

CEOs AND DIRECTORS ON PAY

2016 SURVEY ON CEO COMPENSATION

ROCK CENTER **FOR** CORPORATE GOVERNANCE

STANFORD

STANFORD GRADUATE
BUSINESS SCHOOL

In collaboration with Heidrick & Struggles

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EXECUTIVE SUMMARY AND KEY FINDINGS

DIRECTORS GIVE CEOs SIGNIFICANT CREDIT FOR CORPORATE RESULTS.

MOST BELIEVE PAY IS REASONABLE AND TIED TO PERFORMANCE.

THESE VIEWS, HOWEVER, ARE OUT OF SYNC WITH THE PUBLIC'S—POSING RISKS.

New research from Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University finds that public company directors give CEOs considerable credit for corporate success, believing that 40 percent of a company's overall results, on average, are directly attributed to the CEO's efforts. Seventy-one percent of directors believe that CEOs are paid the correct amount, and 87 percent believe that CEO compensation is tied to performance. These positive views on CEO pay contrast starkly with those of the American public who strongly believe that CEOs are overpaid and that pay levels should be reduced.¹ This disconnect in perception poses significant challenges for corporate directors.

"We find that directors give CEOs considerable credit for corporate performance," says Professor David F. Larcker of Stanford Graduate School of Business. "While it is difficult to measure a CEO's contribution to performance, directors take the viewpoint that CEOs are instrumental in the success or failure of an organization. These findings help to explain why CEO pay levels are as high as they are among the biggest U.S. companies: if you believe CEOs are largely responsible for their company's success, it is understandable that you would want to offer a lot of money to encourage them to be successful."

Nonetheless, the efforts of directors to align pay and performance are not resonating with the general public. "When most directors think CEO pay is reasonable but most

Americans believe that CEO pay is a problem, then you have a serious perception gap," cautions Nick Donatiello, lecturer in corporate governance at Stanford Graduate School of Business. "With more and more of the American public owning stock through retirement accounts, pensions, and mutual funds, public outrage over CEO pay invites legislative or regulatory intervention. Directors need to make the case clearly and convincingly that the pay they offer is not only tied to performance but that it is *deserved* based on market realities, performance, and the CEO contribution to that performance."

Recently, Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University surveyed 107 CEOs and directors of Fortune 500 companies to understand their perception of CEO pay practices among the largest U.S. corporations.

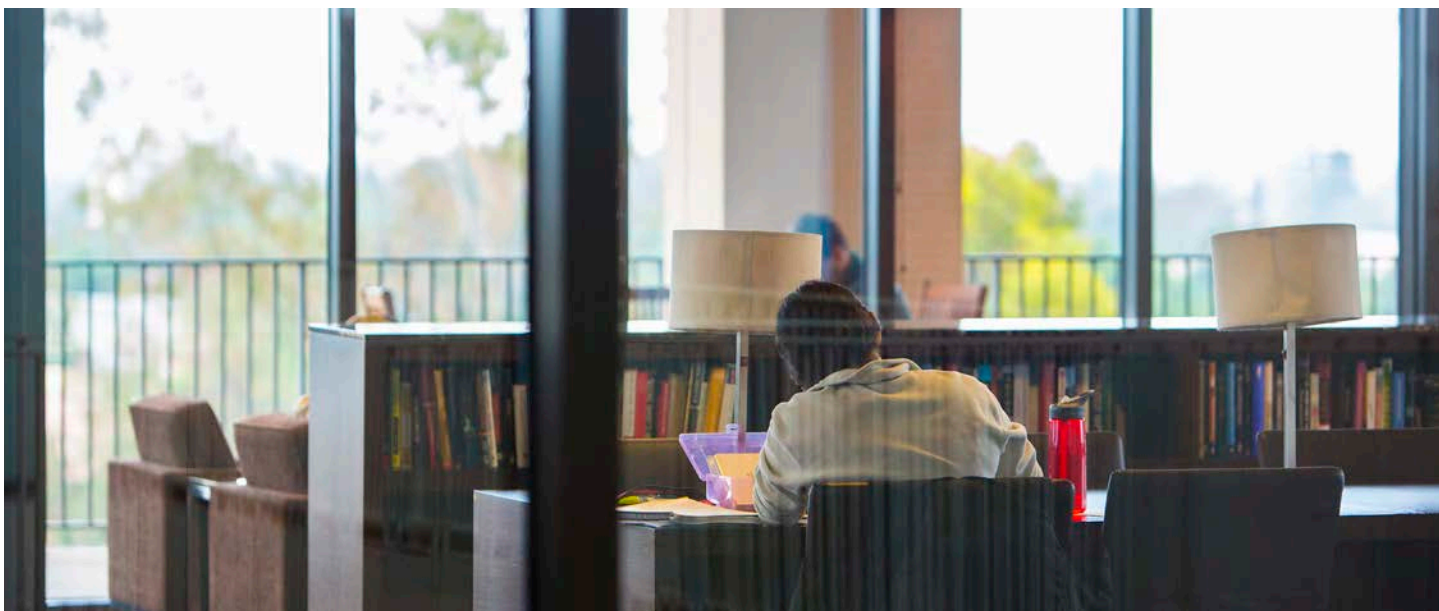
KEY FINDINGS INCLUDE THE FOLLOWING:

CORPORATE LEADERS BELIEVE THAT CEOs ARE PAID THE CORRECT AMOUNT (WITH SOME CAVEATS)

Seventy-six percent of CEOs and directors believe that CEOs are paid correctly, based on the expected value of compensation awards at the time they are granted. CEOs (84 percent) are slightly more likely than directors (71 percent) to have this opinion. Conversely, a sizable minority of directors (25 percent) do not believe that CEOs receive the correct level of pay.

CEOs and directors are somewhat less likely to believe that CEOs receive the correct level of pay based on the amount they *realize* when compensation awards are earned or converted to

1 PUBLIC DATA FROM: THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY, "AMERICANS AND CEO PAY: 2016 PUBLIC PERCEPTION SURVEY ON CEO COMPENSATION," (2016).



cash. Sixty-five percent believe realized pay levels are correct. The decrease in support from expected pay levels is most pronounced among the CEO population, where only 65 percent believe take-home pay levels are correct—a 19 percentage point difference. Twenty-six percent of CEOs and 30 percent of directors do not believe CEOs receive the correct level of take-home pay. Based on their commentary, some respondents believe that some CEOs are paid too much.

CEOs AND DIRECTORS BELIEVE IN “PAY FOR PERFORMANCE” ...

CEOs and directors overwhelmingly believe that CEO pay is aligned with performance. Ninety-five percent of CEOs and 87 percent of directors believe this to be the case.

More than three-quarters (77 percent) also believe that compensation arrangements contain the correct mix of short- and long-term incentives. Responses do not differ considerably between CEOs and directors. Still, a reasonable minority (21 percent) believe that compensation contracts are too short-term. Almost none (3 percent) believe they are too long-term.

CEOs and directors believe that 75 percent of a CEO’s compensation package should be performance-based (rather than fixed or guaranteed). This figure is largely in line with shareholder preferences and existing pay practices.²

2 INSTITUTIONAL INVESTORS BELIEVE THAT 70 PERCENT OF CEO COMPENSATION SHOULD BE PERFORMANCE-BASED. AMONG THE LARGEST 100 PUBLICLY TRADED U.S. CORPORATIONS, APPROXIMATELY 71 PERCENT OF CEO PAY IS PERFORMANCE-BASED. SEE RR DONNELLEY, EQUILAR, AND THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY, “2015 INVESTOR SURVEY: DECONSTRUCTING PROXIES—WHAT MATTERS TO INVESTORS” (2015). AND DAVID F. LARCKER AND BRIAN TAYAN, *CORPORATE GOVERNANCE MATTERS: A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES*, 2ND EDITION (NEW YORK, NY: PEARSON EDUCATION, 2015).

