments in Executive Compensation* (Lake Forest, IL: Meridian Compensation Partners, 2012), 1.

mix." Another member said it was important to do this evaluation, but *"our peer groups are not changed a lot from one year to another. With all the external eyes looking at our proxy, there are unintended consequences of making a dramatic change."*

In some cases, the difficulty of constructing a truly representative peer group leads the compensation committee to dismiss relative TSR as a metric. One member said, *"The lack of a true peer group is always an issue. We don't want to create a group that doesn't make sense, and it is also hard to compete against some large index."* Another added, *"We can cobble together a bunch of companies with similar businesses, but it is extremely challenging to find peers that make enough sense to use relative TSR as a predominant metric. We consider the peer group pay as a data point, but it is not dispositive."*

How does ISS develop and apply its executive compensation policies?

Carol Bowie, head of Americas Research at Institutional Shareholder Services (ISS), joined members to discuss ISS' process for analyzing proxies and making vote recommendations. Members discussed how ISS develops and applies its policies, and how the firm thinks about issues related to executive compensation.

Understanding ISS policy development

Ms. Bowie provided members with details about the processes by which ISS develops policies and recommendations on specific issuers. The firm draws on a range of experts and stakeholders, not just its clients:

> The policy review and update process begins with an internal review of emerging issues and notable trends across global markets. Based on data gathered throughout the year (particularly from client and issuer feedback during proxy season), ISS forms policy committees by governance topics and markets. As part of this process, the policy team examines academic literature, other empirical research, and relevant commentary. ISS also conducts surveys, convenes roundtable discussions, and posts draft policies for a review and comment period. Based on this broad input, ISS' Global Policy Board reviews and approves final drafts and policy updates for the following proxy year.[8]

Ms. Bowie added, *"We seek the perspectives from both our institutional-investor clients and also corporate issuers and board members."* Some members were surprised to hear that ISS' online surveys are open to directors. One said, *"It is a bad sign that many of us have never heard about your survey process or participated in your survey."* Another member, who had received an ISS survey in the past, found the survey hard to interpret.

Ms. Bowie emphasized that, *"At this point, very few ISS policies lead to a recommendation to always vote one way or another on a given issue. The pay-for-performance policy, in particular, is crafted to identify cases for further evaluation."* ISS reviews proxy statements and other corporate filings to assist in the process;

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[8] Institutional Shareholder Services, *Executive Summary: Proxy Voting Guideline Updates and Process* (Rockville, MD: Institutional Shareholder Services, 2014), 3.

it also gathers information through direct engagement with corporate issuers.[9] In 2012, the company set up a feedback review board designed to serve as an additional channel of engagement for stakeholders.[10]

Focusing on compensation policies

Though ISS formulates policies on a range of issues and makes numerous recommendations every year, some draw more attention and controversy than others. In a candid and open dialogue, Ms. Bowie explained ISS' process and solicited feedback on ways to improve. Members expressed concern about how ISS uses Global Industry Classification Standard (GICS) codes and TSR in their pay-for-performance analysis.

- **Members believe that TSR misses important nuances and fails to motivate senior managers.** Ms. Bowie explained that ISS uses TSR to measure alignment between pay and performance in its quantitative pay-for-performance screen for three reasons: *"It is universal, transparent, and aligned with shareholders' interests."* Some members suggested that a process that uses the same measure for all companies, regardless of size, maturity, and industry, is fundamentally flawed. Members also identified specific challenges with TSR. One said, *"TSR is not a goal that a management team can use to run the business."* Other directors explained that TSR does not capture many of the incremental achievements that companies seek to reward, and suggested that ISS consider output metrics, such as free cash flow or return on equity or capital, to obtain a more complete picture. Ms. Bowie noted that ISS analysts consider many other metrics, including those mentioned, during the qualitative analyses that follow the quantitative screens.
- **Reliance on algorithm-driven peer groups minimizes the usefulness of ISS' peer analysis to members.** ISS uses a formula to create a custom peer group of 14 to 24 companies for each company it analyzes, based on GICS code (including GICS codes of a company's self-selected peers) and annual revenues.[11] It then uses those groups as part of an initial quantitative screen in its pay-for-performance analysis. Members said that this process often misses true competitors and includes companies with different business models or talent pools. Other members were concerned that ISS was not open to engagement about why certain companies are included in a peer group. Ms. Bowie explained, *"We don't negotiate peer groups on a company-by-company basis, but we will consider changes to the formula if we receive feedback that it is not working for an industry as a whole."*

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Board directors strive to ensure the success of a company not just for the current quarter or the year, but for many years into the future. Selecting a new CEO, changing the metrics in management's long-term incentive plan, and interacting with proxy advisers and other stakeholders are all carried out with this goal in mind. We look forward to continuing the discussion about setting and achieving long-term priorities.

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[9] "FAQs: Engagement on Proxy Research," Institutional Shareholder Services, accessed June 6, 2016.

[10] Institutional Shareholder Services, "ISS Raises the Bar for Transparency and Responsiveness," news release, March 29, 2012.

[11] Institutional Shareholder Services, *2016 U.S. Proxy Voting Policies and Procedures – Frequently Asked Questions on Peer Group Selection and Methodology* (Rockville, MD: Institutional Shareholder Services, 2015), 3.

About this document

Appendix: Contributing members

The following members participated in the meeting:

- Ramani Ayer, XL Group
- Carl Berquist, Hertz
- Roxanne Decyk, Orbital ATK
- Marianne Harris, Sun Life
- Kathy Hill, Moody's
- Bill Kerr, Interpublic Group
- Annette Leckie, Meridian Compensation Partners
- Mary McDowell, Autodesk
- Don Parfet, Masco
- Samme Thompson, American Tower
- Marc Ullman, Meridian
- Linda Wolf, Wal-Mart

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

- Mel Lagomasino, Cola-Cola and Disney
- Steve Reinemund, Marriott
- Laurie Siegel, CenturyLink