THE CENTRE FOR Leadership Succession

An initiative of Johnson supported by AGSM and Booz & Co

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ASX Regulatory Policy
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To whom it may concern

Consultation on the proposed third edition of the Corporate Governance Principles and Recommendations

We refer to the recent release of the above and make the following submission for consideration by the drafting committee. The sole focus of this submission is on how companies need to approach leadership succession management from a corporate governance perspective to ensure that any risks arising out of inevitable changes in senior leadership positions are minimised. In this context, the objectives are to suggest specific drafting recommendations to ensure ASX corporate governance guidelines cover leadership succession issues with (a) greater clarity, (b) comprehensiveness, and (c) consistency.

The third edition of the Corporate Governance Principles and Recommendations ("Draft Guidelines") play an important role in ensuring Australian corporate governance guidelines keep in line with best practices of the rest of the world. Upon a detailed review, the proposed draft does not sufficiently highlight the importance of leadership succession management to organisational performance, and address the board's role and responsibilities to ensure adequate steps are taken to minimise the risk of potential disruption arising out of inevitable changes in leadership positions. This submission provides specific recommendation that addresses identified inadequacies in the currently proposed draft.

This submission is made on behalf of the Centre for Leadership Succession, a not-for-profit organisation dedicated to ensuring the deliberate management of leadership succession. It is an initiative of leadership advisory firm Johnson Partners ("Johnson") and supported by the Australian Graduate School of Management ("AGSM") as well as management consultancy Booz & Company ("Booz & Co"). As the principal author of this submission, I make this submission in my dual role as a consultant advising companies on leadership succession matters and as a current doctoral candidate at the Sydney Business School, University of Wollongong. The topic of my thesis involves exploring the application of best-practice approaches to leadership succession management in large, complex organisations. It therefore has direct relevance to corporate governance requirements of ASX-listed companies and the subject matter of this submission.

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Background

Succession in the business context has been investigated extensively and identified as a critical factor to an organisation's performance, particularly where it involves changes in key leadership positions (for a review of the academic literature refer to Kesner & Sebora 1994; Mehrabani & Mohamad 2011). As such, ensuring leadership continuity and minimising the negative impact of inevitable leadership changes through deliberate succession management is one of the key organisational management functions and a key priority for boards, CEOs and human resources executives. This is reflected by increasing corporate governance requirements, including, for example, in the USA (NYSE 2003) and the UK (LSE 2012).

The importance of deliberate leadership succession management is also reflected in requirements of leading global credit ratings providers, such as Moody's and Standard & Poor's, which include leadership succession planning factors in their credit ratings (Larcker & Tayan 2010). Despite this, there however appears to be a gap between the recognised importance and effectiveness of succession management approaches and the extent to which organisations integrate these. More specifically, it is currently estimated that at best only 25% of large, listed global organisations are incorporating dedicated and deliberate approaches to managing the succession of its senior leaders (Larcker & Tayan 2010; The Conference Board 2012). In Australia, this number is likely to be even lower (Taylor & McGraw 2004).

A key issue arising in understanding the extent to which succession management practices are implemented is the lack of universally accepted standards or guidelines, against which existing standards of practice can be evaluated against. On this basis, and to address this implementation gap, it is important for those who are ultimately responsible for succession management to have an understanding of existing evidence-based approaches to best-practice succession management. The Draft Guidelines therefore play an important role in conveying an understanding of what sound leadership succession management practices actually entail.

Understanding best-practice approaches to leadership succession management

Succession management has been defined as part of succession processes and ranges on a continuum from mechanical replacement planning to comprehensive succession management (Eastman 1995) with the latter referring to the "more elaborate, integrated, and systematic approach including the identification and development of high potentials so that when a vacancy occurs in a key position, the organization does not have just a list of potential candidates but a pool of better-prepared candidates" (Berke 2005, p.1). This involves a methodical and structured approach to managing eventual staff changes which include members of the executive team and the CEO, in this context referred to as 'leadership succession management' or simply 'succession management'.