... AND GIVE CEOs A LOT OF CREDIT FOR CORPORATE OUTCOMES

When asked to quantify how much of a company’s performance is directly attributable to the efforts of the CEO, corporate leaders give CEOs considerable credit for corporate outcomes. They believe that CEOs are directly responsible for 30 percent of performance results. Directors give more credit to CEOs for performance than CEOs do themselves, believing that they are directly responsible for 40 percent of performance compared with 30 percent according to CEOs.

Similarly, CEOs and directors give the entire senior management team (which includes the CEO) credit for 60 percent of a company’s performance. Directors again attribute a higher percentage of overall performance to the efforts of senior management (73 percent) than CEOs do (50 percent).

“Contribution to performance is a key element in deciding how much a CEO should be paid: What value did the company create, what contribution did the CEO make to that value creation, and how much of that do you want to share with the CEO as compensation. That is the implicit formula for determining CEO pay,” says Professor Larcker. “Directors believe that CEOs contribute a lot to value creation, and so you can see why they are willing to offer the CEO a lot of money to create that value.”

CEOs AND DIRECTORS DISAGREE ON PERFORMANCE METRICS AND DISCRETIONARY BONUSES

Less consensus exists about measuring and rewarding corporate performance. Directors are twice as likely as CEOs to say that stock price performance (total shareholder return) is the single best measure of company performance (51 percent versus 26 percent). By contrast, CEOs are more likely to believe that profitability measures—operating income and free cash flow—are best (49 percent of CEOs versus 20 of directors).



Furthermore, a surprising number of corporate leaders do not believe that CEO performance targets are difficult to achieve. While 58 percent agree or strongly agree that companies select “very challenging” performance goals for compensation plans, fully 14 percent disagree or strongly disagree. Directors (21 percent) are much more likely than CEOs (5 percent) to think that performance targets are not very challenging.

Similarly, CEOs and directors are mixed on whether it is appropriate to pay discretionary bonuses when targets are missed. Forty-six percent of the combined populations agree or strongly agree that it is appropriate to pay a discretionary cash bonus to the CEO if the company misses performance targets because of factors that the board believes are outside the CEO’s control; 31 percent disagree or strongly disagree. CEOs (53 percent) are more likely to agree than directors (43 percent), but even they are mixed with 25 percent of CEOs disagreeing that discretionary bonuses are appropriate.

“These issues are contentious among shareholders, activists, and other governance experts,” observes John Thompson, vice chairman of Heidrick & Struggles. “It should come as little surprise, therefore, that the divide plays out in the boardroom as well. Indeed, the correct performance measures, the correct targets, and the outcomes necessary for awarding contingent compensation are important elements of discussion, and we see directors actively engaging and debating these topics.”

EQUITY SHOULD BE PERFORMANCE-BASED, MIGHT CAUSE “EXCESSIVE” RISK

The vast majority of CEOs and directors (90 percent) believe that stock awards should have performance features. A smaller portion (58 percent) believe that stock options should have performance-based vesting features. Directors (63 percent) are much more likely than CEOs (49 percent) to favor performance-based stock options.³

CEOs and directors (83 percent) generally do not believe that stock options lead to excessive risk taking. However, a significant minority of CEOs (24 percent) believe that they do.

“Executives are notably risk averse when it comes to compensation arrangements. It is understandable that CEOs would not want additional performance-based features in their stock option plans if they believe that strike prices, by definition, make options ‘performance-based,’” says Professor Larcker. “Whether stock options cause ‘excessive’ risk taking is much more difficult to determine. Researchers have long noted that options encourage executives to take on more corporate risk. Whether or not these risks are ‘excessive’ is unclear. Most CEOs and directors believe they are not, but even among these individuals there is not consensus.”

CEOs SHOULD SHARE IN VALUE CREATION, BUT NOT EXTENSIVELY

CEOs and directors generally believe that CEOs should share only modestly in the value they create for shareholders. If a company increases in value by \$100 million, the typical CEO and director believes the CEO should receive 1.5 percent (\$1.5 million) as compensation.

These figures are not substantially higher than what the general American public says when asked the same question. The typical American would share 0.5 percent (\$500,000) with the CEO as compensation. The mean value of responses among both groups is strikingly similar: \$3.6 million according to CEOs and directors compared with \$3.2 million according to the public.⁴

³ WHILE PERFORMANCE-BASED STOCK AWARDS ARE INCLUDED IN TWO-THIRDS OF CEO COMPENSATION ARRANGEMENTS, PERFORMANCE-BASED STOCK OPTIONS REMAIN RARE. SEE EQUILAR, “CEO PAY STRATEGIES REPORT,” (2015).

⁴ THE VIEWPOINT OF A “TYPICAL” RESPONDENT IS BASED ON MEDIAN VALUES, WHICH REPRESENT THE ANSWER GIVEN BY THE RESPONDENT AT THE 50TH PERCENTILE. THE MEAN AVERAGE, BY CONTRAST, IS THE AVERAGE AMOUNT ACROSS ALL RESPONSES. MEAN AVERAGES CAN BE INFLUENCED BY A RELATIVELY SMALL NUMBER OF OUTLIERS, AND FOR THIS REASON MEDIAN NUMBERS ARE A BETTER DESCRIPTOR OF THE VIEWPOINT OF A TYPICAL RESPONDENT.

CORPORATE LEADERS AND THE PUBLIC DISAGREE ON COMPENSATION LIMITS, AND ON GOVERNMENT INTERVENTION

A majority of CEOs and directors (55 percent) believe that CEOs are paid the correct amount relative to the average worker; 29 percent believe they are not; and 16 percent have no opinion. While modest, these numbers are considerably more favorable than the opinion of the American public. Only 16 percent of Americans believe CEOs are paid the correct amount relative to the average worker, and 74 percent believe they are not.⁵

CEOs and directors strongly disagree that there should be a maximum amount that CEOs are paid, relative to the average worker. Only 12 percent support a relative limit to CEO pay, while 79 percent oppose it. These figures, too, are considerably more favorable than public opinion. Two-thirds of Americans (62 percent) favor capping pay, while 28 percent oppose the concept.

Most CEOs and directors (73 percent) do not believe that CEO compensation is a problem; 25 percent believe that it is. Opinion, however, varies between these two groups. Over a third of directors (34 percent) believe that CEO compensation is a problem, while only 12 percent of CEOs believe it to be so. These figures are much less favorable than public opinion, where over two-thirds (70 percent) of Americans believe that CEO compensation is a problem.

Finally, CEOs and directors almost uniformly agree that the government should not do anything to change CEO pay practices. Ninety-seven percent oppose intervention. The American public is more mixed on this issue, with 49 percent favoring government intervention and 35 percent opposing it.

“The gaps in perception between what directors think and what the public thinks are substantial,” says Donatiello. “Clearly directors are in a better position to judge what compensation is required to attract, retain, and motivate qualified CEO talent in a competitive labor market. But with income inequality being such a hot-button issue today, directors need to be careful that they are not inviting the very government intervention that they say they don’t want. It should be a wakeup call to boards that they need to put more efforts into justifying CEO pay.”

⁵ THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY, “AMERICANS AND CEO PAY: 2016 PUBLIC PERCEPTION SURVEY ON CEO COMPENSATION,” (2016).

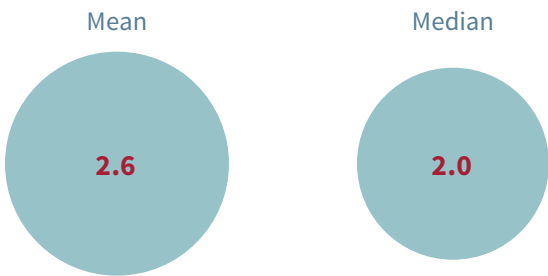


Review of Findings

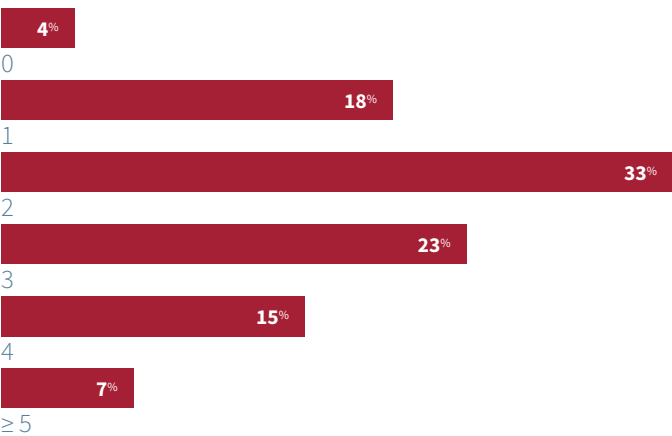
1. Are you the CEO of a publicly traded company?



