

## **Open Letter: Commonsense Principles of Corporate Governance**

For more than two centuries, the American free enterprise system has led to enormous prosperity for our country: the creation of jobs, increases in wages and savings, and the emergence and growth of dynamic companies. Because well-managed and well-governed businesses are the engine of our economy, good corporate governance must be more than just a catch phrase or fad. It's an imperative – especially when it comes to our publicly owned companies. Though they account for only 5,000 of our country's 28 million businesses, our public companies are responsible for one-third of all private sector employment and one-half of all business capital spending, both of which ultimately drive the productivity and health of the country. To ensure their continued strength – to maintain our global competitiveness and to provide opportunities for all Americans – we think it essential that our public companies take a long-term approach to the management and governance of their business (the sort of approach you'd take if you owned 100% of a company).

While most everyone agrees that we need good corporate governance, there has been wide disagreement on what that actually means. So we gathered a small group of executives to see if we could reach some consensus on what we think works in the real world. This group included the CEO of several major asset managers, one activist investor and one public pension plan, as well as several publicly owned companies. We did not convene a group of this size to be exclusive but, rather, so we could sit around a room and have a mature conversation about this important topic – something that would have been very difficult to do in a much larger forum. Indeed, even among our small group, we don't agree on absolutely everything. But we do agree that, taken as a whole, these principles are conducive to good corporate governance, healthy public companies and the continued strength of our public markets. Thus, we are steadfast in our determination not to let our minor differences imperil this important effort.

The principles set forth a number of commonsense recommendations and guidelines about the roles and responsibilities of boards, companies and shareholders. We firmly believe that empowered boards and shareholders, both providing meaningful oversight, are critical to the long-term success of public companies. But knowing that there is significant variability among the thousands of such companies and understanding that both context and circumstance matter, we have tried not to be overly prescriptive in how to achieve those goals. We also recognize that we live in a dynamic, fast-changing world – and that while many of these principles are and should be part of the corporate governance permanent landscape, some will inevitably change over time.

These principles are not intended to be for or against activists, proxy advisors or special interest groups. While we know that not everyone will agree with everything in them, we hope that, at the very least, these principles will serve as a catalyst for thoughtful discussion. More than 90 million Americans own our public companies through their investments in mutual funds, and millions more do so through their participation in corporate, public and union pension plans. These owners include veterans, retirees, teachers, nurses, firemen, and city, state and federal workers. We owe it to all of them – and to all our shareholders and investors who have entrusted us with their savings – to get this right.

## COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE

The following is a series of corporate governance principles for public companies, their board of directors and their shareholders. These principles are intended to provide a basic framework for sound, long-term-oriented governance. But given the differences among our many public companies – including their size, their products and services, their history and their leadership – not every principle (or every part of every principle) will work for every company, and not every principle will be applied in the same fashion by all companies.

### I. Board of Directors – Composition and Internal Governance

#### a. Composition

- Directors' loyalty should be to the shareholders and the company. A board must not be beholden to the CEO or management. A significant majority of the board should be independent under the New York Stock Exchange rules or similar standards.
- All directors must have high integrity and the appropriate competence to represent the interests of all shareholders in achieving the long-term success of their company. Ideally, in order to facilitate engaged and informed oversight of the company and the performance of its management, a subset of directors will have professional experiences directly related to the company's business. At the same time, however, it is important to recognize that some of the best ideas, insights and contributions can come from directors whose professional experiences are not directly related to the company's business.
- Directors should be strong and steadfast, independent of mind and willing to challenge constructively but not be divisive or self-serving. Collaboration and collegiality also are critical for a healthy, functioning board.
- Directors should be business savvy, be shareholder oriented and have a genuine passion for their company.
- Directors should have complementary and diverse skill sets, backgrounds and experiences. Diversity along multiple dimensions is critical to a high-functioning board. Director candidates should be drawn from a rigorously diverse pool.
- While no one size fits all – boards need to be large enough to allow for a variety of perspectives, as well as to manage required board processes – they generally should be as small as practicable so as to promote an open dialogue among directors.
- Directors need to commit substantial time and energy to the role. Therefore, a board should assess the ability of its members to maintain appropriate focus and not be distracted by competing responsibilities. In so doing, the board should carefully consider a director's service on multiple boards and other commitments.

b. Election of directors

- Directors should be elected by a majority of the votes cast “for” and “against/withhold” (i.e., abstentions and non-votes should not be counted for this purpose).

