The Costs of a Combined Chair/CEO

GMIRATINGS

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Executive Summary

The two most authoritative positions in a boardroom are the CEO and the chairman. However, when these roles are combined, all the authority is vested in one individual; there are no checks and balances, and no balance of power. The CEO is charged with monitoring him or herself, presenting an obvious conflict of interest. Indeed, if the CEO is responsible for running the company, and the board is tasked with overseeing the CEO's decisions in the interests of shareholders, how can the board properly monitor the CEO's conduct if he or she is also serving as board chair?

While the theory behind separating the two roles has been the subject of much shareholder and governance activist protest and commentary, an analysis of GMI Ratings' data suggests that other, more practical considerations would support the separation of the two roles. In addition to the inherent conflict of interest already discussed, CEOs who also command the title of chairman are more expensive than their counterparts serving solely as CEO. In fact, executives with a joint role of chairman and CEO are paid more than even the combined cost of a CEO and a separate chairman. Also, companies with a combined CEO and chairman appear to present a greater risk of ESG (environmental, social and governance) and accounting risk than companies that separate the roles. Furthermore, companies with combined CEOs and chairmen also appear to present a greater risk for investors and provide lower stock returns over the longer term than companies that have separated the roles. Thus having a separate chairman and CEO costs less, is less risky and is a better investment. This report focuses on 180 North American mega-caps, those with a market capitalization of $20 billion or more. This group was chosen because, given the relative complexity of running the companies, it might be expected that the resulting differentials between leadership structures in cost structure, performance and risk exposure would be more marked. Here are some of the main findings of the report:

- Executives with a combined CEO and chair role earn a median of just over $16 million.
- CEOs who do not serve as chair earn $9.8 million in total summary compensation at the median.
- Chairman only (all chairmen) earn median total summary compensation of $492,259.
- CEO plus a separate chairman earn a combined $11 million.
- CEO plus a separate, independent chairman earn a combined $9.3 million.
- Less than one percent of companies with a combined chair and CEO and a market cap in excess of $20 billion score an ESG rating of above average compared to almost 20 percent of companies with separate roles.
- 31.74 percent of companies with a combined chairman and CEO score an ESG rating of "F" compared to 15.87 percent of companies with a separate CEO and chair.
- Companies with a combined CEO and chair and an ESG rating of "F" include Goldman Sachs Group, Inc., News Corporation, Bank of New York Mellon Corporation, Wells Fargo & Company, Coca-Cola Company and AT&T Inc.
- Corporations with combined CEO and chair roles are 86 percent more likely to register as "Aggressive" in our Accounting and Governance Risk (AGR®) model.
- Five-year shareholders returns are nearly 28 percent higher at companies with a separate CEO and chair.

Cost of CEO/Chairman

It might be expected that a manager who holds the positions of CEO and chairman would earn more than a manager who is simply the CEO, and our data analysis shows this to be the case. CEO's who are not chairmen earn only 66 percent of what their colleagues earn who are also chairmen, with a median total summary compensation [the total reported figure in company proxy statements] of just over $16 million compared to around $9.8 million. While this compensation premium

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might be expected, the size of the differential is unexpectedly large, so we tested additional data to see if the cost of employing a separate chairman made up for the differential. However, our data shows that it is much cheaper to pay a CEO and a separate chairman. The median combined cost of these two positions is around $11 million, still only 75 percent of the cost of the combined position. This is the case whether the chairman is an executive or a truly independent chairman.

In fact, it is even cheaper to pay these separate positions when the chairman is an independent director. The cost of employing a separate CEO and an independent chairman is even less than the cost of employing a separate CEO alone, since the CEOs who are teamed with independent chairmen earn even less than their counterparts who work with non-independent chairmen of one kind or another. The compensation of an independent chairman and his or her CEO is just less than $9.3 million at the median. On the other hand, non-independent chairmen plus CEOs earn a median of just less than $14.7 million, more than 90 percent of what a combined CEO/chair makes. Other factors that are typically taken into account in compensation analysis are moot here since the group is extremely varied in character, with a range of industries represented and a range of tenures. Furthermore, no one industry group or market capitalization bracket (the one area of relative homogeneity) is over or under-represented in either the split chairman/CEO or combined chairman/CEO group.

Non-independent chairmen are comprised of former CEOs, former executives, executive chairmen and other chairmen with some form of non-independent business relationship with the company. Such chairmen earn far more than their independent colleagues. While that might be expected for executive positions, there is little or no reason for non-executive positions to earn more, yet this is the case. Independent chairmen earn a median total compensation of just over $400,000, compared to almost $500,000 for all chairmen, and almost $2 million for executive chairmen.