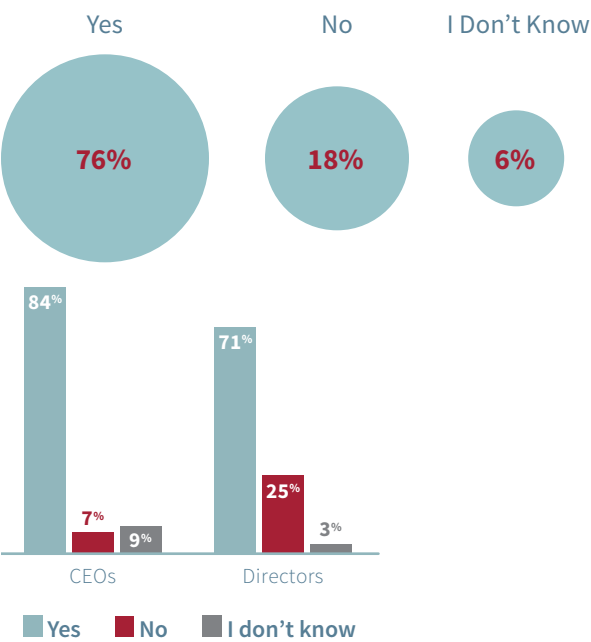
2. What is the total number of corporate boards (public and private) that you serve on, including your own board if applicable?



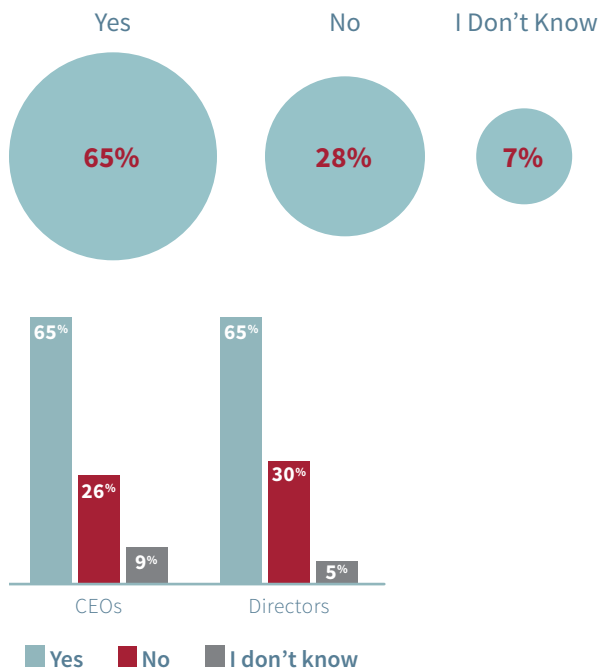
NUMBER OF CORPORATE BOARDS SERVED



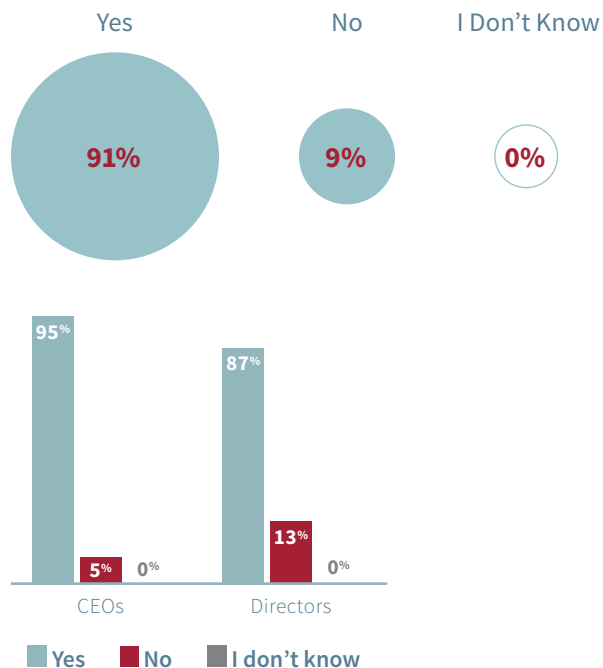
3. In general, do you believe that CEOs receive the correct level of pay, based on the expected value of awards at the time they are granted?



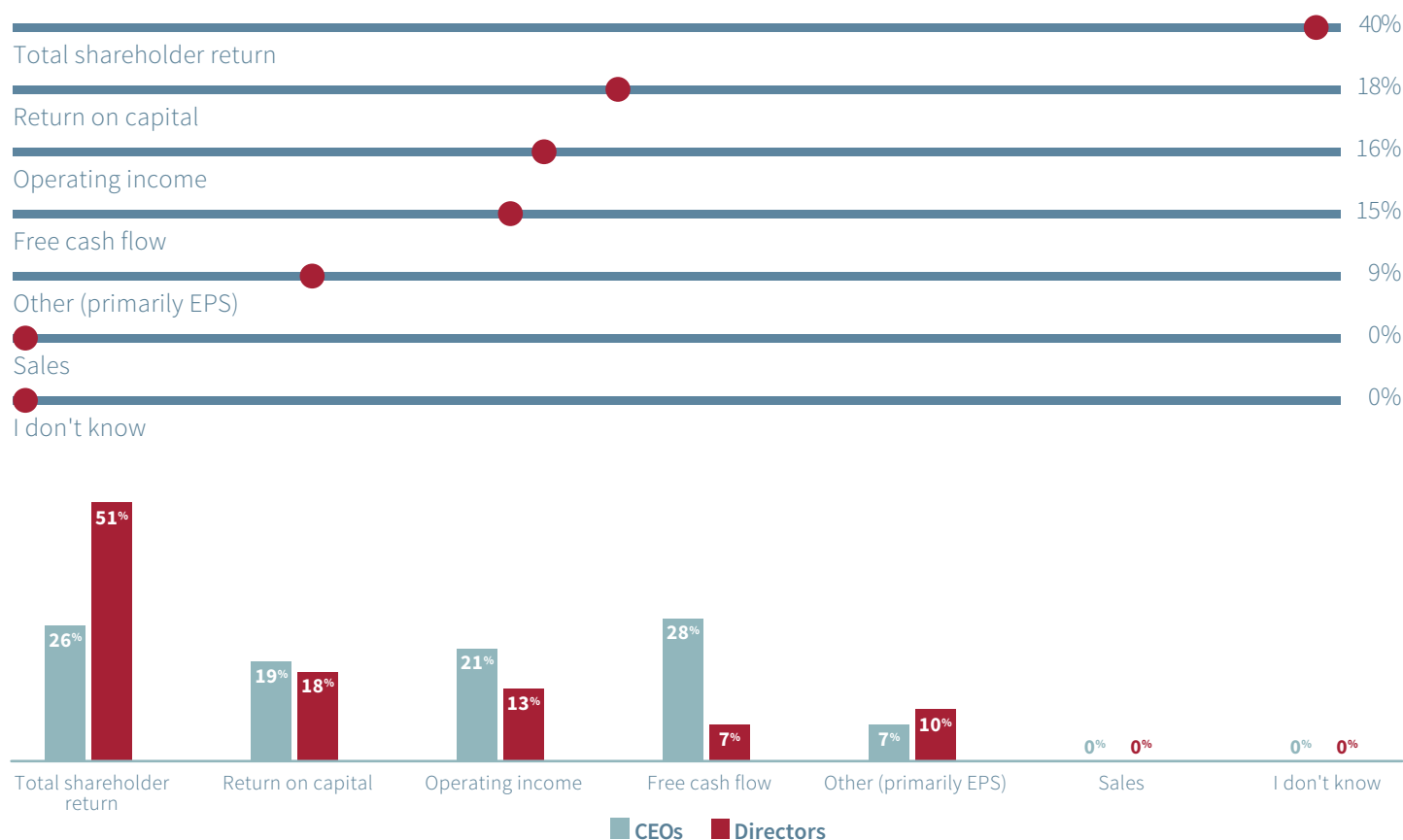
4. In general, do you believe that CEOs receive the correct level of pay, based on what they actually realize ("take home") in terms of compensation?



