

The corporate director and succession planning

Nine points to consider when preparing for SEC Bulletin 14E

by James W. Peters

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Last October, the U.S. Securities and Exchange Commission issued bulletin 14E, which strongly recommends boards of directors provide comprehensive succession plans to shareholders. While compliance regulations are yet to be hammered out, the bulletin provided three core criteria that directors should examine when weighing how to meet this new responsibility. Viewing these criteria in light of best practices for succession planning gives corporate directors a head start on an effective response to bulletin 14E.

Public confidence in the U.S. securities market was shaken deeply in 2002, when major corporate and accounting scandals were uncovered at now notorious companies such as WorldCom, Enron, Tyco International, and others. In response, the U.S. Congress passed the Sarbanes-Oxley Act of 2002. SOX, as the law is known, enhanced accounting standards significantly, and created a daunting array of requirements and responsibilities for directors of public corporations. SOX oversight and implementation fell to the U.S. Securities and Exchange Commission.

In response to our more recent global financial crisis, the U.S. Securities and Exchange Commission has issued a new bulletin indicating their intent to scrutinize the “succession planning practices” of public corporations, placing a further burden of responsibility on the directors’ shoulders.

Bulletin 14E, which was crafted by the SEC’s Division of Corporation Finance and issued on October 27, 2009, states:

One of the board's key functions is to provide for succession planning so that the company is not adversely affected due to a vacancy in leadership. Recent events have underscored the importance of this board function to the governance of the corporation. We now recognize that CEO succession planning raises a significant policy issue regarding the governance of the corporation that transcends day-to-day business matters of managing the workforce.

The current financial crisis exposed the lack of coherent and effective succession planning practices at leading financial service companies including Citigroup, Merrill Lynch, and Bank of America. When orderly succession in a time of turbulence was required, their succession planning processes failed, leading to dwindling shareholder confidence in the board's command of the situation and the potential loss of significant shareholder value (Clark 2008).

Whereas succession historically has been viewed as the prerogative of management, best corporate governance practice today puts this

responsibility on the shoulders of the board of directors. Succession planning is now viewed as part of a board's fiduciary and risk-mitigation responsibilities, and shareholders can be expected to

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be more vocal on the issue (Griffith 2009).

SEC Bulletin 14E goes further in its recommendation that boards adopt and disclose detailed CEO succession planning policies that include:

- Comprehensive criteria for the CEO position
- Identified internal candidates with appropriate development plans in place
- A formal assessment process to evaluate internal candidates

Bulletin 14E undeniably represents a new set of expectations for directors. Unlike SOX, however, compliance should not be viewed as daunting. A body of well-documented research has built the framework already for effective succession plans. Contemporary succession planning programs were initially spearheaded in the 1970s by notable companies such as General Electric, IBM, and Exxon, and the art and science of succession has been honed and refined since.

Those who grasp this body of knowledge can deliver the effective stream of talent that a strategically responsive corporation demands. And yet studies by the National Association of Corporate Directors (2007 and 2009) and others show that 42 percent of publicly traded companies lack an effective succession planning process, if they have one at all. The succession failures at Bank of America, Merrill Lynch, and Citigroup can be attributed to those companies' failure to pay more than superficial attention to this critical process.

Further, as happened with SOX, financial markets and governments outside the United States are starting to adopt similar principles, requirements, or regulations. Mitigating against the risk inherent in succession is a global issue.

The following overview looks at the art and science of succession as it applies to the three requirements suggested by Bulletin 14E. For each requirement we have provided three points that are essential for corporate directors to consider as they assume responsibility for CEO succession and succession planning in general.

Criteria for the CEO position

Corporations are confronting rapid changes: technological innovations, shifting customer expectations, new competitors, new business models, globalization, as well as public policy issues such as environmental sustainability. In other words, today's successful CEO may not be the CEO a company needs in a few years. Succession planning, then, doesn't simply mean identifying a "replacement" CEO, but anticipating the appropriate candidate pool for the future.

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In a well-considered succession planning process, the board of directors, most often in conjunction with the CEO, determines which competencies are essential to executing the company's strategy. Most often, the board focuses on key senior executives who appear suited to lead in the future. So once the set of competencies, or criteria, for the CEO role is established, all those executives and a few standout high-potential executives undergo a comprehensive assessment.