Role combination	Median total summary compensation	Notes
CEO and chair combined	$16,079,480	
CEO plus separate chairman (all non-independent chairmen)	$14,668,866	For non-independent chairmen plus CEO the summed cost is the highest for the two separate positions but still represents only 91% of combined CEO/chair pay
CEO plus separate chairman (all chairmen)	$10,619,540	If all separate chairmen are included in the analysis, the summed pay is only 66% of combined CEO/chair pay
CEO only	$9,784,185	CEO's who are not chairmen earn only 60% of what their colleagues earn who are chairmen as well
CEO plus separate chairman (independent chair)	$9,291,489	If just independent chairmen are included, the summed cost is even lower at 57% of combined CEO/chair pay
Executive chairman	$1,998,551	Executive chairmen, predictably, are paid the most of any kind of chairman
Chairman only (all non-independent chairmen)	$630,930	Other chairmen, including executive chairmen, are paid 50% more than independent chairmen
Chairman only (all chairmen)	$492,259	
Chairman only (independent directors)	$417,910	Chairmen who are independent directors are paid the least

Total summary compensation includes: base salary, bonus, non-equity incentive compensation, all other compensation (benefits and perquisites), the grant date value of stock and stock option awards and any increase in pension or other retirement benefits.

Separate chairmen are either independent directors or non-independent. Non-independent chairmen can be a current or former executive of the firm, a former CEO, or what GMI Ratings describes as an outside-related director. An outside-related director is a director who has some significant relationship to the company other than their board service.

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Some separate chairmen are extremely well-paid, though in most cases this is as a result of their being a former CEO and/or a CEO for part of the year. For example, Sumner Redstone earned over $20 million each from his chairmanship at both CBS and Viacom, Ray Irani earned almost $50 million as chairman of Occidental. Both Samuel Palmisano and James Moffett earned around $30 million as chairmen of IBM and Freeport-McMoRan respectively. Highest paid of all, however, was former CEO and current chairman of Google, Eric Schmidt, who earned over $100 million due to a very significant award of stock. On the other hand, Lonnie Smith, chairman of Intuitive Surgical, and Charles Johnson, chairman of Franklin Resources, earned nothing during 2011. As did three executive chairmen: Steven Rales of Danaher, Robson Walton of Wal-Mart, and Philip Knight of Nike.

None of the independent chairmen earned nothing and the highest paid was the chairman of Canadian National Railway, David McLean, who earned just over $800,000.

ESG Ratings

ESG ratings of companies with combined v. separated CEO and chair roles		
	Combined CEO and Chairman	**Separate CEO and Chairman**
A	0.00%	3.17%
B	0.93%	14.29%
C	34.58%	36.51%
D	32.71%	30.16%
F	31.78%	15.87%

At GMI Ratings, our environmental, social and governance (ESG) ratings reflect a comprehensive set of indicators designed to predict sustainability risk. Companies receive red flags based on our ESG KeyMetrics™ such as significant votes against pay policy, over-boarded directors and the presence of a poison pill, with ESG scores correspondingly lowered with each flag. Less than one percent of companies with a combined chair and CEO and a market capitalization in excess of $20 billion score an ESG rating of above average. By comparison, nearly 20 percent of companies with separate chairman and CEO roles have an ESG rating above average. While the separation of the chairman and CEO role is one of the key metrics that influences scoring, its influence is nowhere near significant enough to create a differential of this kind.

While 15.87 percent of companies with a separate CEO and chair score an ESG rating of "F", the percentage almost doubles to 31.74 percent for companies with a combined chairman and CEO. Indeed, of the 107 companies included in this survey with a combined chair and CEO, 34 of them registered "F" in ESG. This is particularly noteworthy given that only five percent of our total coverage universe is awarded our lowest rating of "F" after analytical review. The fact that nearly a third of companies in this market cap range with a combined CEO and chair score an "F" ratings is indicative of a major disconnect between management and investor interests. The list of companies with a combined CEO and chair and an ESG rating of "F" includes Goldman Sachs Group, Inc., News Corporation, Bank of New York Mellon Corporation, Wells Fargo & Company, Coca-Cola Company and AT&T Inc.