5. In general, do you believe that CEO compensation is aligned with company performance?

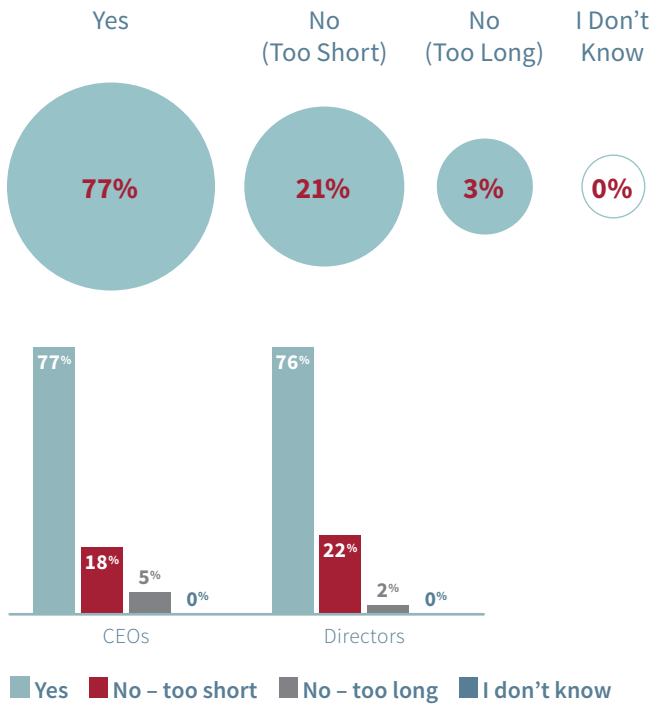


6. In your opinion, if you were to select only one metric, which of the following is the best measure of company performance?

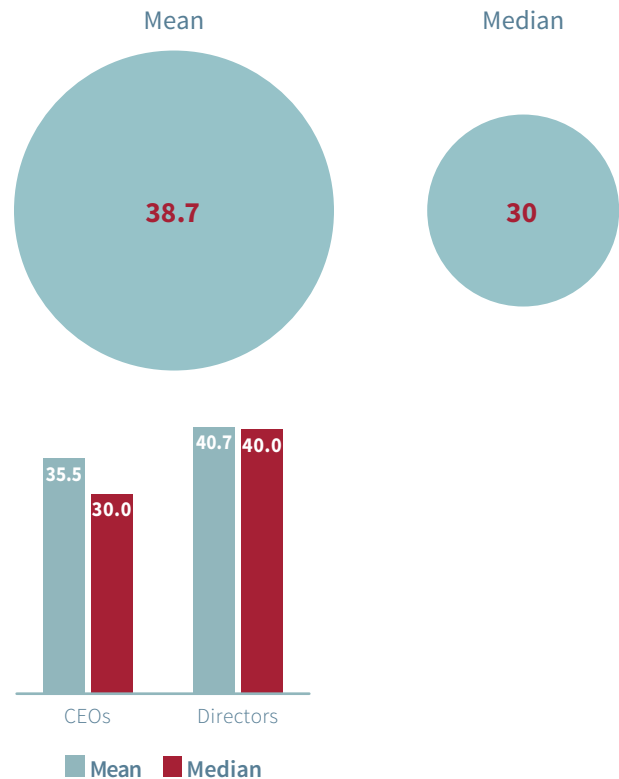




7. In general, do CEO compensation packages contain the correct mix of short- and long-term incentives?

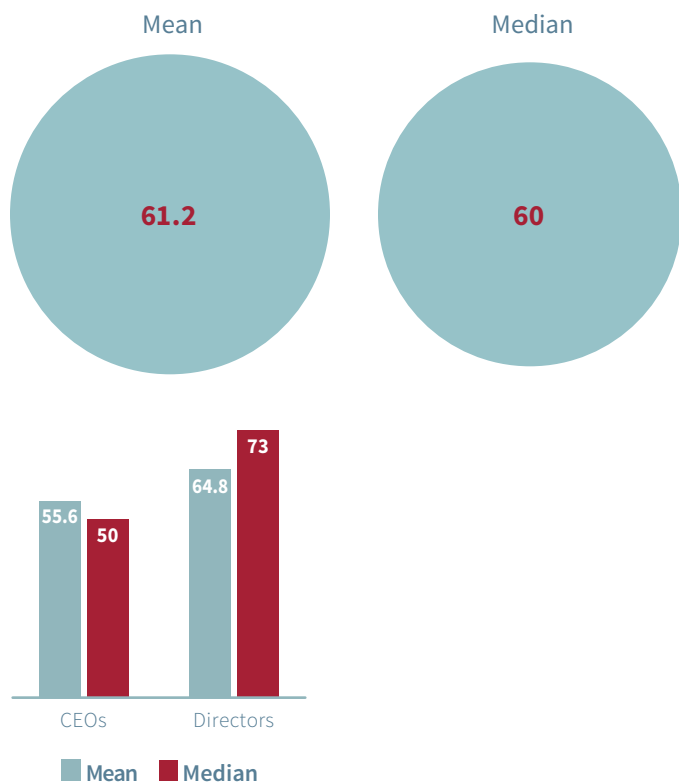


8. In your best estimate, what percentage of a company's overall performance is directly attributable to the efforts of the CEO?

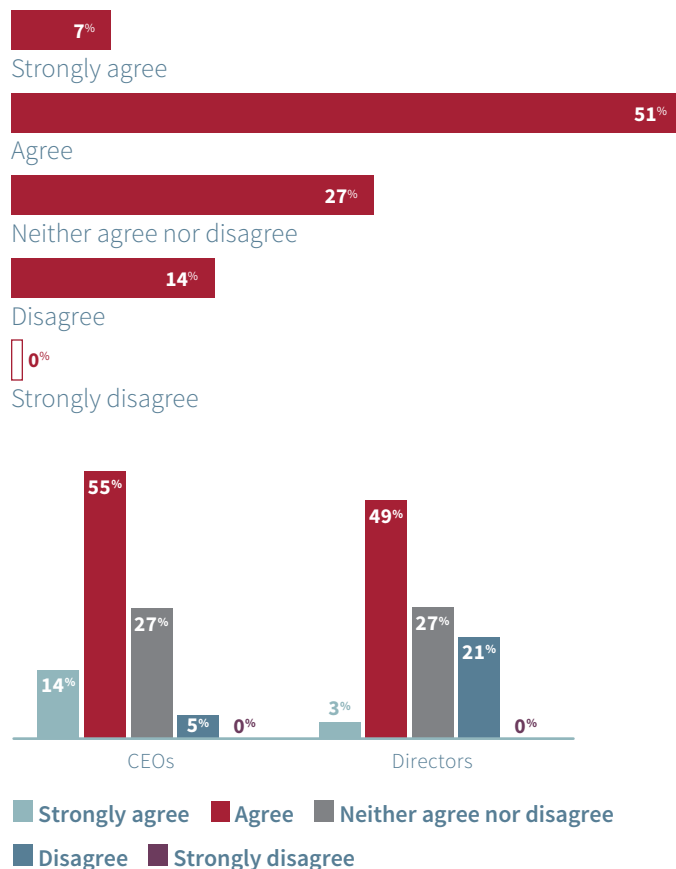




9. In your best estimate, what percentage of a company's overall performance is directly attributable to the efforts of the senior management team (including the CEO)?

