

CHAPTER

5.5

LEADERSHIP AND REMUNERATION

How the Board selects, motivates, evaluates and plans the succession of the CEO, and how it oversees remuneration across the company.

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5.5.1

THE CEO: SELECTION, MOTIVATION, EVALUATION AND SUCCESSION

One of the main functions of the Board is to select and appoint the most suitable CEO, to make sure that the CEO is properly motivated, evaluated and remunerated, and to replace the CEO if the results are unsatisfactory, the CEO retires or other circumstances, such as illness or death, make a change necessary.

Selection and appointment process

The nomination and appointment process is key to strong company performance and effective accountability. In a well-run company, the selection of candidates for the CEO position is therefore best conducted through the Board's nomination committee, where one exists, or by the Board itself. The task of the committee is to carry out the selection process for the appointment and re-appointment of the CEO (and other senior managers) and to make recommendations to the Board.

The CEO must be selected on the basis of the company's stage of development, future plans and ambitions. The profile will differ considerably depending on whether the company is in a start-up, growth, mature, turnaround or distress phase. The requirements for the CEO should be based on the company's current and expected needs.

When preparing the search for a new CEO, the Board or its nomination committee must weigh the merits of an internal candidate against those of an external one. Selecting an **internal candidate** may bring continuity and stability, better alignment with the long-term goals, familiarity with the company's culture and internal processes and stronger internal networks. An **external candidate** may bring a fresh perspective, an objective assessment of the company's challenges, the ability to drive change, wider business networks, and specialised expertise and experience that the company needs at that particular time. In each case the Board has to consider the long-term goals of the company, its stage of development and the qualities the new CEO will need.

There are several important aspects to consider when onboarding a newly appointed CEO:

- Onboarding process – a structured introduction is one of the most critical factors in helping a new CEO to work at full speed as soon as possible.
- Regular feedback – make sure that the new CEO receives the right information early; do not wait until things have gone too far before raising an issue.

- Tolerance of mistakes – no one is immune to mistakes, least of all a person who has just joined the company.
- Respecting roles – avoid the temptation to micro-manage or to solve problems that are the CEO's responsibility.
- Dealing with negative information and rumours – there will naturally be some displeased subordinates, and some of them may even try to undermine the new CEO by providing false, distorted or tendentious information.

Main employment terms and motivation

The main terms of the CEO's employment agreement for the Board to consider are:

- Non-compete – the main function of a non-compete clause is to provide the company with greater assurance that its intellectual property, information on clients, confidential resources and proprietary information will not be made available to or used by a competitor.
- Non-solicitation – this clause assists the company in retaining valuable employees and reduces the risk of their being recruited by a former CEO who would use their knowledge for competitive advantage.
- Confidentiality – a clause that goes hand in hand with the non-compete clause and prohibits the former CEO from sharing the company's confidential information, trade secrets and know-how with any third party, in particular a competitor, after the end of employment.
- Notice period – a clause setting the period of notice to be given by the CEO to the company, or by the company to the CEO, before termination takes effect. If no notice period is agreed, the statutory period applies, which may not suit the company's needs.

Once the CEO is selected, the Board should make sure that the CEO is motivated and appropriately remunerated in line with market and industry practice, using well-established means such as performance bonuses, share options and fringe benefits (company car, health care, life insurance and similar). The motivation system aims to ensure the achievement of the company's long-term goals.

Evaluation of performance

Evaluating the performance of the CEO is the responsibility of the Board, which often asks its relevant committee for assistance. The CEO is the link between the Board and the management team in the governance of the company, and the Board has an interest in the CEO being effective. As the Board and the CEO share responsibility for ensuring that the company meets its goals and objectives, the

following aspects of preparing and running the evaluation of the CEO's performance should be considered:

- the criteria against which the review is undertaken, agreed in advance;
- the use of common methods and tools for such reviews (360° feedback, company performance, stakeholder relations);
- a process run by the Board (its Chair) or a Board committee;
- an agenda for the review and the key issues to be discussed;
- sufficient time to prepare;
- an open and transparent manner (constructive criticism, areas for improvement, acknowledgement of achievements).

The purpose and benefits of evaluating the CEO's performance include:

- aligning the CEO's capabilities with the strategic direction of the company;
- spotting any potential management problems early on;
- setting appropriate goals for future growth;
- giving the Board greater objectivity about the CEO's remuneration;
- promoting collaboration between the CEO and the Board.

The success of the CEO's evaluation depends largely on setting the right KPIs at the outset and tracking the CEO's performance against them. KPIs may be "hard", based on specific metrics and therefore easily measurable (such as adherence to budget, financial performance or employee turnover), or "soft" and more difficult to measure (such as communication and personal qualities). The most widely used KPIs are SMART: specific, measurable, achievable, relevant and time-bound. Such KPIs enable the Board to make data-driven decisions, identify areas where the CEO or the company is falling short and take swift action to improve. Companies may choose other frameworks for setting the CEO's goals and objectives, such as OKRs (objectives and key results), FAST (frequently discussed, ambitious, specific, transparent) or CLEAR (collaborative, limited, emotional, appreciable, refinable).