AGR® Ratings

AGR ratings of companies with combined v. separated CEO and chair roles		
	Combined CEO and Chairman	**Separate CEO and Chairman**
Conservative	0.89%	4.76%
Average	33.93%	50.79%
Aggressive	47.32%	25.40%
Very Aggressive	17.86%	19.05%

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Our AGR rating uses a more quantitative, statistical process in identifying accounting items that might signal fraudulent financial statements. The AGR rating also includes governance characteristics associated with firms prosecuted by the US SEC for accounting fraud. While nearly 5 percent of companies with a market cap over $20 billion and separated chair and CEO roles are rated "Conservative" (the highest rating), less than one percent of companies that combine the roles are rated "Conservative". Similarly to our ESG rating, AGR also takes into account the separation of the CEO/chair position, but, again, its influence is not significant enough to create a differential of the magnitude shown here.

Slightly less than 34 percent of companies with a combined CEO and chair are rated "Average" as opposed to half of those companies with separate roles. Interestingly, the corporations with combined CEO and chair roles are 86 percent more likely to register as "Aggressive" in our AGR model. The worst 10 percent of companies receive a rating of "Very Aggressive", with little differential to be made between companies who combine, and those who separate the roles of CEO and chair. Companies with a combined CEO and chair which have a "Very Aggressive" rating include Texas Instruments Inc., Visa Inc., JPMorgan Chase & Co., and Pfizer Inc. Companies that have split the roles of CEO and chair and remain "Very Aggressive" in terms of accounting include CVS Caremark Corporation, Bank of America Corporation, MasterCard Inc. and Citigroup Inc.

Total Shareholder Returns

Median performance of companies with combined v. separated CEO and chair roles		
	Combined CEO and Chairman	**Separate CEO and Chairman**
1yr Shareholder Returns	11.65%	2.27%
3yr Shareholder Returns	103.54%	94.89%
5yr Shareholder Returns	31.30%	39.96%

In the short term, companies with combined chair and CEO roles fared much better than those companies with a separate CEO and chair. One possible reason is that a CEO unopposed by an independent chairman may find more freedom to make decisions in a way that immediately benefit the company. These aren't always the decisions, however, that lead to a successful long-term model. While returns over the last year and over the medium term of three years certainly appear to favor companies with a combined CEO and chair, the picture changes over a longer time period.

Five-year shareholder returns are nearly 28 percent higher at companies with a separate CEO and chair. This could be interpreted as indicative of a leadership structure built for the long-term sustainability of the company as opposed to short-term rewards. Clearly there are investment policies that favor short-term returns over long-term investments, but this is not the policy of indexed, so-called passive investors, many of whom are the shareholders and activists who most commonly call for and campaign for the separation of the roles. In addition, while long-term shareholder returns would seem to support the separation of the roles, we have not extended this study to other measures of performance such as return on equity, revenue or profits; this is food for additional research on this issue alone.

Strong shareholder returns and sustainability extend beyond separating the role of CEO and chair, however, the decision to have the roles separate is likely to set off a chain reaction of decisions at the company that are made with the proper checks and balances in place.

Conclusion

The rationale behind combining the roles of CEO and chair is usually independent of shareholder interests. For example, CEO's recruited by a corporation sometimes make it a condition of signing their employment agreement that they also be board chair in addition to chief executive and in some cases president as well. In other instances, the founder of the company is trusted with carrying out both roles. In either case, the lack of an independent board chair represents an absence of key oversight for shareholders.

In addition to the conflict of interest, however, this report concludes that it is far more expensive to combine the roles of CEO and chairman. It also appears to be indicative of the potential for other governance and management failures.

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Companies that combine the roles of CEO and chair score far worse in our ESG model, which evaluates companies using GMI Ratings' comprehensive list of ESG KeyMetrics, as well as scoring far worse on our AGR Ratings, which test for fraud and financial restatements, among other quantitative accounting items. Furthermore, shareholder returns over an extended period seem to be favorable for those companies which separate the CEO and chairman roles. Indeed, there appears to be very little benefit to long-term shareholders in having a combined CEO and chair. The only benefit seems to be an economic one to those CEOs who have convinced the board to allow them also to serve as chair.

GMI Ratings is the leading independent provider of global corporate governance and ESG ratings for companies worldwide. Our ratings are built on extensive research and modeling that incorporates a broad spectrum of Environmental, Social and Governance (ESG) metrics as well as incorporating accounting transparency issues, to support the goal of identifying companies at risk. GMI Ratings is a signatory to the United Nations-backed Principles for Responsible Investment Initiative (PRI), a network committed to incorporating ESG research into the investment process. GMI Ratings is the combined entity of GovernanceMetrics International, The Corporate Library and Audit Integrity, which all merged in December 2010. For additional information about GMI Ratings, including our partnerships with the Sustainable Investments Institute (Si2), Style Research and Trucost, please contact us at info@gmiratings.com or + 1 877-479-7500, or visit our website at www.gmiratings.com