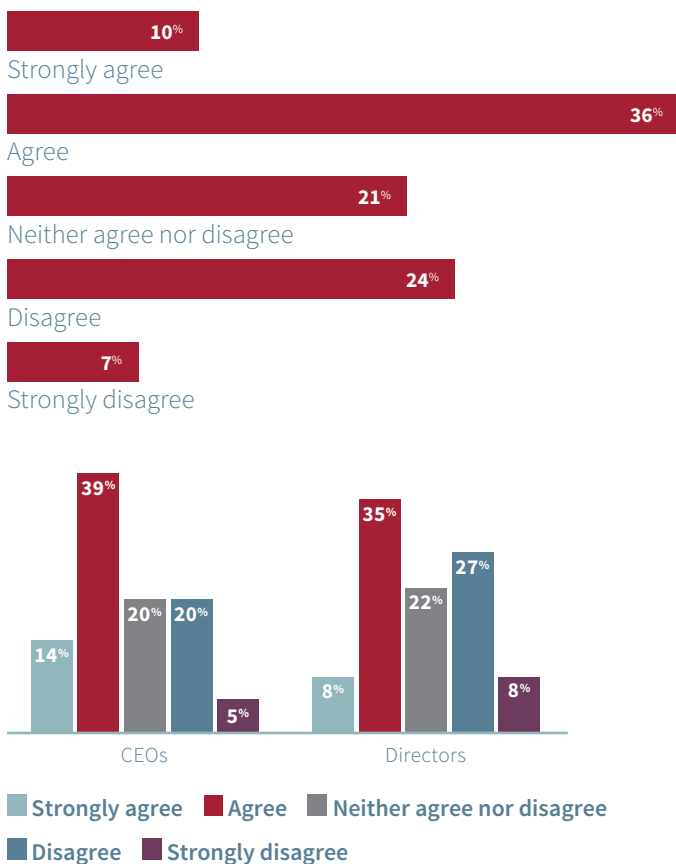


10. To what extent do you agree with the following statement: "In general, companies select performance goals for compensation plans that are very challenging for the CEO to achieve"?

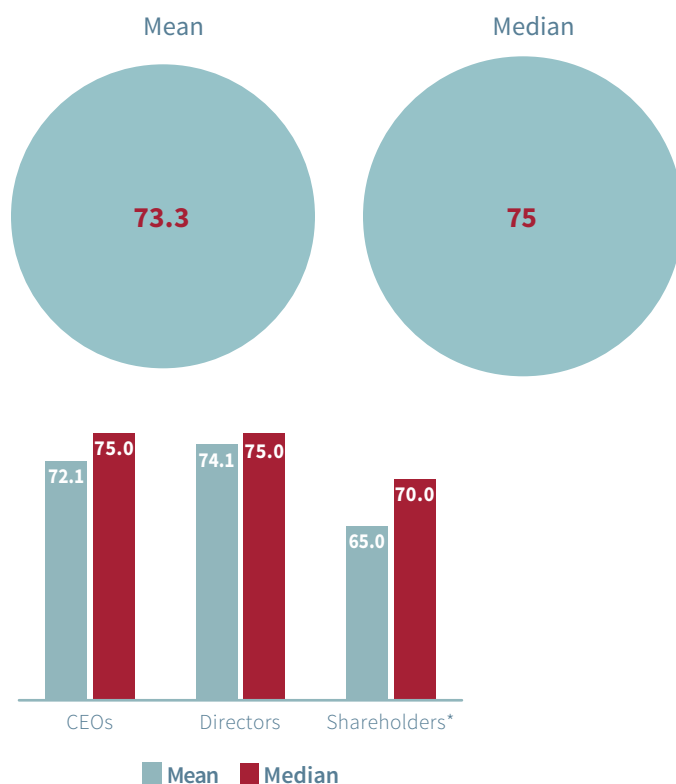




11. To what extent do you agree with the following statement: “It is appropriate for the board of directors to pay a discretionary cash bonus to the CEO if the company misses performance targets because of factors that the board believes are outside the CEO’s control”?

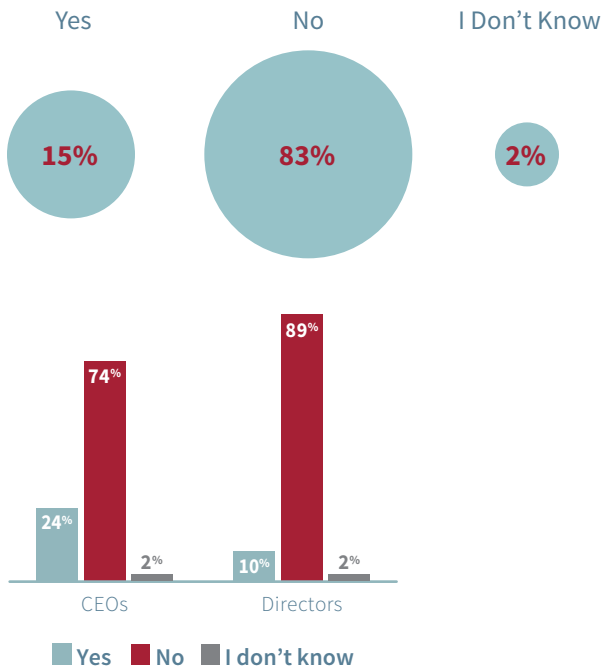


12. In general, what percentage of a CEO’s total compensation package should be performance-based?

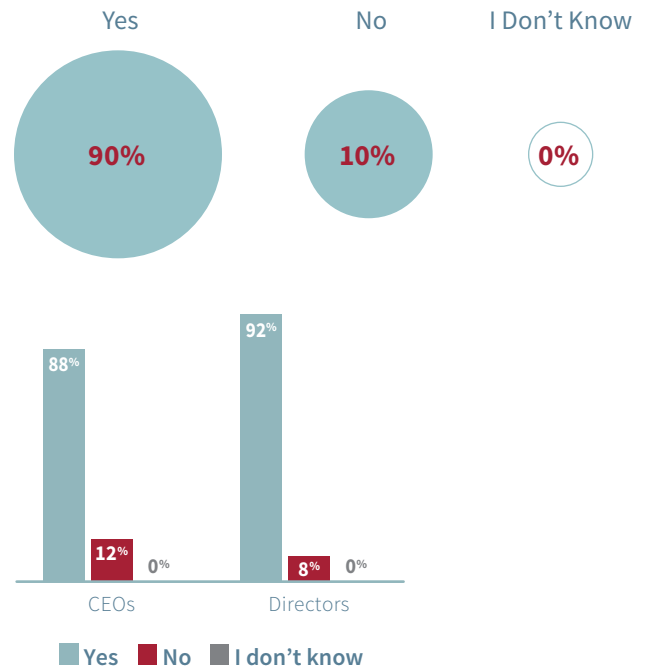


* SOURCE: RR DONNELLEY, EQUILAR, AND THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY, “2015 INVESTOR SURVEY: DECONSTRUCTING PROXIES—WHAT MATTERS TO INVESTORS” (2015).