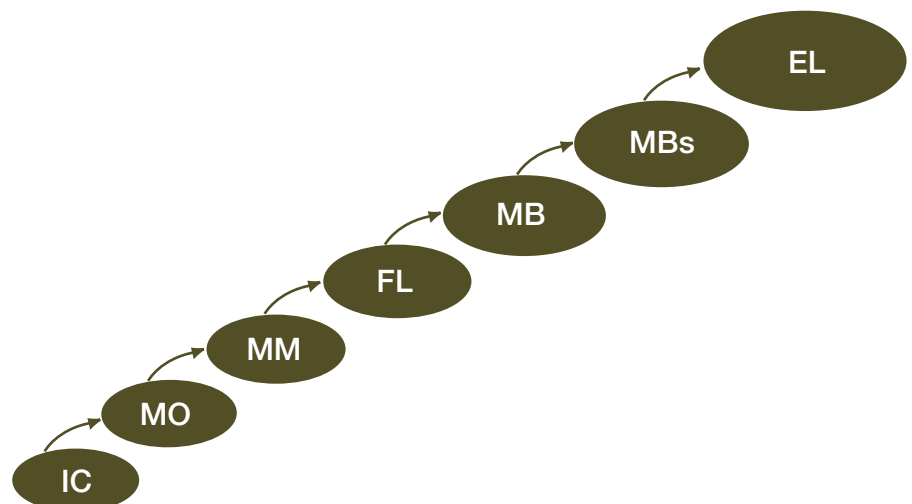
The board also must be prepared to deal with a CEO's sudden departure, of course. But that process and its immediate result may be very different in terms of interim structure and leadership. The focus may still be on key senior executives within the company, but also can include consideration of board members and external candidates.

1. Align the criteria for CEO to strategy. There is a well-honed methodology to develop and forecast strategic scenarios. For instance, each company has certain *organizational capabilities*, which represent the knowledge and skills within the organization. Before pursuing any given strategy, the company must ensure that it has in place the required set of organizational capabilities, each of which require different individual competencies from executives (Eichinger, Ruyle, and Ulrich 2007).

The leadership team's competencies and experience should be audited against those demanded by mission-critical organizational capabilities. That will reveal the individual competencies required for future CEO candidates. In assessing CEO candidates, boards can identify the degree to which each meets the future requirements of the organization, and then implement the appropriate development plans to close any gaps.

2. Apply the criteria deep in the organization. The average tenure of a CEO today is approximately five years. Strategy plans, however, often extend beyond a five-year window. Therefore, a succession planning process that focuses only on existing members of the C-suite may be limiting the potential pool of candidates for consideration.

Figure 1
The Leadership Pipeline



A useful model to consider is the Leadership Pipeline. As the graphic below illustrates, there are normally seven mission-critical roles that exist in an enterprise: the individual contributor (IC), manager of others (MO), the manager of managers (MM), functional leader (FL), the manager of a business (MB), the manager of multiple businesses (MBs), and the enterprise leader (EL), commonly referred to as the C-suite (Charan, Drotter, and Noel, 2001).

Progressing through the pipeline, an individual goes through a series of strategic transitions and learns the competencies requisite for success in each role. For instance, a functional leader can lead through knowledge and authority; he or she knows more about the function or technology than anyone else and, as a result, is the authority. In managing a business, however, that executive is now responsible for managing and leading others in a multifunctional setting where he or she relies on influence, not authoritative knowledge. These are completely different challenges, requiring very different competencies.

The value of the leadership pipeline construct was on display when GE found its successor for CEO Jack Welch in Jeffrey Immelt in 2001. The process was well-documented and reported in the popular financial press. What is less well-known is that Immelt was identified in 1982 as having the potential to be a GE leader at the enterprise level—though not necessarily CEO. His career experiences were then carefully evaluated and guided through the leadership pipeline in preparation.

