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Snapshot: The (Slowly) Changing Face of the Board

By Jannice Koors, Lianne Chew and Matt Vnuk

The cartoon image of cigar-chomping Directors and executives furtively conducting business in a smoky room has long been obsolete. Boards today operate in an environment characterized by public scrutiny, stricter regulatory mandates aimed at bringing their decision-making process to light, and governance pressures from shareholders to act independently of management.

Yet recent studies, including the new **2007-2008 Director Compensation Report** by the National Association of Corporate Directors in collaboration with Pearl Meyer & Partners (NACD/PM&P Report), suggest that changes in the Boardroom profile remain a work in progress. This snapshot takes a look at some recent research that shows how far companies have moved in some key areas and where they are headed.

The companies included in the **NACD/PM&P 2007-2008 Director Compensation Report** are categorized by annual revenue as follows:	
• **Smaller** companies (324):	$50 million to < $500 million
• **Small** companies (257):	$500 million to < $1 billion
• **Medium** companies (300):	$1 billion to < $2.5 billion
• **Large** companies (319):	$2.5 billion to < $10 billion
• **Top 200** companies (200):	$10 billion or greater

1) Boards are getting smaller

Over the past 30 years, the average corporate Board has shrunk by nearly half, from an average of 16 Directors to about nine, according to an NACD report, **The Governance Committee: Driving Board Performance Best Practices and Key Resources.** Much of that change has resulted from the need to promote more manageable and in-depth discussions and less unwieldy decision-making. Stricter proxy disclosure requirements have prompted Boards to raise the standards for Board membership, with companies now less likely to recruit celebrities, candidates with interlocking company relationships or prospective members who cannot commit to attending at least 75 percent of meetings or who already sit on numerous public Boards.

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Generally, Board membership correlates with company size. The NACD/PM&P Report found median Board size ranging from seven Directors at the *Smaller* companies to 11 members at the Top 200. Some parts of the financial sector have bucked the trend toward *Smaller* sized Boards. Among the 22 industries studied, Banks/Savings & Loans maintained larger Boards – ranging in size from 12 to 14 members at median – than other industries across all revenue groups. The difference is particularly striking among the smallest revenue group studied, where Banks/Savings & Loan Boards have 12 members at median, compared to seven members for all sectors combined. Utility & Energy Boards also tend to have slightly larger Boards compared to other industries.

> ***PM&P Observation:***
> *We believe that the trend toward reducing Board membership has run its course. While Boards have been getting smaller, we have also observed an increased workload for the Audit, Compensation and Governance/Nominating committees. Therefore, we find it hard to imagine that the size of the Board will get smaller as there are a minimum number of Directors needed to staff and cover Board responsibilities.*

2) Boards are trying to come to terms with limitations on age and service

Companies continue to face challenges in recruiting independent candidates with the necessary time, experience and expertise to meet the increased challenges of boardroom service. As a result, some companies have opted to retain members with valuable experience by permitting service beyond previously mandated age limits. Proxy disclosure of age limits on Board service, which is voluntary, generally correlates with company size and ranges from 26% of *Smaller* companies to 81% of the *Top 200* companies, according to the NACD/PM&P Report.

Another survey by recruiter Spencer Stuart found that 67% of companies that limit Board service require members to step down at age 72 – up from just 35% of companies with a similar standard in 2002. The same survey found 11% of companies permitting Board service to age 75 or older, up from just 1% of firms that did so five years earlier.

The NACD/PM&P Report found the mandatory retirement age is set between 70 and 75, with *Smaller* companies tending toward the upper end of the spectrum. On an industry basis, the NACD/PM&P Report found Healthcare companies had the highest age of mandatory retirement across all revenue groups, at a median of 71 to 74 years. At the other end of the spectrum, Banks/Savings & Loans companies typically have the lowest median retirement age, at 70 to 72 years. At median, the tenure of Directors ranged from seven years at the *Smaller* companies down to four years at the *Top 200*.

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In terms of the age of Directors, company size and industry has less bearing. Across all revenue groups, Board members at median were between the ages of 60 and 61. Relative to other industries, Utility & Energy companies had the oldest Boards, between 61 and 63 years at median, while Retail companies had the youngest members, between 57 and 60 years at median.