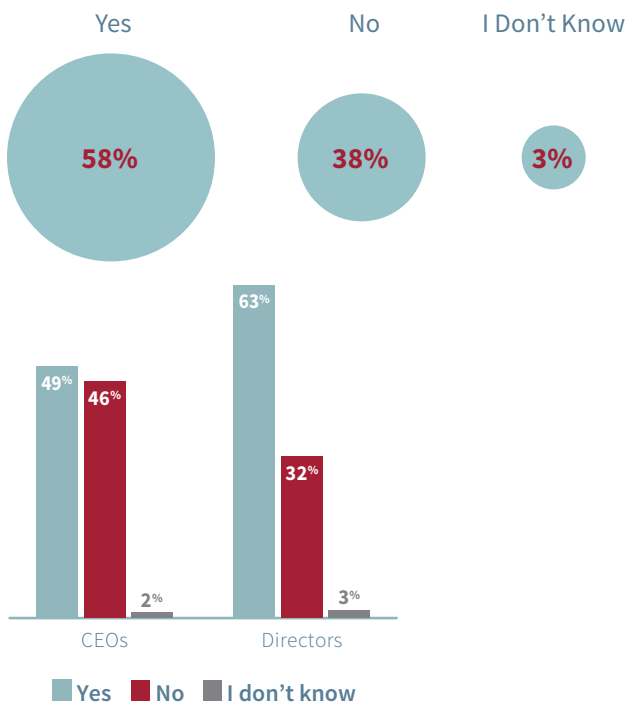
13. In general, do you believe that stock options encourage CEOs to engage in excessive risk taking?



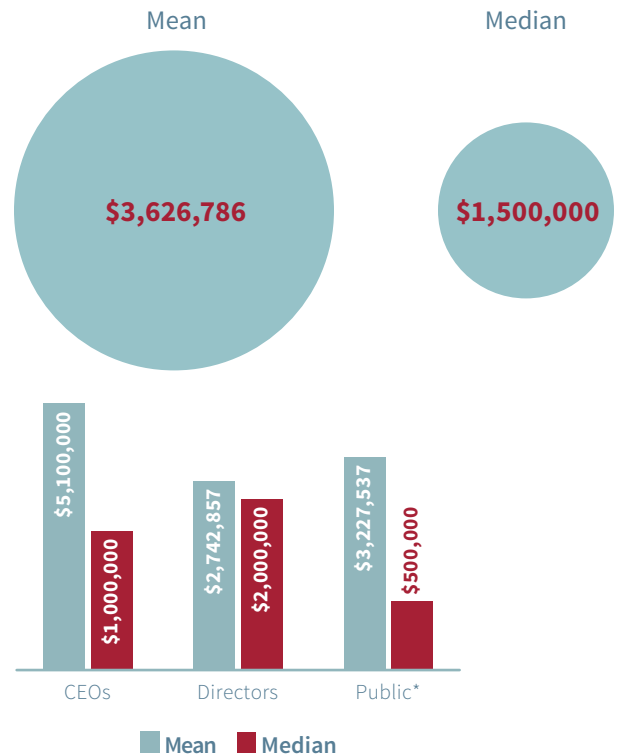
15. In general, should stock awards have performance-based vesting features?



14. In general, should stock options have performance-based vesting features?



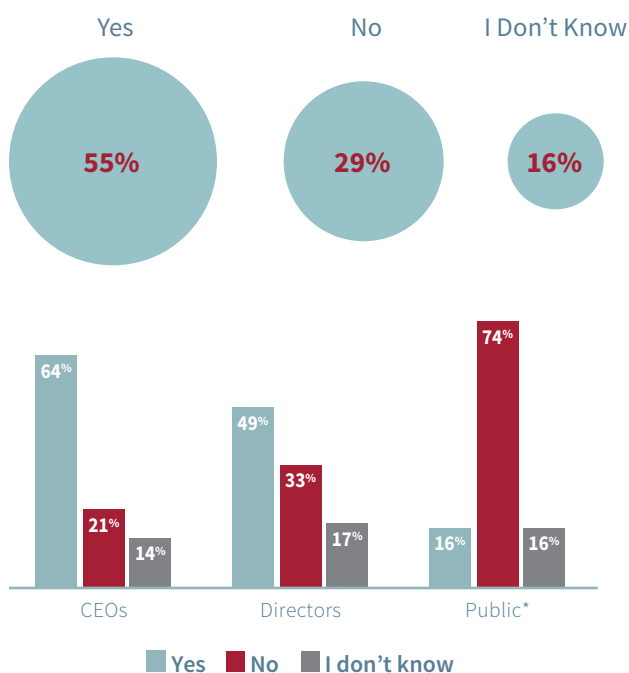
16. Hypothetically, if a company is worth \$100 million more than at the beginning of the year, how much of this \$100 million should be given to the CEO as compensation?



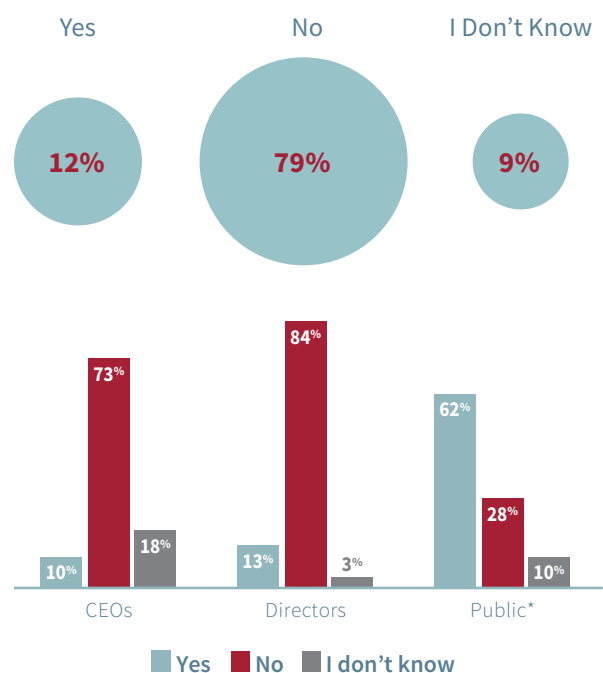
* SOURCE: THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY, "AMERICANS AND CEO PAY: 2016 PUBLIC PERCEPTION SURVEY ON CEO COMPENSATION," (2016).



17. In general, do you think that CEOs in the largest 500 companies are paid the correct amount relative to the average worker?

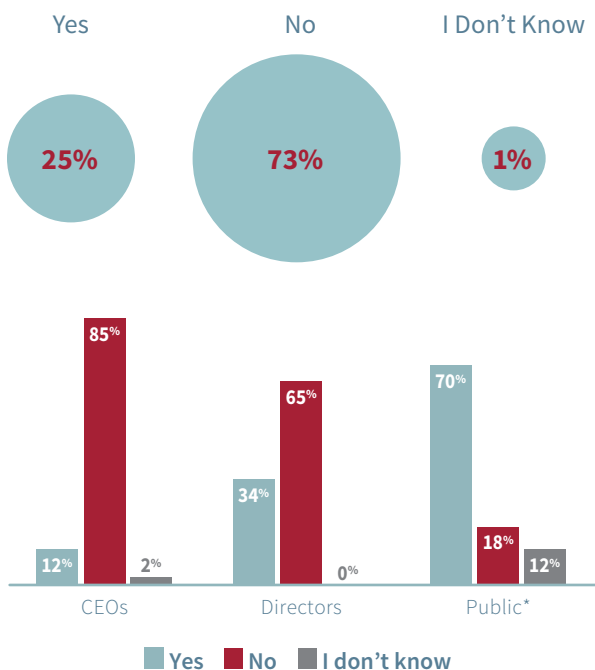


18. In general, do you believe there is a maximum amount that a CEO should be paid relative to the average worker, no matter the company and its performance?