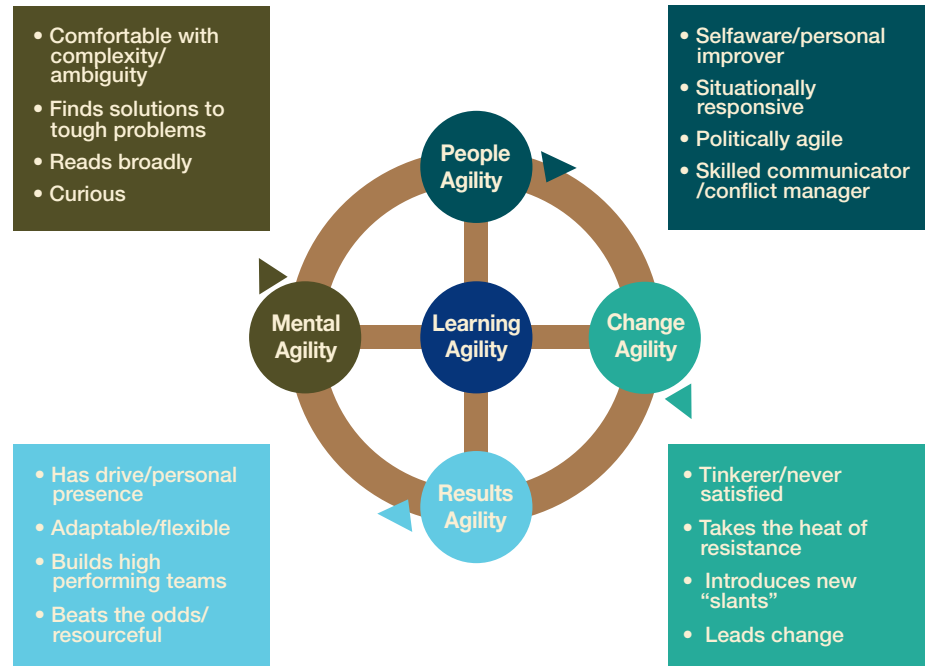
So were the careers of hundreds of other executives. After nineteen years of preparation, he was one of three primary candidates eventually was chosen by GE's board of directors as the best-equipped to address the strategic challenges of the company (Welch, 2001).

The best internal successor to the CEO years into the future may well be deep and unknown in the organization today. A good succession plan will unearth that person.

3. Include learning agility in any criteria. Most executives can readily repeat the mantra: “Past behavior predicts future behavior.” This is an excellent truism if the task at hand is similar. But what if the executive needs to do something new or different? Who is most likely to be successful taking on a completely new role, such as CEO? Who is most likely to be successful in working in a new company, executing a new strategy, working in a new industry, managing in a new culture, or assembling and leading a brand new executive team? Research says it's the agile learner.

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Figure 2
Four Factor Model of Learning Agility



Learning agile people can respond quickly to diverse, intense, varied, and adverse assignments. Essentially, these are the leaders who quickly “get it” when placed in a new situation or when circumstances require them to quickly change course (Eichinger and Ruyle 2010).

Given that a chief executive officer will always face unanticipated challenges, one critical criterion for identifying, developing, and selecting a CEO candidate must be the executive’s level of learning agility. A lack of learning agility may even explain why the average CEO tenure is about five years—not longer.

When Edward D. Breen took the reins at a troubled Tyco, he and his senior talent officers created a competency model against which the top 500 executives would be evaluated, assessed, and developed. The model also served to clarify what he valued, and it notified everyone of a major culture change.

Breen then used a quarterly conference call with financial analysts to explain what he was doing. Shortly afterward, in April 2004, Moody's Investor Services published the following:

A successful transition from acquisition to operations-based growth will require further development of managers who are skilled in day-to-day operations rather than acquisition-strategy and financing. This transition is already well under way....The shift in needs and expectations demands a focused and active succession planning process. The CEO [Breen] and the Board have put in place a more robust succession planning process at the corporate level, naturally the first priority. The CEO, for example, personally reviews data on the performance of the top 500 executives and reviews data on about 75 promising candidates for promotion with the Board.

Breen understood that superior performance required superior and learning-agile talent, and that an enterprise that nurtured and developed talent was more likely to achieve its financial goals than one that does not. The analysts and shareholders seemed to understand as well. In the weeks following that report, Tyco stock rose \$3 (Johnson 2004).