c. Nominating directors

- Long-term shareholders should recommend potential directors if they know the individuals well and believe they would be additive to the board.
- A company is more likely to attract and retain strong directors if the board focuses on big-picture issues and can delegate other matters to management (see below at II.b., “Board of Directors’ Responsibilities/Critical activities of the board; setting the agenda”).

d. Director compensation and stock ownership

- A company’s independent directors should be fairly and equally compensated for board service, although (i) lead independent directors and committee chairs may receive additional compensation and (ii) committee service fees may vary. If directors receive any additional compensation from the company that is not related to their service as a board member, such activity should be disclosed and explained.
- Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of director compensation in stock, performance stock units or similar equity-like instruments. Companies also should consider requiring directors to retain a significant portion of their equity compensation for the duration of their tenure to further directors’ economic alignment with the long-term performance of the company.

e. Board committee structure and service

- Companies should conduct a thorough and robust orientation program for their new directors, including background on the industry and the competitive landscape in which the company operates, the company’s business, its operations, and important legal and regulatory issues, etc.
- A board should have a well-developed committee structure with clearly understood responsibilities. Disclosures to shareholders should describe the structure and function of each board committee.
- Boards should consider periodic rotation of board leadership roles (i.e., committee chairs and the lead independent director), balancing the benefits of rotation against the benefits of continuity, experience and expertise.

f. Director tenure and retirement age

- It is essential that a company attract and retain strong, experienced and knowledgeable board members.
- Some boards have rules around maximum length of service and mandatory retirement age for directors; others have such rules but permit exceptions; and still others have no such rules at all. Whatever the case, companies should clearly articulate their approach on term limits and retirement age. And insofar as a board permits exceptions, the board should explain (ordinarily in the company's proxy statement) why a particular exception was warranted in the context of the board's assessment of its performance and composition.
- Board refreshment should always be considered in order to ensure that the board's skill set and perspectives remain sufficiently current and broad in dealing with fast-changing business dynamics. But the importance of fresh thinking and new perspectives should be tempered with the understanding that age and experience often bring wisdom, judgment and knowledge.

g. Director effectiveness

- Boards should have a robust process to evaluate themselves on a regular basis, led by the non-executive chair, lead independent director or appropriate committee chair. The board should have the fortitude to replace ineffective directors.

II. Board of Directors' Responsibilities

a. Director communication with third parties

- Robust communication of a board's thinking to the company's shareholders is important. There are multiple ways of going about it. For example, companies may wish to designate certain directors – as and when appropriate and in coordination with management – to communicate directly with shareholders on governance and key shareholder issues, such as CEO compensation. Directors who communicate directly with shareholders ideally will be experienced in such matters.
- Directors should speak with the media about the company only if authorized by the board and in accordance with company policy.
- In addition, the CEO should actively engage on corporate governance and key shareholder issues (other than the CEO's own compensation) when meeting with shareholders.

b. Critical activities of the board; setting the agenda

- The full board (including, where appropriate, through the non-executive chair or lead independent director) should have input into the setting of the board agenda.
- Over the course of the year, the agenda should include and focus on the following items, among others:
  - ❖ A robust, forward-looking discussion of the business.
  - ❖ The performance of the current CEO and other key members of management and succession planning for each of them. One of the board's most important jobs is making sure the company has the right CEO. If the company does not have the appropriate CEO, the board should act promptly to address the issue.
  - ❖ Creation of shareholder value, with a focus on the long term. This means encouraging the sort of long-term thinking owners of a private company might bring to their strategic discussions, including investments that may not pay off in the short run.
  - ❖ Major strategic issues (including material mergers and acquisitions and major capital commitments) and long-term strategy, including thorough consideration of operational and financial plans, quantitative and qualitative key performance indicators, and assessment of organic and inorganic growth, among others.
  - ❖ The board should receive a balanced assessment on strategic fit, risks and valuation in connection with material mergers and acquisitions. The board should consider establishing an ad hoc Transaction Committee if significant board time is otherwise required to consider a material merger or acquisition. If the company's stock is to be used in such a transaction, the board should carefully assess the company's valuation relative to the valuation implied in the acquisition. The objective is to properly evaluate the value of what you are giving vs. the value of what you are getting.
  - ❖ Significant risks, including reputational risks. The board should not be reflexively risk averse; it should seek the proper calibration of risk and reward as it focuses on the long-term interests of the company's shareholders.
  - ❖ Standards of performance, including the maintaining and strengthening of the company's culture and values.
  - ❖ Material corporate responsibility matters.
  - ❖ Shareholder proposals and key shareholder concerns.
  - ❖ The board (or appropriate board committee) should determine the best approach to compensate management, taking into account all the factors it

deems appropriate, including corporate and individual performance and other qualitative and quantitative factors (see below at VII., “Compensation of Management”).