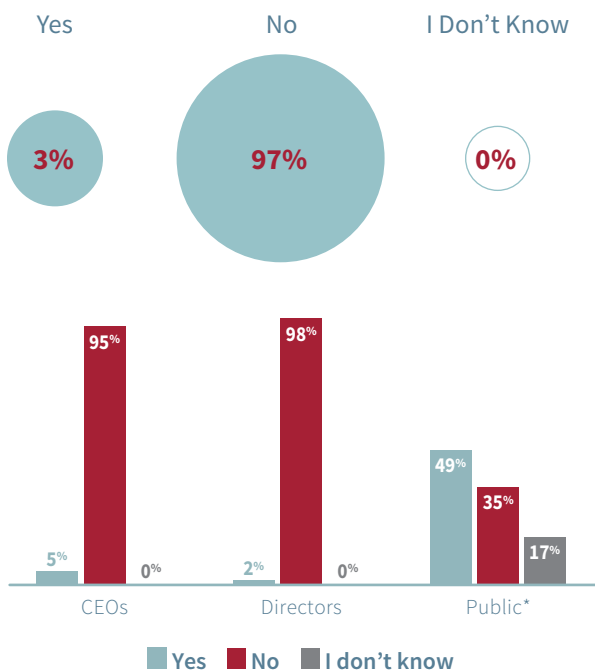


* SOURCE: THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY, "AMERICANS AND CEO PAY: 2016 PUBLIC PERCEPTION SURVEY ON CEO COMPENSATION," (2016).

19. In general, do you believe that CEO compensation at the largest U.S. companies is a problem?



20. Do you believe the government should do something to change current CEO pay practices?



21. Is there anything else you wish to tell us about CEO compensation?

CEO VERBATIM*

Good CEOs live and breathe the company 24/7/365 days a year. The best CEOs run their companies so that they live up to their potential, so that people would be proud to have their children work there, and so they would feel comfortable investing their parents' retirement money in the company stock.

There is no "cookie cutter" solution or model. Strong board oversight and good communication with shareholders will create good pay practices.

A market-based approach to CEO selection and compensation is the most effective approach to creating value for shareholders. The board should establish demanding performance expectations and have clear accountability for results. No excuses.

Compensation must be at market levels and include performance measures that create value. The performance measures should be reasonably hard to achieve. The current practice of 90%+ "at risk" encourages risky actions and—at times—oversized compensation packages. When this happens, the actions of the few taint the entire class.

I believe CEO pay is too high.

CEO jobs sort of "max out" for companies over a certain size. Unfortunately, executive compensation does not. CEOs of \$100 billion companies should not make 10 times the salaries of CEOs of \$10 billion companies.

* EDITED SLIGHTLY FOR CLARITY

* SOURCE: THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY, "AMERICANS AND CEO PAY: 2016 PUBLIC PERCEPTION SURVEY ON CEO COMPENSATION," (2016).



CEO compensation should be based principally on performance. There are two performance dimensions that matter:

1. The company's strategic and tactical plan—how well did it execute vs. the plan, approved by the board anticipated to add value.
2. Performance of the company's stock, either in an absolute fashion or relative to properly composite index, whose purpose is to normalize some of the “uncontrollable” (favorable or unfavorable).

The CEO's contribution to performance varies a lot by company and sector of the economy (it is much more in technology than, say, automotive), but in general tends to be overestimated.

The process of measuring CEO compensation at a multiple of the average worker is ridiculous. This does not take into consideration payment of workers in emerging markets that are in many cases above the standard for their respective countries.

The government should stay out of CEO compensation. It is the job of the board and the compensation committee. The idea of calculating the gap between the average worker's comp and the CEO's comp and comparing that gap across various companies is insane.

Compensation and governance committees take compensation seriously. CEO compensation is a matter for boards and shareholders to address—not the government.

We operate in a free market economy. Are these same questions asked of movie stars: Should the star make X% more than the gaffer? Or athletes: Should the quarterback make X% more than the equipment manager or Gatorade cup kid? The SEC and government seem obsessed by this topic, and I'm not certain why.

DIRECTOR VERBATIM

The biggest concern is pay for performance. Companies need to establish what great performance looks like and set reasonable guidance for corporations accordingly.

Most executives are paid well and based on performance. There are outliers that receive outrageous salaries and bonuses, which tend to give all executive compensation a bad reputation. The government should not regulate, but boards should be more diligent in these extreme cases.

There are always going to be underpaid and overpaid CEOs. This problem should be handled by the Board of Directors. It is their responsibility and obligation to shareholders.

CEOs perform on a bell curve like everyone else. Most are paid at the 75th percentile, which is illogical. CEO comp in many cases is excessive.

Entertainers, sports stars, even politicians can make fabulous sums. Why pick on CEOs? Leave it to boards to set pay.

Regarding pay vs. the average worker, it is a completely misleading statistic. It is driven by the kind of workforce a company has including how it utilizes outsourcing, in what countries it has operations, what amount of professional services it provides vs. operations, and more. One thing is clear: executive pay should be more volatile than average worker pay, which means the ratio should vary.

Whether or not stock options encourage the taking of risk all depends. Pressure from the board, shareholders, media, government, and other stakeholders can create a situation of encouraging risk, even when less risk is desired, depending on how the stakeholders exert their influence.



Everyone is competing for talent. If all boats are lifted due to high water, you have to do the same. Until the averages come down, everyone keeps raising salaries to stay competitive. If government limits public CEO compensation, then companies will go private. Not sure how we stop the upward spiral but disclosure and transparency does focus shareholder attention.

The practice of pegging compensation to a group of like companies causes escalation of salaries as no one wants to pay below the average or median, which only serves to grow the average faster than other salaries. The move to put so much comp at risk to avoid the tax penalty results in unintended consequences such as high pay when the market goes up, short-term thinking, or an excessive focus on shareholders return at the expense of all other stakeholders.

One size doesn't fit all. While there are 'best practices,' compensation schemes need to be tailored to the specific company and market.

Much depends on industry, size of the company, and its state. The CEO compensation should be tied to quantitative goals—both financial and strategic—that clearly tie to external benchmarks.

Boards that are well run make independent decisions on CEO pay based on performance, specific company factors, and external environment. No one size fits all. Total Shareholder Return (TSR) suffers from a start and end date problem and from the vagaries of the stock market, but in general it is a good very long-term measure.

There is no doubt CEO compensation has grown substantially. However, if the company outperforms peers it is well earned. The biggest problem is high pay among poorly performing companies.

CEO comp is a runaway train! The average worker earns less today in real dollars while CEOs earn significantly more compared to where they were 20 years ago. It is all about greed.

Many boards set comp for CEOs based on achievement of annual budgets and/or achievement of Long Term (LT) plans. But often, not enough attention is paid to the details in the budget or long-term plan, leading to targets that are not efficiently challenging. Additionally, TSR targets should not be measured in absolute terms but should be measured relative to peer groups.

Companies are very different and thus require different compensation schemes. Unfortunately, some methods to try to benchmark (like CEO pay to average worker pay) really miss the mark in my opinion, and will only lead to sensational headlines that are not helpful (nor provide real transparency). Truth is that this is a difficult topic to generalize. With that said, I believe boards (and comp committees) of large publicly traded companies spend significant time on this issue to try to "get it right." And most do! I don't see the need for additional government intervention.