Internal candidates and appropriate development plans

Shortly after the very public selection of Jeffrey R. Immelt as CEO of GE, a chief executive officer of a multibillion-dollar computer services company expressed disbelief. "How can they do that?" he asked. What he found shocking was that GE, in fact, had *three* excellent and well-credentialed executives in a horseshoe to replace Jack Welch. (Within 48 hours of naming Immelt the successor, the other two—Robert Nardelli and James McNerney—were named CEOs outside of GE. Nardelli went to Home Depot and McNerney was named CEO of 3M.) (Colvin 2001 and Sellers 2002)

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The shocked CEO had just completed his annual succession plan in which the key backup to five of the company's mission-critical roles was the same person—who was 58 years old at the time. Like many others, this CEO's company had a significant bench strength issue.

Asked about his budget for talent development, this CEO readily pointed to the very elegant training center found on the company campus. In his eyes, development was training. His entire budget for executive and leadership development was spent on courses and formal education programs—admirable, but in stark contrast to what research recommends.

1. Follow the 70/20/10 rule. The formula for developing successful executives is quite clear: 70 percent of development comes from experience, 20 percent from feedback and people, and 10 percent from courses or training events.

Corporate directors must understand this paradigm. Experience should be the core of leadership and executive development, and those experiences should provide sufficient “developmental heat.” Interesting and thought-provoking courses at leading educational institutions have their use, but development plans need to be loaded with assignments—such as leading a start-up or working internationally—designed to create well-tested executives. High-potential executives also should get comprehensive, multi-rater feedback each year.

2. Provide coaching to emerging executives. During the next decade, the global population of 35- to 50-year-olds—the prime age of emerging executive talent—will decrease in number by 15 percent.

As a result of this drop-off, companies will be forced to move talent through the leadership development pipeline faster. Because of this,

business is facing a potential talent pool that Kerry Bunker, a noted leadership research scientist at the Center for Creative Leadership, dubbed the “young

and the clueless” in the Harvard Business Review. “Putting these unseasoned managers into positions of authority too quickly robs them of the opportunity to develop the emotional competencies that come with time and experience—competencies like the ability to negotiate with peers, regulate their emotions in times of crisis, or win support for change,” wrote Bunker and his co-authors (Bunker, Kram, and Ting 2002). In other words, the very skills senior managers and CEOs need most.

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Shorted on time, this next generation of business leaders would benefit significantly from the assistance from a skilled executive coach with a

blend of leadership expertise, human development knowledge, and strong business acumen. Recent studies have shown that 86 percent of participants view the coaching experience as very effective (Parker-Wilkins 2006). In one notable U.K. study, more than 90 percent of organizations reported improvements in leadership and management effectiveness after coaching was introduced (Coaching Counts 2007).

3. Monitor and measure talent management plans. The adage “What gets measured, gets done” should ring in the ears of the corporate director. Executives devote their attention to how they are measured for merit raises, bonuses, stock awards, and recognition. So if the C-suite executives are evaluated on talent-development metrics, they are more certain to keep the development of talent throughout the firm flowing.

Before Ed Breen became CEO of Tyco International, the company was largely unconcerned about the development of its human capital. All that mattered was making annual financial numbers. After Breen’s arrival, he and his talent management team implemented an Organization and Leadership Review to parallel the normal strategic and operational (budget) review processes. In addition to the typical talent-review forms, business units had to report their top three early career hires, diversity hires, employees ready for a big move, anticipated openings, and more. As you can imagine, what got measured at Tyco got done (Johnson 2004).

Formal assessment processes to evaluate internal candidates

The operative word in this third requirement is “formal.” For those organizations that actually have one, a succession planning process typically is driven by a *one-up* talent review. For example, the general manager for Brazil provides the head of Latin America with a short list of succession candidates. This list may be scrubbed by the head of Latin America but is usually passed upward and onward. This notoriously subjective approach is rife with documented problems, such as the halo effect (one can do no wrong) and personal biases toward a given person.