The CEO's performance should be monitored and constructive feedback given on an ongoing basis (quarterly or at least twice a year). This alerts the Board to emerging issues and gives the Board and the CEO the opportunity to address them before they escalate.

Succession planning

Succession planning is critical to the continuity of the business and is increasingly recognised as a significant aspect of good corporate governance. It is the process of identifying and developing new leaders and key employees who can replace

existing ones when they leave or retire. Failure to focus on succession planning may result in a weak, ineffective and insufficiently diverse senior management team, which in turn creates a risk to the company's long-term success.

The aims and advantages of good succession planning include:

- ensuring that the senior management team consists of people with the right diversity of skills and talent needed to achieve the company's business objectives and promote its long-term success;
- having a procedure for identifying and developing possible successors to the CEO and other key employees, which includes determining the experience, professional capabilities and personal characteristics needed for each senior management role and assessing candidates in the light of the company's strategy and culture; and
- selecting the optimal candidates to replace the CEO and other key employees following their departure, whether planned or unexpected.

There is no one-size-fits-all way of approaching these issues, nor is there one specific succession planning procedure that would suit every company. The Board must therefore take into account the company's particular situation when formulating and implementing its succession planning policy.

To maintain continuous and efficient operations and a seamless transition of leadership, the succession planning process should be properly defined and implemented. A written succession plan is therefore highly recommended. It should at least include:

- the key (critical) management positions in the company;
- potential successors, their development plans and development opportunities;
- a step-by-step plan for emergency succession;
- alignment with the company's strategy;
- legal and financial considerations;
- regular review and updating.

The succession plan and its execution should be reviewed by the Board at least annually.

KEY TAKEAWAYS

A. Selecting, motivating, evaluating and, when necessary, replacing the CEO is one of the Board's most important functions. The selection is best run by the nomination committee, where one exists, and the profile must match the company's stage of development and expected needs.

B. Internal and external candidates each have advantages; the Board weighs continuity and cultural fit against fresh perspective and change capability in the light of the company's long-term goals.

C. A new CEO needs structured onboarding, early and regular feedback, tolerance of initial mistakes and a Board that respects the boundary between oversight and management.

D. The CEO's contract should address non-competition, non-solicitation, confidentiality and the notice period, and the remuneration should motivate the achievement of long-term goals.

E. The Board evaluates the CEO against criteria and KPIs agreed in advance, in an open and transparent process, with feedback at least twice a year.

F. Succession planning for the CEO and other key positions, including an emergency plan, is part of good governance; the plan should be written and reviewed by the Board at least annually.

QUESTIONS FOR THE BOARD

1. *Does the Board have an agreed profile for the CEO that reflects the company's stage of development and strategy, and a defined process, led by the nomination committee or the Board, for selection and re-appointment?*
2. *How did the Board support the current CEO in the first months, and does it respect the line between oversight and management?*
3. *Does the CEO's contract contain adequate non-compete, non-solicitation, confidentiality and notice provisions, and when were they last reviewed?*
4. *Against which KPIs and criteria is the CEO evaluated, were they agreed at the start of the year, and when did the Board last give the CEO structured feedback?*
5. *Do we have a written succession plan for the CEO and other critical positions, including emergency succession, and when did the Board last review it?*
6. *Who would run the company tomorrow if the CEO were unexpectedly unavailable, and does that person know it?*

5.5.2

REMUNERATION OF THE CEO, MANAGEMENT AND EMPLOYEES

Remuneration policy

The Board is responsible for establishing the remuneration policy for the CEO, Management Board members, other managers and employees of the company and for ensuring its effectiveness. To assist the Board in this responsibility, a remuneration committee may be established; larger companies and public-interest entities usually establish one, to comply with the more stringent regulatory requirements that apply to them and with good corporate governance practice.

In relation to remuneration, the main functions of the Board are to:

1. adopt the remuneration policy and ensure its regular review;
2. oversee the implementation of the remuneration policy and practices, to make sure that the policy operates as intended and continues to comply with applicable laws;
3. ensure that the remuneration of the CEO and management, both the elements of the package and the actual amounts awarded, achieves the objectives of the remuneration policy;
4. provide sufficient information to shareholders and other stakeholders to ensure external transparency of the remuneration policy and of management remuneration packages.