According to the above, succession management is predominantly focused on individuals who are identified and developed internally, although, as shown below, this does not preclude considering external candidates at the time at which such vacancies occur and a successor needs to be appointed. A useful working definition can be derived from Rothwell's (2001) explanation of a succession planning and management function. Accordingly, succession management describes the "deliberate and systematic effort by an organisation to ensure leadership continuity in key positions, retain and develop intellectual and knowledge capital for the future and encourage individual advancement" (Rothwell 2001, p.6).

In general, a sophisticated response by a board to succession issues considers potential internal and external replacements and future roles in an organised and structured way at multiple levels of the organisation. This typically starts with the intake of new hires that represent future leadership potential and allow the creation of formal talent pools, and the systematic development of 'talent bench strength' at multiple levels of the organisation. In line with this, succession management extends the CEO succession process to key management positions, and from there to other roles. Where the senior executives' requirement for performance and promotion includes the identification and active development of a future successor, the cascading effect can translate into succession health at multiple levels of the organisation and what Charan and colleagues term the 'leadership pipeline' (Charan, Drotter & Noel 2011). In this context, it makes sense for boards to gain visibility of the top leadership talent of the organisation, ideally two levels or more below the CEO.

More specifically and on the basis of processes that have been successfully applied at a number of leading Australian ASX-listed organisations in recent years (including AMP, BHP, Brambles, CBA, CSR, Qantas and Worley Parsons), there are a three key questions that are underlying a proven a best-practice approach to leadership succession planning.

1. What leadership does the organisation need to succeed going forward?
2. What leadership does the organisation have in place at present?
3. What must happen to close the gap and keep it closed?

With respect to CEO succession, one of the most common failures is for the board to jump to the second question and identify an individual who appears to be a strong leader and a logical appointment. The consequence of this is that the chosen individual may or may not incorporate the skills, knowledge and attributes required to ensure sustainable performance and successful execution of strategy. Answering the first question involves gaining clarity of current performance as well as future strategic requirements, and capturing the expectations of key stakeholders of the type of leadership that is needed for the ongoing, sustainable success of the organisation. This is typically translated into a 'leadership capability blueprint' that can be role specific, as well as capturing a broader set of the experience, skills, knowledge and abilities of the senior leaders of the organisation. Only once this 'blueprint' has been defined, can the second question be answered reliably, and an evaluation of key internal leadership talent conducted.

It should be noted that this second stage of assessing each individual can often be intimidating to even the most senior leaders (or perhaps, especially those), and sophisticated approaches are able to focus on the future opportunities rather than allowing participants to feel like they are being 'judged' in their current roles. Finally, but not least important, the 'gap closing', i.e. developmental aspect, is ideally normalised by recognising that even the most successful, senior individual has important gaps to close to remain successful. Such a focus on elevating 'leadership development' (rather than emphasizing succession) also minimises the risk of encouraging internal competition which represents a risk in leadership succession.

The evidence supporting deliberate and systematic effort of ensuring leadership succession events are optimised is extensive as can be seen from the next section.

Evidence in Support of Leadership Succession Management

Disruptions to leadership continuity have been well documented. Examples of high-profile failed CEO leadership successions include Carol Bartz at Yahoo, Chuck Prince at Citigroup, Leo Apotheker at Hewlett Packard, and David Stewart at Leighton Group (Strebel 2013). In all of these cases, and more recently in Australia, David Jones and Investec Bank, they represent examples where high profile organisations have been caught unprepared without the availability of a ready successor. These cases demonstrate that in order to minimise the risk of disruption and maximise the probability of appointing the best-suited individual, an organisation needs to consider internal as well as external candidates.

Comparing internal and external candidates

A central aspect of modern succession management is the assessment and development of existing staff so that they are able to successfully take on more complex, senior roles. In contrast, external recruitment has been found to be less effective in ensuring leadership continuity, suggesting higher failure rates of external candidates (Carlson 1961; Helmich & Brown 1972; Zajac 1990) and, in relation to CEO succession, organisational performance as measured by total shareholder returns (Carlson 1961; Grusky 1963; Helmich & Brown 1972; Allen, Panian & Lotz 1979; Davidson & Gravestock 2012).