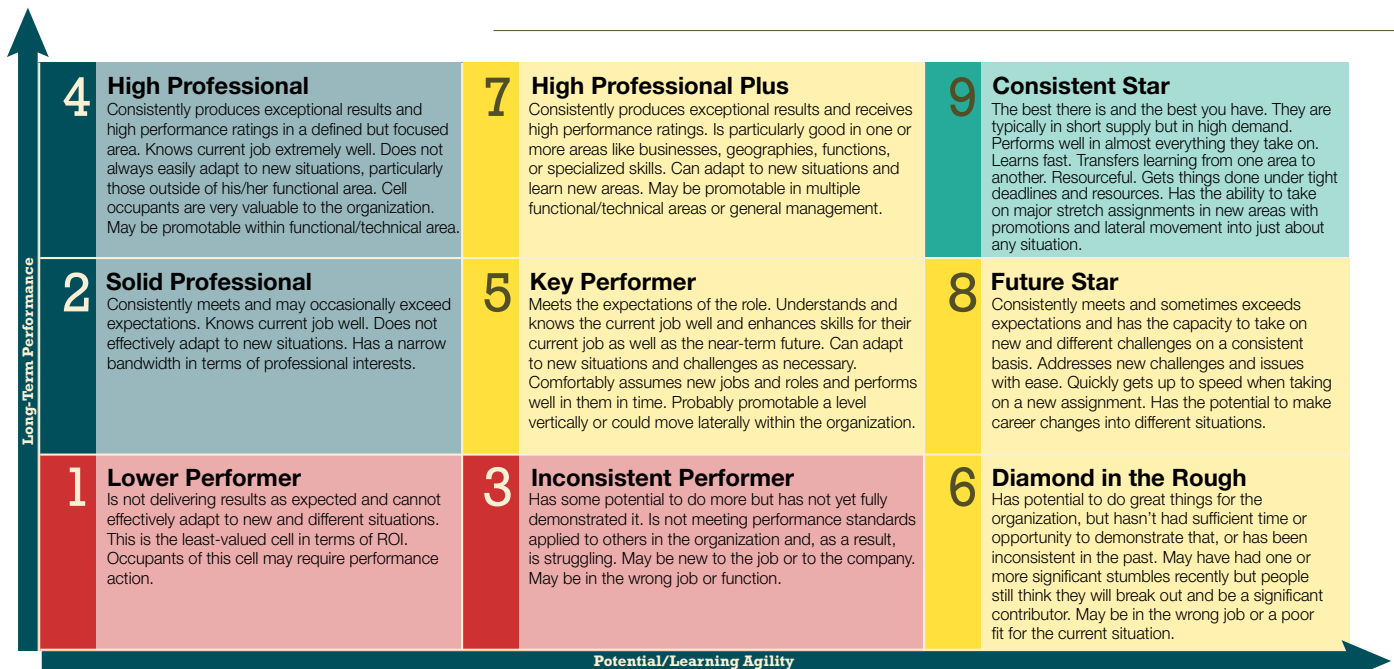
As previously noted, objectivity and transparency should drive succession plans within a framework of possible strategic scenarios. These criteria can be met through a formal assessment approach.

1. Use calibrated and validated talent reviews. Most executives overrate the performance of their direct reports and confuse high performance with high potential. As a result, any one-up succession process risks being filled with bad data. How can these problems be avoided? Primarily by providing clear, research-based definitions of performance and potential that will facilitate the calibration and internal validation of talent (Kessinich and Peters 2009).

Many companies use a performance/potential matrix, to plot where an executive would see his or her direct reports.

On the vertical axis is *sustained performance*. This should take into account a three- to five-year period, not only last year’s results. High performance means superior—the best people have seen. Middle performance indicates someone is meeting the expectation of the role. Lower performance indicates that there are conditions interfering with a person’s ability to meet the requirements.

Figure 3
Performance Potential Matrix



PERFORMANCE

The ability to consistently deliver results over time. The focus is on an individuals *sustained* performance over the past three to five years, not one specific accomplishment or performance period.

POTENTIAL

Can quickly respond to diverse, intense, varied and **adverse** assignment. Demonstrates superior performance under **first time** or **different**, not repeat, conditions. Eagerly learns new competencies in order to perform.