For listed companies, the EU Shareholder Rights Directive II, as transposed in Estonia, Latvia and Lithuania, requires the remuneration policy to be submitted to the general meeting of shareholders for a vote and an annual remuneration report to be published and put to the general meeting. State-owned and municipally owned enterprises are subject to additional statutory rules and limits on management remuneration. The Board should know which of these requirements apply to the company.[23]

The remuneration policy, and the practices used to determine remuneration, should be clear, documented and transparent. The remuneration policy should:

1. state its objectives, which should generally be to ensure that the company:
    a. provides strong incentives for management to perform in a way that is aligned with the company's long-term goals and increases long-term value

for its shareholders and other stakeholders, taking into account the company's sustainability (ESG) goals;

   b. attracts and retains the talent necessary for its successful operation;

2. be aligned with the company's purpose, vision, mission, strategy, long-term objectives and values;
3. be objective and fair, based on rewarding performance and results aligned with the long-term goals of the company;
4. be gender-neutral, non-discriminatory and inclusive;
5. provide an effective framework for performance measurement and a clear link between reward and performance aligned with the company's long-term goals;
6. include the following:
   a. a description of the structure of the remuneration package, listing all components of fixed and variable remuneration, including all bonuses and other benefits in whatever form that may be awarded to management, and their relative proportions;
   b. a link between the variable part of remuneration and the financial and non-financial performance of the company and of the individual manager;
   c. where the company awards share-based remuneration, the vesting and delivery periods and, where applicable, the rules for retaining shares after delivery;
   d. the possibility of, and conditions for, adjusting variable remuneration before it is awarded (malus) and reclaiming it after payment (claw-back), in the event of failure to achieve the performance targets, payment based on misstated data or serious misconduct by the manager concerned;
   e. the deferral of part of the cash or share-based variable remuneration;
7. be reviewed regularly, preferably at least once a year and whenever the need arises (for example, changes in the company's strategy or in labour market trends).

Management remuneration package

The management remuneration package is the total amount a manager earns for their performance and for achieving the objectives set by the Board. It may consist of various elements and usually includes:

– ***Fixed remuneration*** *(fixed monthly salary)* is non-discretionary: it cannot be unilaterally adjusted by the company or the Board and does not depend on the

23 Directive (EU) 2017/828 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (Shareholder Rights Directive II), Articles 9a and 9b.

manager's performance. Its amount may vary greatly according to the business sector, the manager's experience and track record and other considerations.

– ***Performance-based variable remuneration*** depends on the performance of the company and of the manager, that is, on the achievement of company and individual goals. It is good practice to ensure that such remuneration is at all times aligned with the achievement of the company's long-term goals and the shareholders' interests.

It is common to provide variable remuneration as an ***annual*** cash bonus (***short-term incentive***, ***STI***), which usually ranges from one to six months of the manager's fixed salary. Good practice, however, is for the major part of variable remuneration to be tied to the achievement of ***long-term*** goals (long-term incentive, ***LTI***). An LTI programme usually (a) runs for three to five years, (b) is larger than the STI, (c) preferably consists of shares as well as cash, (d) includes the deferral of part of the cash element, the delivery of awarded shares at the end of the programme and a requirement to retain part of the delivered shares for a certain period, and (e) allows the awarded cash or shares to be adjusted or reclaimed in the event of misconduct or a subsequent restatement of the company's financial results. The Board may also award ***a one-off*** cash bonus for extraordinary performance, significantly above the goals set or in extraordinary situations that were not taken into account when the goals were set.

– ***Other cash and in-kind benefits*** provided by the company, such as health insurance, life insurance, a car or travel allowance, pension plans, sports and wellness programmes, family leave, compensation of relocation costs and discounts on company products or services.
– ***Severance pay*** is a payment for early termination of the contract (before the end of the term for fixed-term contracts, or before retirement for indefinite contracts), which may amount to 6 to 18 months of fixed monthly salary. Such conditions could be a subject to national law.

When defining and reviewing the management remuneration package, the Board should take into account the latest market data and trends in salaries, to ensure that its decision fits the market and motivates management.

KEY TAKEAWAYS

A. The Board establishes the remuneration policy for the CEO, management and employees and ensures its effectiveness, usually with the support of a remuneration committee in larger companies and public-interest entities.

B. The policy should be clear, documented and transparent, aligned with the company's purpose, strategy and values, objective, fair and inclusive, and built on a clear link between reward and performance against the long-term goals, including sustainability goals.

C. The policy should describe all components of fixed and variable remuneration and their proportions, link variable pay to financial and non-financial performance, and provide for deferral, share retention, malus and claw-back.

D. A remuneration package typically consists of fixed salary, short-term and long-term variable remuneration, other benefits and severance terms; good practice ties the larger part of variable pay to long-term goals through an LTI programme of three to five years.

E. For listed companies the remuneration policy and report are put to the shareholders under SRD II, and state-owned enterprises face statutory limits; the Board sets pay with reference to current market data.

QUESTIONS FOR THE BOARD

1. *Has the Board approved a remuneration policy covering the CEO, management and employees, and when was it last reviewed?*
2. *Is the variable remuneration of the CEO and management clearly linked to the company's long-term goals, including sustainability goals, and is the larger part of it long-term?*
3. *Does the policy provide for deferral, share retention, malus and claw-back, and have these provisions ever been applied?*
4. *How does management remuneration compare with the market and with the pay of the wider workforce, and can the Board justify the differences?*
5. *Are the legal requirements on shareholder approval and disclosure of remuneration (SRD II, rules for state-owned enterprises) met, and is the remuneration report clear to shareholders?*
6. *Are the amounts of severance pay in management contracts reasonable, and are they known to the Board before a termination decision is taken?*