For example, recent data published by Booz & Company (Favaro, Karlsson & Neilson 2013), which examines CEO turnover of the world's largest 2,500 companies during the last 12 years, indicates that total shareholder returns are higher for internally appointed candidates, about 10% p.a., compared to 8% p.a. for external candidates. In Australia, a similar analysis of CEO succession events of the ASX Top-200 listed companies over a 13-year period shows median shareholder returns associated with internally appointed CEOs of 4.2% compared to 2.6% for external candidates (Davidson & Rabb 2013). The same study also shows median tenures of CEOs of 4.5 years and 3.6 years for internally and externally appointed CEOs, respectively. This demonstrates the need for a consistent and ongoing process of evaluating and developing potential successors.

A 2011 study by the Kelley School of Business (Steingraber, Magjuka & Snively 2011) examined the leadership of the most successful S&P500 companies over a 20-year period to 2007 and found that 36 most highly performing companies all relied on internal CEO appointments. Similar findings also apply to leadership positions below CEO level. In a study of personnel of a US investment banking arm of a financial services organisation between 2003 and 2009, Bidwell (2011) finds that internal appointments are significantly more successful during an initial two year period even though external hires have significantly higher salaries, some 18% on average, and higher educational qualifications.

Outcome studies evidencing the efficacy of succession management practices

In the private sector there are a significant number of consulting firms which refer to the link between succession management and shareholder returns including The Hay Group (2001), Development Directions International (Bernthal, Rioux & Wellins 1999), Booz Allen Hamilton (Booz Allen Hamilton Sydney & Business Council Of Australia 2003) and McKinsey & Co (Michaels, Axelrod & Handfield-Jones 2001).

Scholarly research evidencing the efficacy of succession management initiatives includes examining the impact of succession management initiatives on financial performance. It is important to recognise that the performance of the successor and the performance of the firm are not synonymous; a CEO and senior leadership team arguably represent the group of individuals ultimately responsible for the firm performance. In reality however there are a vast number of interrelated factors that would impact a firm's shareholder returns, as well as time lag of cause and effect (Gordon & Rosen 1981). Individual performance is only but one aspect of this and it is relevant to consider other indicators such as the tenure of internal compared to external successors, employee turnover or client satisfaction feedback.

Notwithstanding the above limitations, reviewing available outcome studies with reference to organisational performance is an important starting point as, ultimately, superior and sustainable economic value creation is at the heart of managing leadership succession. As can be seen from the following, the weight of evidence in favour of succession management leading to better performance outcomes is extensive.

One of the early noteworthy studies by Friedman (1986) showed that firms who dedicate more resources to succession management also perform better from a financial perspective. In another key study Huselid (1995) demonstrated the link between human resource best-practices including succession management and organisational performance. More specifically, this study identified superior firm value performance of organisations with more sophisticated HR approaches equivalent to $42,000 per employee.

Other significant outcome based studies, include that by Lamoreux (2009) highlighting the overwhelming perceived importance by senior decision makers of leadership succession management to organisational outcomes and Reid (2005) who points to the importance of succession management for public organisations and describes key benefits of succession management initiatives. This latter is similar to a major survey conducted by Bernthal and Wellins (2006) which confirms that organisations with formal succession management and high quality leadership development programs have are leading in business performance as measured by a variety of metrics including financial performance, productivity, quality, employee and customer satisfaction and retention of employees.

Appendix 1 below summarises the above and other research relevant to identifying the importance and benefits of leadership succession management. This evidence in support of deliberate management of leadership succession has been reflected in governance guidelines of other major economies.

Succession in the context of other relevant corporate governance guidelines

Including leadership succession management as a key corporate governance requirement is not new to the governance frameworks of other major markets. The governance guidelines of the London Stock Exchange (LSE 2012) set out various references to 'succession planning', including that:

- the "attributes of non-executive directors" need to include "skills sufficient to ensure succession planning" (p. 69);
- the responsibility of the remuneration and nominations committee includes to "look forward and plan for the succession to key roles among the executives" (p. 78);
- there is a requirement for "sound corporate governance programs to include chief executive succession planning" (p. 169);
- best-practice corporate reporting includes providing "evidence that there is succession planning and a pipeline of talent" (p.182); and

- factors influencing the work of the board need to include the "maturity of executive succession planning and leadership development" (p. 195).