On the horizontal axis is *learning agility*. As discussed in detail earlier, this is the ability of the person to effectively respond to an unfamiliar or changing situation.

The intersection of superior sustained performance with high learning agility is the definition of high-potential talent.

Internal calibration and validation is accomplished through a peer group discussion, during which each executive's direct reports are discussed to determine if they are in the right cell on the matrix. To facilitate this discussion, each cell is clearly defined and an individual is compared against this definition to make certain he or she is placed appropriately. From there, tailored development plans can be created for the high potentials, who could lead in a multifunctional capacity, and *high professionals*, those with lower learning agility who can become experts in a specific field or discipline.

This process is exceptionally effective. Executive participants learn how to distinguish between performance and potential. They learn the value and merits of differentiating their talent. They gain an accurate picture of their supply of talent. The organization benefits significantly as well, because it can now intelligently respond to any gaps between the supply and demand for talent. The differentiation of talent is far and away a best practice (Becker, Huselid, and Beatty 2009).

2. Supplement the talent review with best-in-class formal assessments.

A talent review using the performance/potential matrix is an invaluable exercise. Yet the process can err due to organizational subjectivity; that is to say that the culture of an organization can exhibit the same biases that taint the judgment of individual executives.

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In response, organizations also should undertake a formal assessment of the high-potential talent pool that includes a 360-degree feedback process. In this approach, an immediate boss, peers, and direct reports proffer their perspectives on the current skills of the executive in question. This not only provides executives with valuable feedback, it can measure in great detail the degree of “fit” to the future requirements of the organization.

Many assessment tools include “norms” for a comparison point. But if the goal is to build superior performance in the executive talent pipeline, the assessment vehicle must rely on an up-to-date and industry-relevant “best-in-class” profile for comparison.

3. Consider macro-succession planning. A company’s “micro”-succession planning system always presupposes it has the time necessary to “build,” or develop, the requisite talent. But what if it does not have time? What if it takes five years to develop a particular executive, and you need the talent in two?

Then you have to be ready to “buy” talent, or hire from outside. In other areas, organizations do this all of the time. Who are the best vendors for materials? Where can I get the best price? Where can I secure the best quality? Talent should be no different.

Andy Pearson, a legendary CEO of PepsiCo, wrote a paper in 1987 called “Muscle-Build the Organization,” which appeared in the Harvard Business Review. At the time, Pepsi was in a very public war with Coca-Cola. To win, Pearson believed he needed the absolute best talent in the world. He also realized that despite PepsiCo’s exhaustive talent review and development processes, it would be arrogant to assume they had the best talent.

In response, PepsiCo established relationships with select executive search firms. These firms were not asked to fill a specific job. Instead, they were chartered to find the best talent, period. The best general managers. The best marketers in the consumer packaged goods. The best supply chain managers. If the search firms found an executive with talent superior to the internal talent at PepsiCo, that person was offered a position in the company. If PepsiCo had no immediate opening, they were brought onto the payroll anyway until a suitable position was identified (Stolz 2006). As a result of this muscle-building process, Pearson systematically raised the performance standard for the company.

Compliance and noncompliance

SEC Bulletin 14E can be construed as a shot across the bow of the boardroom. As of this writing, the SEC remains silent regarding evidence of compliance and repercussion of noncompliance. How will directors know if they are meeting the SEC’s expectations for risk mitigation? What happens if they don’t?

It seems safe to assume Bulletin 14E will not lead to a new “10-S” (for succession) type of report. The criteria used for selecting a CEO, potential successors, and assessment results all should be viewed as competitive intelligence. No organization will readily make these details public, nor is it likely that a federal agency will require them.

What appears more likely is that organizations will undergo an audit, akin to an annual financial audit, to confirm that succession planning practices meet generally acceptable standards. The nine previously discussed considerations provide an outline for acceptable practices.

Corporate directors can use the three criteria and nine essential considerations as the basis for a “needs analysis” for bulletin14E compliance and begin to close any gaps. Following this outline, corporate directors also can rest assured the best research into the art and science of succession planning will underpin their every move toward mitigating succession-related risks.

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James W. Peters is a Senior Partner at Korn/Ferry International's Leadership and Talent Consulting, and a specialist in global succession solutions.

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