> ***PM&P Observation:***
> *Looking forward, public companies increasingly will find themselves between a rock and a hard place in recruiting new members, as the need for higher standards and the heightened demands of Board service make it harder to recruit qualified candidates. As such, we believe the use of retirement policies may have plateaued, with the median age of Board members likely to gradually increase. More companies may eventually eliminate mandatory retirement requirements altogether.*

3) Boards are recruiting new members from further afield

The difficulty of finding qualified and independent Board members has pushed Board recruitment efforts beyond the corner office and both widened and deepened the pool of potential candidates. Companies are dipping lower on the management ladder for candidates, particularly those with specific expertise in areas such as finance and technology, and seeking out retired executives with specific skill sets. At the same time, with non-profit Boards now under tougher regulatory and public scrutiny, their members' growing expertise with governance and regulatory issues has made them more attractive candidates for service at public companies. Academics are also being more actively recruited.

To accommodate the more diverse financial needs of non-executive recruits, some Boards are likely to make changes in the design of Board compensation packages, possibly by changing the mix of pay to provide more cash versus equity. Such changes would reverse a long-term trend toward equity compensation for Board members. Other "sweeteners" used by some companies to attract a more diverse set of potential Board members include larger initial one-time equity grants and flexible pay structures that allow Directors to tailor, within reason, their own pay program (e.g., the option to take cash in lieu of equity or vice versa).

Despite being a widely stated goal of many companies, recruitment of women and minorities has yielded relatively modest results to date. One recent study by Spencer Stuart found that while 70% of companies said they were actively recruiting outside women Directors, more than 80% of new Board members in 2007 were male. Similarly, the NACD's 2007 Governance Survey found that the proportion of public Boards with at least one female member was unchanged from a year earlier, at 65%.

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Overall, the proportion of women on corporate Boards tends to correlate with company size. The NACD/PM&P Report found that on average, women account for 6% of Board members in the *Smaller* companies, up to 17% of *Top 200* Boards. On an industry basis, the largest percentages of women Directors were found among companies in the Healthcare, Pharmaceutical & Medical Products, Retail, and Utility & Energy sectors.

Advances in minority recruitment (based on race and nationality) have also been slow. According to the NACD's 2007 Governance Survey, close to 42% of the 791 firms responding had at least one minority Director, compared to just over 38% a year earlier. The same NACD survey found Boards generally averaged fewer than two minority Directors, unchanged from the previous year.

> ***PM&P Observation:***
> *Board membership will – very gradually – continue to become more diverse.*

4) Boards are moving toward declassification

Shareholder activists are pushing for the elimination of classified Boards, a structure in which Directors serve overlapping, multi-year terms. Critics of classified Boards argue that the resulting difficulty in electing entirely new Board leadership is an impediment to meaningful corporate change and encourages an overly close relationship between Directors and the executives they oversee.

The NACD/PM&P Report found that fewer than half of companies in each revenue group studied have changed to annual elections (declassified Boards) with the exception of the *Top 200*, where over two-thirds of Boards have been declassified. This outcome probably reflects a focus on larger companies by shareholder activists. The median Board term across all revenue groups is three years, again with the exception of the *Top 200*, where the median is one year. Banks/Savings & Loans, Chemical/Paper Products, and Healthcare are the only industries in which a majority of companies still have classified Boards across all revenue groups.

> ***PM&P Observation:***
> *The current focus on giving shareholders a larger say in public company governance, especially in regard to hot-button issues such as say-on-pay and majority voting, seems certain to increasingly push companies below the Top 200 to declassify their Boards over the next few years.*

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Summary

A gradual evolution in the structure and composition of corporate Boards is influencing compensation programs and recruiting strategies for new Board members. We believe that Board members will be older, longer-serving and more diverse in the future. The most important outcome will be the extent to which these changes result in meaningful improvements in Board effectiveness and governance in the years ahead.

Board Composition and Structure					
	Smaller	**Small**	**Medium**	**Large**	**Top 200**
No. of Companies	324	257	300	319	200
No. of Total Directors	7	8	9	10	11
Median Term Length (yrs)	3	3	3	3	1
% with 1 year term	47%	44%	44%	47%	67%
% with term > 1 year	53%	56%	56%	53%	33%
Retirement Age					
Prevalence of disclosure	26%	32%	45%	68%	81%
Median Ret. Age	72	72	72	72	72
Age Range (25th – 75th Perct.)	70-75	70-74	70-72	70-72	70-72
Board Composition (Median)					
Male	100% (a)	91%	89%	89%	83%
Female	0% (a)	9%	11%	11%	17%

(a) On average, *Smaller* companies consist of 94% male Directors and 6% female Directors.

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