BOARD OF DIRECTORS

SELECTION, COMPENSATION, AND REMOVAL
MARKET FOR DIRECTORS

• Among public corporations in the U.S.:
  – Total number of directors: 40,000+
  – 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.
Directors have a mix of managerial, functional, and specialized backgrounds.

Spencer Stuart (2013)
The most important qualification is relevant industry experience.

Directors also prefer board candidates with senior-level executive experience.
- Chief executive officers (active or former)
- Chief financial officers
- Chief operating officers

Other background preferences:

<table>
<thead>
<tr>
<th>ETHNIC MINORITIES</th>
<th>56%</th>
<th>TECHNOLOGY</th>
<th>22%</th>
</tr>
</thead>
<tbody>
<tr>
<td>WOMEN</td>
<td>54%</td>
<td>MARKETING</td>
<td>22%</td>
</tr>
<tr>
<td>FINANCIAL</td>
<td>47%</td>
<td>REGULATORY</td>
<td>20%</td>
</tr>
<tr>
<td>INTERNATIONAL</td>
<td>44%</td>
<td>DIGITAL OR SOCIAL MEDIA</td>
<td>12%</td>
</tr>
<tr>
<td>RISK</td>
<td>25%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Spencer Stuart (2013); NACD (2009)
DIRECTORS: ACTIVE CEOS

• Are directors with CEO-level experience “better” directors?
  
  (+) Managerial, industry, and functional knowledge.
  (+) Contribute to advisory functions: strategy, succession, shareholder/stakeholder relations.
  (+) Contribute to oversight: risk management, performance measurement.
  
  (-) Active CEOs are busy; unavailable on short notice; miss or are late for meetings.
  (-) Can be bossy, poor collaborators, poor listeners.

• In recent years, there has been a decrease in active CEOs serving on outside boards as companies limit their directorships.

Stock market reacts favorably to the appointment of an active-CEO director. However, there is no evidence that they contribute to future performance.

Fich (2005); Fahlenbrach, Low, and Stulz (2010)
DIRECTORS: INTERNATIONAL EXPERIENCE

- 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.
- Representation of directors with international experience is low but has been increasing.

Foreign independent directors are associated with better cross-border acquisitions when the target company is from the director’s home country.

Masulis, Wang, and Xie (2012)
Companies need directors to advise on specialized 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 representation with specific knowledge? When should this be done on a temporary or advisory basis?

Industry expertise at the board level is positively associated with innovation and firm value, in industries where innovation is important.

Faley, Hoitash, and Hoitash (2013)
• Professional directors serve on boards as their primary career.

(+) Considerable experience; have witnessed multiple successes and failures.
(+ ) More time to dedicate to boardroom responsibilities.
(+ ) Extensive personal and professional networks.

(-) Might be too “busy” if they serve on many boards concurrently.
(-) Might not be effective monitors if they view directorship as a form of “active retirement.”

Directors with multiple directorships distribute their effort unequally, dedicating more time to prestigious corporations.

Masulis and Mobbs (2014)
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 candidate successively and offer job.
  6. Put before shareholders for a vote.

• Director recruitment differs from CEO recruitment in that candidates are ranked in order before interviews take place.
DIRECTOR COMPENSATION

• Compensation must be sufficient to attract, retain, and motivate qualified directors.

• Compensation covers time directly spent on board matters, cost to keeping schedule flexible to address urgent issues, and financial and reputational risk from corporate scandal or lawsuit.

• Compensation level varies by company size; mix does not.

<table>
<thead>
<tr>
<th>(MEDIUM)</th>
<th>LARGE (S&amp;P 500)</th>
<th>MEDIUM (S&amp;P 400)</th>
<th>SMALL (S&amp;P 600)</th>
<th>AVERAGE (S&amp;P 1500)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANNUAL RETAINER</td>
<td>$220,000</td>
<td>$160,000</td>
<td>$119,280</td>
<td>$168,270</td>
</tr>
<tr>
<td>% CASH</td>
<td>38%</td>
<td>38%</td>
<td>39%</td>
<td>38%</td>
</tr>
<tr>
<td>% EQUITY</td>
<td>62%</td>
<td>63%</td>
<td>63%</td>
<td>63%</td>
</tr>
</tbody>
</table>

Equilar (2013)
Companies also pay fees for serving on committees.

Fees are intended to compensate for time, expertise, and potential risk of being named in shareholder litigation.

<table>
<thead>
<tr>
<th>Committee</th>
<th>(MEDIAN) LARGE (S&amp;P 500)</th>
<th>(MEDIAN) MEDIUM (S&amp;P 400)</th>
<th>(MEDIAN) SMALL (S&amp;P 600)</th>
<th>(MEDIAN) AVERAGE (S&amp;P 1500)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AUDIT COMMITTEE</strong></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>- RETAINER</td>
<td>$10,000</td>
<td>$10,000</td>
<td>$9,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>- MEETING FEE</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>- RETAINER (CHAIR)</td>
<td>$15,000</td>
<td>$15,000</td>
<td>$11,000</td>
<td>$15,000</td>
</tr>
<tr>
<td><strong>COMP COMMITTEE</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- RETAINER</td>
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<td>$7,500</td>
<td>$6,250</td>
<td>$7,500</td>
</tr>
<tr>
<td>- MEETING FEE</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,425</td>
<td>$1,500</td>
</tr>
<tr>
<td>- RETAINER (CHAIR)</td>
<td>$15,000</td>
<td>$10,000</td>
<td>$7,500</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>NOM/GOV COMMITTEE</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- RETAINER</td>
<td>$7,500</td>
<td>$6,000</td>
<td>$5,000</td>
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Equilar (2013)
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 100 Companies**

78% have equity ownership guidelines. Of these:

• 64% stated as a multiple of annual retainer.
• 20% as fixed number of shares.
• 11% as fixed dollar value of shares.

On average, companies give directors five years to meet guidelines.

Equilar (2012)
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.
• 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.

Only 38% of companies evaluate the performance of individual directors. Large companies are more likely to do so (47%) than small companies (30%).

NACD (2014)
A company may replace a director for a variety of reasons.

(+): 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:
  – Wait to replace the director at the annual meeting.
  – Encourage him/her to resign.

• Shareholders, too, have limited rights to remove directors.
  – Pass special resolution, if they can demonstrate cause.
  – Vote for removal, if election is by majority voting.

• Does this reduce accountability?

Only 106 directors were dismissed in 2009, across all public companies in the U.S.

Audit Analytics (2009)


NACD. Public Company Governance Survey. 2014.

Audit Analytics. Director Departures: A Five Year Overview. 2009.