STANFORD
GRADUATE SCHOOL OF BUSINESS

Board of Directors: Selection, Compensation, and Removal

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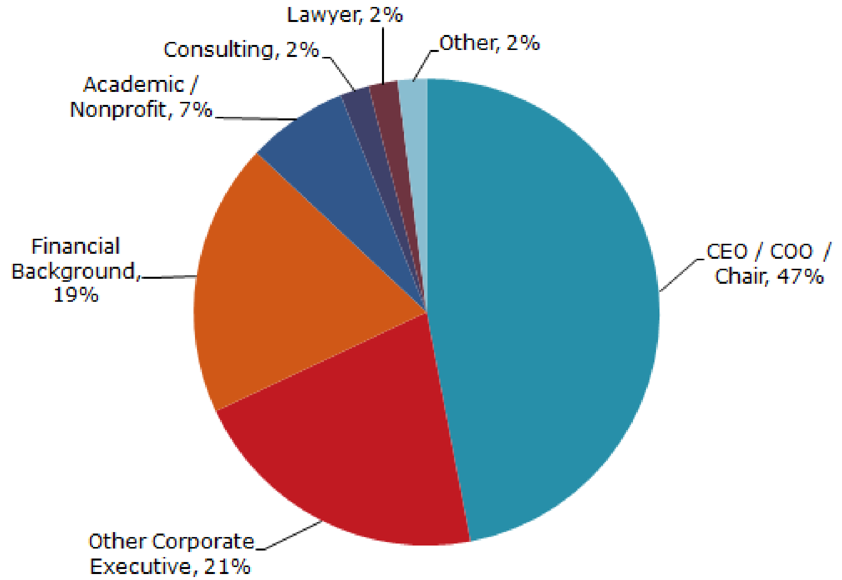
Market for Directors

- Among public corporations in the U.S.:
  - Total number of directors: 50,000
  - Average tenure on board: 7 years
  - Average mandatory retirement age: 72
- Directors tend to retire voluntarily.
- Only 2 percent of directors who step down are dismissed or not reelected.

Market for Directors

- Directors have a mix of managerial, functional, and specialized backgrounds.

Background of New Independent Directors



Spencer Stuart (2007)

Market for Directors

- Are there enough "qualified" directors?
- If supply > demand, companies should have no trouble identifying and recruiting qualified candidates.
- If supply < demand, board quality will suffer. Inadequate supply need not be broad-based; it may be concentrated in specific areas.

- 56%of directors believe there are not enough qualified directors.
- Directors most difficult to recruit include ethnically diverse (57%), women (50%), technological expertise (45%), and international expertise (42%).

Corporate Board Member and PricewaterhouseCoopers (2009)

Market for Directors: Active CEOs

- Do directors with current CEO-level experience increase or decrease board quality?
- (+) Active CEOs have managerial, industry, and functional knowledge.
- (-) Active CEOs are busy. Can they manage their own company and still have time to advise and monitor another?
- In recent years, there has been a decrease in active CEOs serving on outside boards.

More than half of S&P 500 companies limit outside directorships for their CEO, a policy not widely in effect a few years ago.

Spencer Stuart (2008)

Market for Directors: International

- International experience is important as companies enter new markets.
- Directors with this knowledge help the board understand strategy, operations, finance, risk, and regulations.
- Directors may have contacts with government officials, suppliers, manufacturers, distributors, and customers.
- Evidence suggests there is insufficient supply of international directors.

Among U.S. Directors:

- 27% have worked abroad.
- 9% were educated abroad.
- 7% are foreign born.

Egon Zehnder (2008)

Market for Directors: Special Expertise

- Companies need directors to advise on specific areas.
  - Research, development, and production
  - Turnarounds and restructuring
  - Regulations and law
  - Mergers, acquisitions and divestitures

- In some cases, board advisers or board observers are invited to attend board meetings for this purpose.

- When does the company need permanent board representation with specific knowledge? When should this be done on a temporary or advisory basis?

Market for Directors: Diversity

- Companies seek diverse directors when they believe diversity of personal perspective contributes to board deliberations or decision making.
- Diverse groups have low representation in the senior ranks of corporations.
- If CEO experience is preferred background for a new board member, ethnic minorities and females will be slow to obtain director positions.