Succession management has also been part of the United States' SEC corporate governance framework for some time and is also reflected in the corporate governance guidelines of the NYSE since 2003. Their framework requires listed organisations to "include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO" (NYSE 2003).

In the US, there have been a number of challenges by shareholders where organisations have failed to adequately disclose succession management detail. This has resulted in the issue of SEC guidance notes clarifying the issue of disclosure and confirming that companies have a responsibility to disclose adequate information with respect to the organisation's succession management activities (SEC 2009).

In the context of these precedents and the existing evidence in support of sound leadership succession management practices, the following reviews the proposed third edition of the ASX Draft Guidelines.

Review of the Draft Guidelines with respect to Succession Management

The Draft Guidelines refer to "succession" under "Principle 2 – Structure the board to add value".

Recommendation 2.4 (b) sets out a requirement for a company that does not have a dedicated nominations committee to "disclose the fact [it does not have nominations committee] and the processes it employs to address board succession issues…" (p. 16).

The Commentary to this section recognises that "board renewal is critical to performance". It also sets out that one of the responsibilities of the nominations committee is to "review and make recommendations in relation to board succession planning generally […], and ensuring there are plans in place to manage the succession of the CEO and other senior executives" (p. 17)

Finally, the Commentary to Recommendation 2.4 also includes an exemption for "smaller listed entities [which] may decide that they are able to deal efficiently and effectively with board composition and succession issues without establishing a separate nomination committee". If this is the case the guidelines suggest a need for the entity to disclose in its annual report or on its website the fact that it does not have a nominations committee and explain the processes it employs to address board succession issues…" (p. 17).

Recommendation 2.5 sets out a requirement for a listed entity to "disclose a statement as to the mix of skills and diversity that the board is looking to achieve in its membership" (p. 17). The Commentary to this recommendation states that the collective skills of the board and any gaps "should be addressed as part of the entity's professional development program for directors and in its board succession planning".

Although a pleasing progression to the current second edition of the Corporate Governance Principles and Recommendations, the proposed Draft Guidelines fall short of setting an acceptable standard that ensures the risks associated with leadership succession are adequately addressed by Australian listed companies and their boards.

Specific recommendations for amendment of the Draft Guidelines

The proposed Draft Guidelines currently present two broad areas of deficiency. Firstly, the Draft Guidelines do not, as currently set out, ensure that succession issues are comprehensively addressed to reflect the intention to highlight the board's responsibility for (a) the active management of succession at board level and (b) supervision of adequate succession planning for key leadership positions. Secondly, the Draft Guidelines do not, as currently set out, reflect a consistent and clear messaging of this intention. The following specific recommendations would overcome these deficiencies.

Recommendation 1: Clarify that the role of the board includes responsibility for ensuring that the risk of disruption as a result of inevitable changes in leadership are minimised through adequate succession management practices. Section "Principle 1: Lay solid foundations for management and oversight" needs to include a bullet point under the Commentary of Section 1.1 to state "ensuring that the risk of disruption from inevitable changes in key leadership positions, at board, CEO or senior executive level, are addressed through sound succession management practices". Logically, this statement would be inserted following the third bullet point "approving the appointment, and when necessary replacement, of other senior executives" (p. 8).

Recommendation 2: Insert a separate Recommendation 1.8 to provide an understanding of basic succession management reporting requirements. Accordingly, the following draft wording is suggested: "Recommendation 1.8: A listed entity should: (a) have and disclose processes to ensure succession is managed on a continuous and consistent basis for key leadership roles including at board, CEO and senior executive level; and (b) disclose in relation to each reporting period, whether the entity has succession management processes that are current and up-to-date.

Recommendation 3: Amend Recommendation 2.4 (b) to reflect the nomination committee broader responsibility for leadership succession management. Accordingly, the following draft wording is suggested: "if it does not have a nomination committee, disclose that fact and the processes it employs to address succession issues for key leadership roles including at board, CEO and senior executive level." To ensure consistency, the statement "Board renewal is critical to performance." needs to read "Leadership continuity is critical to performance." Also, it would be more consistent to move the last bullet point starting "ensuring there are plans in place to manage the succession of the CEO and other senior executives" to follow the first bullet point which refers to "board succession planning" generally. Alternatively, the first bullet point could be amended to reflect the role of the nomination committee in relation to "succession planning for key leadership roles, including at board, CEO and senior executive level".