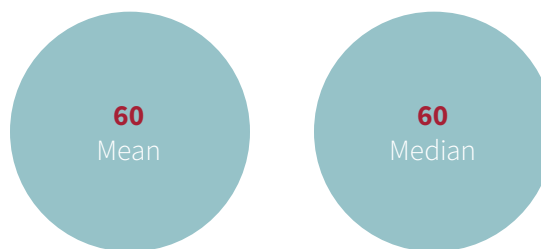


Demographic Information

1. Gender



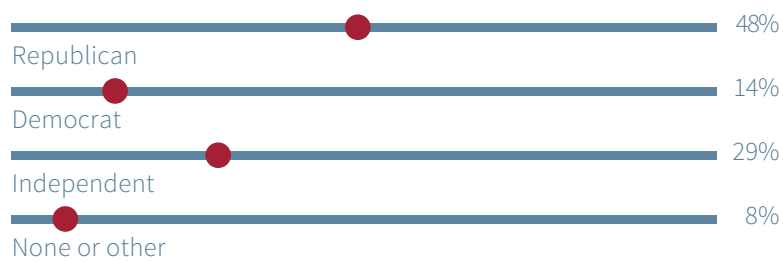
2. Age



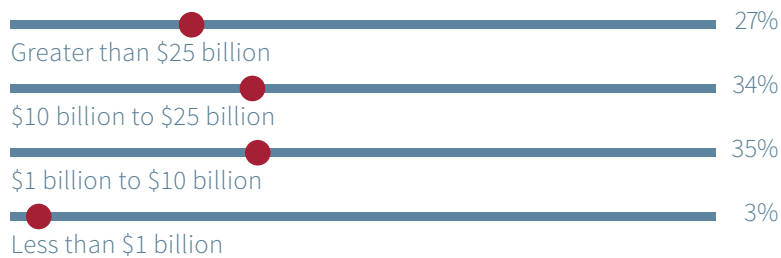
3. Ethnicity



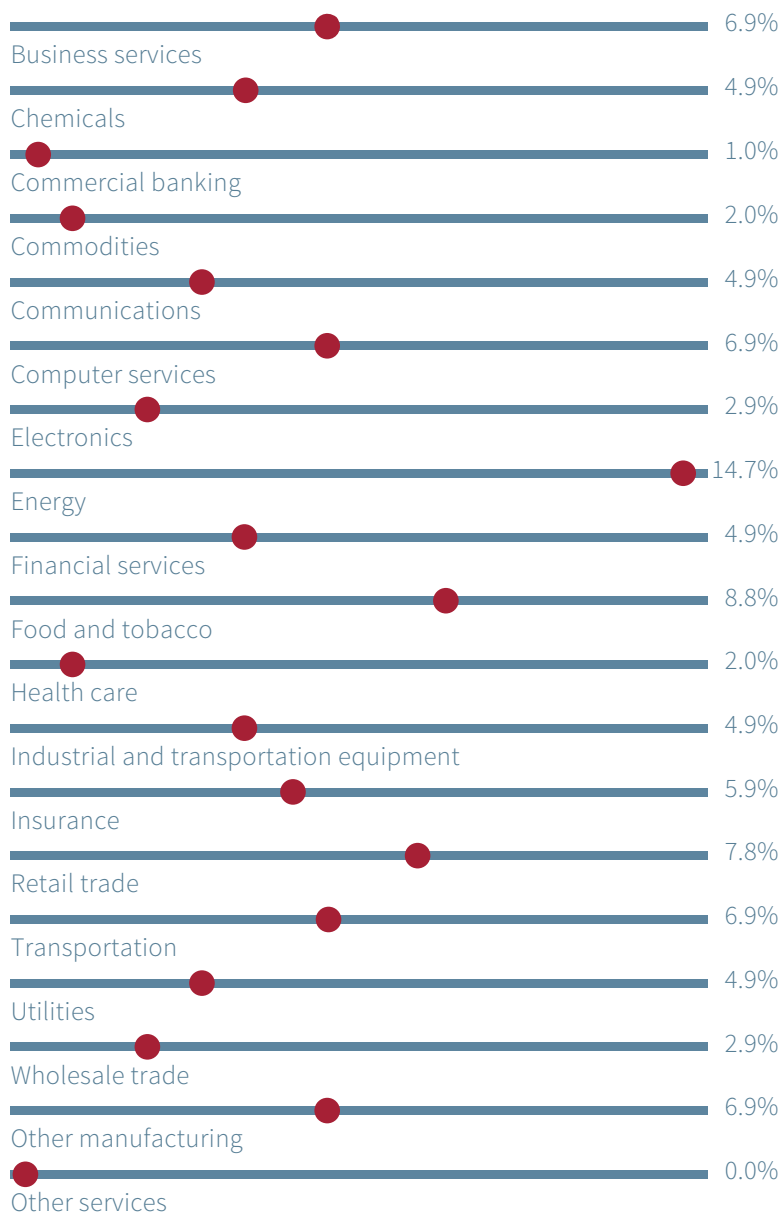
4. Political affiliation



5. What is the revenue of company that you are most closely identified with?



6. What is the industry of the company that you are most closely identified with?





Methodology

IN DECEMBER 2015 AND JANUARY 2016, HEIDRICK & STRUGGLES AND THE ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY SURVEYED 107 CEOs AND DIRECTORS OF FORTUNE 500 COMPANIES TO UNDERSTAND THEIR PERCEPTION OF CEO PAY PRACTICES AMONG THE LARGEST U.S. CORPORATIONS.

ABOUT THE AUTHORS



DAVID F. LARCKER

David F. Larcker is the James Irvin Miller Professor of Accounting at Stanford Graduate School of Business; director of the Corporate Governance Research Initiative; and senior faculty of the Arthur and Toni Rembe Rock Center for Corporate Governance. His research focuses on executive compensation and corporate governance. Professor Larcker presently serves on the Board of Trustees for Wells Fargo Advantage Funds. He is coauthor of the books *A Real Look at Real World Corporate Governance* and *Corporate Governance Matters*.

Email: dlarcker@stanford.edu

Twitter: [@stanfordcorpgov](https://twitter.com/stanfordcorpgov)

Full Bio: <http://www.gsb.stanford.edu/faculty-research/faculty/david-f-larcker>



JOHN T. THOMPSON

John Thompson serves as Vice Chairman, Global CEO and Board Practice, at Heidrick & Struggles. He is recognized as one of the most respected CEO and board advisors in the nation having completed over 200 CEO searches and 250 director searches in the last 33 years. In addition, he serves as an advisor to CEOs on organization transformation projects, succession planning, executive assessments and organizational restructuring.

Email: jthompson@heidrick.com

Full bio: http://www.heidrick.com/Where-We-Work/Consultants/Thompson_John_10456



ABOUT THE AUTHORS (CONT)



NICHOLAS DONATIELLO

Nicholas Donatiello is a recognized expert in the areas of consumers, media, and technology. He is president and CEO of Odyssey and a lecturer at Stanford Graduate School of Business, where he lectures on the roles, responsibilities, and performance of boards in public, early stage private and not-for-profit companies. Donatiello is Chairman of the Board of several of the American Funds from Capital Research and Management. He is also a member of the Board of both public and early stage private companies including Dolby Laboratories, where he chairs the Compensation Committee, and Big 5 Sporting Goods. Donatiello is a director of the Schwab Charitable Fund, one of the nation's largest grantmaking charities, distributing more than \$1 billion in annual grants to charities. He chairs the Compensation Committee.

Email: donatiello@stanford.edu

Twitter: [@nickdonatiello](https://twitter.com/nickdonatiello)

Full Bio: <http://www.gsb.stanford.edu/faculty-research/faculty/nicholas-donatiello>



BRIAN TAYAN

Brian Tayan is a member of the Corporate Governance Research Initiative at Stanford Graduate School of Business. He has written broadly on the subject of corporate governance, including the boards of directors, succession planning, compensation, financial accounting, and shareholder relations. He is coauthor with David Larcker of the books *A Real Look at Real World Corporate Governance* and *Corporate Governance Matters*.

Email: btayan@stanford.edu

Acknowledgments

THE AUTHORS WOULD LIKE TO THANK MICHELLE E. GUTMAN OF THE CORPORATE GOVERNANCE RESEARCH INITIATIVE AT STANFORD GRADUATE SCHOOL OF BUSINESS AND JESSICA GENTILE OF HEIDRICK & STRUGGLES FOR THEIR RESEARCH ASSISTANCE ON THIS STUDY.



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The Corporate Governance Research Initiative at Stanford Graduate School of Business focuses on research to advance the intellectual understanding of corporate governance, both domestically and abroad. By collaborating with academics and practitioners from the public and private sectors, we seek to generate insights into critical issues and bridge the gap between theory and practice. Our research covers a broad range of topics that include executive compensation, board governance, CEO succession, and proxy voting. gsb.stanford.edu/cgri

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Contact Information

FOR MORE INFORMATION ON THIS REPORT,
PLEASE CONTACT:

HEATHER HANSEN
ASSISTANT COMMUNICATIONS DIRECTOR
Stanford Graduate School of Business
Knight Management Center
Stanford University
655 Knight Way
Stanford, CA 94305-7298
Phone: +1.650.723.0887
hhansen@stanford.edu