Fortune 500 Companies

- 3.8% of CEOs are African-American, Latino, or Asian.
- 2.4% are female.

DiversityInc. (2008); Catalyst (2010)

Director Recruitment Process

- Director recruitment is a responsibility of the nominating/ governance committee.
    1. Identify needs of company.
    2. Identify gaps in director capabilities.
    3. Identify potential candidates, either through director networks or with professional recruiter.
    4. Rank candidates in order of preference.
    5. Meet with each candidates successively and offer job.
    6. Put before shareholders for a vote.

- Director recruitment differs from CEO recruitment in that candidates are ranked in order <u>before</u> interviews take place.

Director Compensation

- Compensation must be sufficient to attract, retain, and motivate qualified directors.
- Compensation covers time directly spend on board matters, cost to keeping schedule flexible to address urgent issues, and financial and reputational risk from corporate scandal or lawsuit.

(median)	Revenues > $20 bn	Revenues $1 - $2.5 bn
Annual Retainer	$ 80,000	$45,000
Committee Fees	10,500	16,200
Non-Retainer Equity	105,800	57,800
Total Director Comp	$229,900	$132,600
% Equity	45%	46%

Hewitt (2010)

Director Compensation

- Companies pay fees for serving on committees.
- Fees are intended to compensate for time, expertise, and potential risk of committee role.

(median)	Revenues > $20 bn	Revenues $1 - $2.5 bn
Audit Retainer	$10,000	$ 10,000
Audit Meeting Fee	2,000	1,500
Audit Chair	20,000	12,500
Comp Retainer	$ 9,500	$ 5,000
Comp Meeting Fee	2,000	1,500
Comp Chair	15,000	8,250
Nom/Gov Retainer	$ 9,000	$ 5,000
Nom/Gov Meeting Fee	2,000	1,500
Nom/Gov Chair	10,000	7,500

Hewitt (2010)

Director Ownership Guidelines

- Many companies require directors to maintain minimum ownership levels of company equity.
- Equity ownership by directors is intended to improve the alignment between their interests and those of shareholders.
- Equity ownership guidelines may be stated as a specified number of shares, dollar value, or a multiple of the annual cash retainer.

Fortune 250 Companies

80% have equity ownership guidelines. Of these:

- 55% stated as a multiple of annual retainer.
- 24% as fixed number of shares.
- 14% as fixed dollar value of shares.

Equilar (2010)

Director Ownership Guidelines

- There are potential drawbacks to equity ownership guidelines.
  - Directors are not managers.
  - Directors might become risk averse (e.g., fail to approve long-term projects if near-term expenditures reduce stock price).
  - Directors may make decisions from standpoint of personal benefit rather than professional judgment.
  - Ownership guidelines are not calibrated to personal wealth, and so may have varying impact on directors.

- The research evidence is mixed on whether equity ownership by nonexecutive directors improves firm performance.

Board Evaluations

- The entire board, committees, and/or individual directors are evaluated for effectiveness in carrying out responsibilities.
- New York Stock Exchange rules require board evaluations; evaluations of individual directors are not required.
- Evaluations may review the composition and skills of the board, meeting structure and process, effectiveness in setting strategy, effectiveness in monitoring performance, and director relations with each other, management, and shareholders.

In the U.S.:

- 76% of officers believe individual directors should be evaluated, but
- Only 45% of companies do so.

Korn/Ferry(2007)

Removal of Directors

- A company may replace a director for a variety of reasons, both good and bad:
  - (+) Requires new skills and capabilities on the board.
  - (+) Company wants to “refresh” the board.
  - (+) Director wishes to retire.
  - (+) Director reaches mandatory retirement age.
  - (-) Director is negligent or performing below expectations.
  - (-) Director has irresolvable disagreement with other directors or management.

- Shareholders often do not know the real reason a director leaves the board.

Removal of Directors

- The process for removing a director is complicated.

- The board does not have the power to remove a fellow board member. It must either:
  A. Wait to replace the director at the annual meeting.
  B. Encourage him/her to resign.

- Shareholders, too, have limited rights to remove directors.
  A. Pass special resolution, <u>if</u> they can demonstrate cause.
  B. Vote for removal, <u>if</u> election is by majority voting.

- Does this reduce accountability?

Only 106 directors were dismissed in 2009.

Audit Analytics (2009)

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