Recommendation 4: In light of the fact that deliberate leadership succession management is first and foremost a risk management activity, section "Principle 7: Recognise and manage risk" needs to reflect this explicitly. As leadership succession is generally regarded as the responsibility of the nomination committee – the current as well as the suggested drafting of the Draft Guidelines reflects this – amendments need to clarify the relevance to both of these board functions. Accordingly, the following draft wording is suggested: Insert under Commentary, the role of the risk committee to include as a final bullet point "an evaluation of key leadership roles and the risk associated with potential discontinuity in such roles". An explanation may seek to clarify that the risk committee's evaluation of key leadership roles representing risk to performance could be provided to the nomination committee where the committee has responsibility for the entity's leadership succession management.

It is important to recognise that the above recommendations are not representative of a best-practice approach to leadership succession management, but rather represent a basic approach to ensuring that this important function is adequately addressed by Australian listed companies. For instance, the LSE guidelines explicitly state that an organisation's leadership succession management includes development initiatives and talent management. It could therefore be considered to amend the Draft Guidelines even further (than suggested in this submission) to provide a better understanding to boards of what is involved in managing leadership succession. This, for example, includes the deliberate development of internal leadership talent. This however could potentially blur the line between setting principles and guidelines and providing content which may not be the role of the Draft Guidelines.

It is hoped though, that by incorporating the above recommendations, boards will be encouraged to become more knowledgeable and skilled in actively managing the risk of succession for key leadership roles. This step-up is warranted because of the identified implementation gap and it does not mean that the board does not rely on management to implement processes and monitor outcomes. To the contrary, by being more knowledgeable and skilled, the board will be able to more effectively guide and supervise management to ensure sound succession management practices are implemented and kept current.

We are most grateful to be able to make this submission in consideration for further amendments to be reflected in the upcoming third edition of the Guidelines. Please do not hesitate to contact the undersigned on 0413 054 598 or ingo.susing@johnsonpartners.co should you wish to clarify any of the content of this submission, or require further information.

Yours faithfully,

The Centre for Leadership Succession

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Appendix 1: Summary of succession management outcome studies and demonstrated benefits

Author(s) & Area of Investigation	Demonstrated benefits
Day (2007): Human capital and talent management Stahl et al. (2009): Expats and talent mobility	Succession management benefits the availability of internal candidates which avoids the significant costs of external hiring
Carlson (1961): Executive succession and its consequences Helmich & Brown: (1972): Succession in the context of organisational change Zajac (1990): CEO succession and organisational performance	External candidates have higher failure rates than internal ones
Allen et al (1979): Managerial succession and organisational performance Carlson (1961): Executive succession and its consequences Favaro et al. (2013): CEO succession Grusky (1963): Managerial succession and organisational performance Helmich & Brown: (1972): Succession in the context of organisational change	Internal CEO appointments are associated with greater shareholder returns
Michaels et al. (2001): Organisational performance	More extensive succession management benefits greater employee retention
Lamoureux (2009): Talent management in organisations	Succession management informs more accurate performance management data
Freyens (2010): Leadership in the public sector	Succession management ameliorates limitations of labour and skills shortages
Hugh & Rog (2008): Talent management in hospitality	Succession management is critical to talent management and helps organisations successfully deal with increasing complexity
Taylor & McGraw (2004): Succession management in Australian organisations Watt & Busine (2005): Succession management in Australian organisations	Succession management helps counter shortening tenures of CEOs over time as well as on a comparative basis in Australia
Bradshaw (2001): Reviews the development of succession management strategies in public sector organisations	Succession management benefits the quality of leadership and organisational culture
Barron et al. (2010): Organisational strategy Fulmer & Conger (2004): CEO Succession & Strategy	Succession management benefits an organisation's ability to respond to strategic changes