- A board should be continually educated on the company and its industry. If a Board feels it would be productive, outside experts and advisors should be brought in to inform directors on issues and events affecting the company.
- The board should minimize the amount of time it spends on frivolous or non-essential matters – the goal is to provide perspective and make decisions to build real value for the company and its shareholders.
- As authorized and coordinated by the board, directors should have unfettered access to management, including those below the CEO’s direct reports.
- At each meeting, to ensure open and free discussion, the board should meet in executive session without the CEO or other members of management. The independent directors should ensure that they have enough time to do this properly.
- The board (or appropriate board committee) should discuss and approve the CEO’s compensation.
- In addition to its other responsibilities, the Audit Committee should focus on whether the company’s financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation.

### III. Shareholder Rights

- a. Many public companies and asset managers have recently reviewed their approach to proxy access. Others have not yet undertaken such a review or may have one under way. Among the larger market capitalization companies that have adopted proxy access provisions, generally a shareholder (or group of up to 20 shareholders) who has continuously held a minimum of 3% of the company’s outstanding shares for three years is eligible to include on the company’s proxy statement nominees for a minimum of 20% (and, in some cases, 25%) of the company’s board seats. Generally, only shares in which the shareholder has full, unhedged economic interest count toward satisfaction of the ownership/holding period requirements. A higher threshold of ownership (e.g., 5%) often has been adopted for smaller market capitalization companies (e.g., less than \$2 billion).
- b. Dual class voting is not a best practice. If a company has dual class voting, which sometimes is intended to protect the company from short-term behavior, the company should consider having specific sunset provisions based upon time or a triggering event, which eliminate dual class voting. In addition, all shareholders should be treated equally in any corporate transaction.

- c. Written consent and special meeting provisions can be important mechanisms for shareholder action. Where they are adopted, there should be a reasonable minimum amount of outstanding shares required in order to prevent a small minority of shareholders from being able to abuse the rights or waste corporate time and resources.

#### IV. Public Reporting

- a. Transparency around quarterly financial results is important.
- b. Companies should frame their required quarterly reporting in the broader context of their articulated strategy and provide an outlook, as appropriate, for trends and metrics that reflect progress (or not) on long-term goals. A company should not feel obligated to provide earnings guidance – and should determine whether providing earnings guidance for the company’s shareholders does more harm than good. If a company does provide earnings guidance, the company should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run.
- c. As appropriate, long-term goals should be disclosed and explained in a specific and measurable way.
- d. A company should take a long-term strategic view, as though the company were private, and explain clearly to shareholders how material decisions and actions are consistent with that view.
- e. Companies should explain when and why they are undertaking material mergers or acquisitions or major capital commitments.
- f. Companies are required to report their results in accordance with Generally Accepted Accounting Principles (“GAAP”). While it is acceptable in certain instances to use non-GAAP measures to explain and clarify results for shareholders, such measures should be sensible and should not be used to obscure GAAP results. In this regard, it is important to note that *all* compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings.

#### V. Board Leadership (Including the Lead Independent Director’s Role)

- a. The board’s independent directors should decide, based upon the circumstances at the time, whether it is appropriate for the company to have separate or combined chair and CEO roles. The board should explain clearly (ordinarily in the company’s proxy statement) to shareholders why it has separated or combined the roles.
- b. If a board decides to combine the chair and CEO roles, it is critical that the board has in place a strong designated lead independent director and governance structure.

- c. Depending on the circumstances, a lead independent director's responsibilities may include:
- Serving as liaison between the chair and the independent directors
  - Presiding over meetings of the board at which the chair is not present, including executive sessions of the independent directors
  - Ensuring that the board has proper input into meeting agendas for, and information sent to, the board
  - Having the authority to call meetings of the independent directors
  - Insofar as the company's board wishes to communicate directly with shareholders, engaging (or overseeing the board's process for engaging) with those shareholders
  - Guiding the annual board self-assessment
  - Guiding the board's consideration of CEO compensation
  - Guiding the CEO succession planning process

#### VI. Management Succession Planning

- a. Senior management bench strength can be evaluated by the board and shareholders through an assessment of key company employees; direct exposure to those employees is helpful in making that assessment.
- b. Companies should inform shareholders of the process the board has for succession planning and also should have an appropriate plan if an unexpected, emergency succession is necessary.

