BOARD GOVERNANCE SERIES

This quarter's edition of the Board Governance Series takes a closer look at two hot topics: CEO compensation and cyber risk priorities. In our first article, Bob Romanchek with Meridian Compensation Partners discusses pay considerations when hiring a new CEO from outside the organization. Next, Diligent's Jeffry Powell addresses cyber risk management priorities for boards in 2016.

These articles, which are condensed, edited versions of the webcasts available online, are designed to supplement boardroom discussion. For a full video presentation, the associated webcasts can be accessed at nyse.com/corporate-services/nysegs or at the contributors' websites.

By Laura J. Finn and Deborah Scally

PAY CONSIDERATIONS WHEN HIRING A NEW CEO FROM THE OUTSIDE

CEO tenure right now is about five years, and that makes succession planning one of the top issues boards should be thinking about and discussing. When boards are looking at candidates, are there differences between an internal candidate and an outsider?

Yes, absolutely. Let's step back for just a minute. If you look at current data on this topic, about 75% of CEOs within the last couple of years who have been replaced were done so through internal promotions. From that perspective, you can imagine those executives are participating in the company's current compensation plans and programs, and so we're talking exclusively about a bump in compensation to be competitive. Now, contrast that to an external CEO candidate. About 25% of the recent CEO replacements were from external hires. This presents a completely different situation and a completely different process to determine the proper compensation. And because of the additional risk, with a late-career executive switching companies, you are going to end up paying more to compensate that external hire for the incremental employment risk.

So when hiring an external CEO, is there a different compensation approach that is necessary, and how has this approach changed over the years?

With the internal hire, typically that executive has been with the organization through the succession planning process. That person knows that he or she is in line to be promoted into the CEO position. So you are probably not redesigning the incentive program upon their promotion. As a matter of fact, that executive probably had some input on the design of the executive pay program and on the level of the goal setting. So he or she is familiar with the compensation plans, the facts and circumstances of the company, and the business strategy. Therefore, we are really talking about an increase in compensation so that he or she gets a competitive pay package at the new CEO level.

Compare that to an external hire, where there are more significant considerations. First and foremost, you need to get the pay package competitive for the new CEO role. So the ongoing, regular-cycle base pay, target bonus, and annualized, long-term incentive grants all need to be within a competitive range matching the company's philosophy as articulated. Second, an external CEO candidate may be coming from another organization where he or she is forfeiting pay, i.e., compensation that is not yet vested, in particular long-term incentives, and perhaps supplemental retirement benefits. Most organizations have three-year performance and vesting cycles on their long-term incentives. So there are probably going to be three cycles outstanding, with various pieces that are not yet vested. Those typically come into the negotiation process, as an incoming executive is going to want these forfeitures replaced to some degree.

Given the circumstances—with the enhanced risk of late-career job switching and the ensuing uncertainty—in addition to providing a formalized severance program, it would be very common to provide some additional inducement for the executive to come aboard. This likely comes in the form of additional long-term incentives, equity in particular. In considering the regular pay package, I try not to alter the internal pay structure for the executive population by making an exception for any of the regular pay components for the incoming CEO. So all these additional pieces—the forfeiture replacement, the inducement—should be dealt with using a new pay component, which very simply is a one-time special equity grant. And what you're really doing is sizing that grant. It might be smaller as inducement, or it might be larger because of the material value required to replace the forfeitures.

Let's look at the long-term incentive program in a little more detail and talk about some of the components of the long-term incentives that could be changing for the external hire.

Ideally the focus should be on providing a competitive pay package with an extra, one-time, long-term equity grant. It would be nice if that special equity grant matched the design and performance weighting of the ongoing long-term incentive program. However, I would say in many cases that doing so is not possible because of the negotiation for replacement of the forfeitures from the prior employer being left on the table. Very often, the incoming CEO wants full-value shares, dollar for dollar for forfeitures, without subjecting that compensation to additional performance goals and thereby additional risk. So if you can get half of that special grant to be performance based, that's fantastic. You may not be able to achieve that. It could be that this is all just a full-value share restricted stock grant with three-year vesting. So, you're getting shareholder alignment and some retention out of that special grant while the executive is getting additional value that's shoring him or her up from forfeitures and inducing that person to join the organization, without wrecking your ongoing internal pay structure.

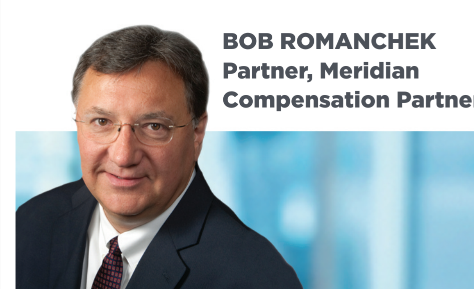
How do shareholders typically feel about special equity grants?

That is a great question. Let me give you a twofold answer. First, to make a grant, you typically need shareholder-approved shares. However, for this type of special equity grant, there's an exception. For those grants used for hiring from the outside, you can use so-called "inducement grants." Both the NYSE and NASDAQ stock exchanges have formal exceptions that are not very well known. These special grants do not need to come out of a shareholder-approved pool. And that's a very critical and important difference when otherwise you would burn up a lot of shares, which could cause you to go back to shareholders early. However, if this entire special inducement grant for outside hires can come out of a nonshareholder pool, your shareholder-approved pool will last longer. The proxy advisory firms are OK with that as well. All you need to do is get your board or compensation committee to approve that grant by a majority, then notify the exchange in writing (in a few simple sentences). Interestingly, the listing requirement actually requires you to issue a brief press release that identifies all the material aspects—who it is, what the vehicle is, and how much.

The second part of the answer is that in thinking about large shareholders, if you're hiring a new CEO, that transaction is going to get scrutiny immediately, whatever you do. The compensation, in particular, is going to be a material component of that scrutiny; it will be disclosed as part of the public record, so people are going to be looking at it. Thus you want to make sure the compensation package is structured appropriately and there is some tie to the company's strategy, alignment with shareholders, and the facts and circumstances unique to the company.

Also keep in mind that the tests used by proxy advisory firms focus on the CEO. So whoever is the CEO at the end of the year, even if it's only for a week, that's the compensation they're plugging into these tests to determine "yes" or "no" on say on pay, for example.

Therefore, if you have a very high sign-on or inducement grant with a competitive pay package, made even higher by replacement of forfeitures, you're setting a high pay value for the company's anchor year for the five-year test, for example, in comparison to TSR performance. Just be aware of that. The more you can make that one-time, special inducement grant performance based, versus pure time-based vesting, the better time you'll have with the large shareholders and proxy advisory firms.



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