#### VII. Compensation of Management

- a. To be successful, companies must attract and retain the best people – and competitive compensation of management is critical in this regard. To this end, compensation plans should be appropriately tailored to the nature of the company's business and the industry in which it competes. Varied forms of compensation may be necessary for different types of businesses and different types of employees. While a company's compensation plans will evolve over time, they should have continuity over multiple years and ensure alignment with long-term performance.
- b. Compensation should have both a current component and a long-term component.
- c. Benchmarks and performance measurements ordinarily should be disclosed to enable shareholders to evaluate the rigor of the company's goals and the goal-setting process.

That said, compensation should not be entirely formula based, and companies should retain discretion (appropriately disclosed) to consider qualitative factors, such as integrity, work ethic, effectiveness, openness, etc. Those matters are essential to a company's long-term health and ordinarily should be part of how compensation is determined.

- d. Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of compensation for senior management in the form of stock, performance stock units or similar equity-like instruments. The vesting or holding period for such equity compensation should be appropriate for the business to further senior management's economic alignment with the long-term performance of the company. With properly designed performance hurdles, stock options may be one element of effective compensation plans, particularly for the CEO. All equity grants (whether stock or options) should be made at fair market value, or higher, at the time of the grant, with particular attention given to any dilutive effect of such grants on existing shareholders.
- e. Companies should clearly articulate their compensation plans to shareholders. While companies should not, in the design of their compensation plans, feel constrained by the preferences of their competitors or the models of proxy advisors, they should be prepared to articulate how their approach links compensation to performance and aligns the interests of management and shareholders over the long term. If a company has well-designed compensation plans and clearly explains its rationale for those plans, shareholders should consider giving the company latitude in connection with individual annual compensation decisions.
- f. If large special compensation awards (not normally recurring annual or biannual awards but those considered special awards or special retention awards) are given to management, they should be carefully evaluated and – in the case of the CEO and other “Named Executive Officers” whose compensation is set forth in the company's proxy statement – clearly explained.
- g. Companies should maintain clawback policies for both cash and equity compensation.

#### VIII. Asset Managers' Role in Corporate Governance

Asset managers, on behalf of their clients, are significant owners of public companies, and, therefore, often are in a position to influence the corporate governance practices of those companies. Asset managers should exercise their voting rights thoughtfully and act in what they believe to be the long-term economic interests of their clients.

- a. Asset managers should devote sufficient time and resources to evaluate matters presented for shareholder vote in the context of long-term value creation. Asset managers should actively engage, as appropriate, based on the issues, with the management and/or board of the company, both to convey the asset manager's point of view and to understand the company's perspective. Asset managers should give due consideration to the company's rationale for its positions, including its perspective on certain governance issues where the company might take a novel or unconventional approach.

- b. Given their importance to long-term investment success, proxy voting and corporate governance activities should receive appropriate senior-level oversight by the asset manager.
- c. Asset managers, on behalf of their clients, should evaluate the performance of boards of directors, including thorough consideration of the following:
  - To the extent directors are speaking directly with shareholders, the directors' (i) knowledge of their company's corporate governance and policies and (ii) interest in understanding the key concerns of the company's shareholders
  - The board's focus on a thoughtful, long-term strategic plan and on performance against that plan
- d. An asset manager's ultimate decision makers on proxy issues important to long-term value creation should have access to the company, its management and, in some circumstances, the company's board. Similarly, a company, its management and board should have access to an asset manager's ultimate decision makers on those issues.
- e. Asset managers should raise critical issues to companies (and vice versa) as early as possible in a constructive and proactive way. Building trust between the shareholders and the company is a healthy objective.
- f. Asset managers may rely on a variety of information sources to support their evaluation and decision-making processes. While data and recommendations from proxy advisors may form pieces of the information mosaic on which asset managers rely in their analysis, ultimately, their votes should be based on independent application of their own voting guidelines and policies.
- g. Asset managers should make public their proxy voting process and voting guidelines and have clear engagement protocols and procedures.
- h. Asset managers should consider sharing their issues and concerns (including, as appropriate, voting intentions and rationales therefor) with the company (especially where they oppose the board's recommendations) in order to facilitate a robust dialogue if they believe that doing so is in the best interests of their clients.