Testimony of

Anne Simpson
Investment Director, Sustainability
California Public Employees' Retirement System

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Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on
"Corporate Governance: Fostering a System that Promotes Capital Formation and Maximizes Shareholder Value"

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Chairman Garrett, Ranking Member Maloney, and other Members of the Subcommittee:

Thank you for the opportunity to testify at today's hearing. I am Anne Simpson, Investment Director, Sustainability at the California Public Employees' Retirement System ("CalPERS"). I am pleased to appear before you today on behalf of CalPERS and appreciate the Subcommittee's focus on corporate governance and on ways to foster a system that promotes capital formation and maximizes shareowner value.

CalPERS is the largest public pension fund in the United States with approximately $301 billion in global assets, as of market close on September 16, 2016, and equity holdings in over 10,000 companies. In addition, CalPERS is a fiduciary that in Fiscal Year (FY) 2015 paid out $19.4 billion in retirement benefits to more than 1.8 million public employees, retirees, their families, and beneficiaries. For every dollar that we pay in benefits to our members, 65 cents are generated by investment returns, which is why the topic of today's hearing is so important. The CalPERS Global Governance Principles, which is included in the appendix to this testimony, are the framework by which we execute our shareowner proxy voting responsibilities, engage portfolio companies to achieve long-term returns, and request internal and external managers of CalPERS' capital to take into consideration when making investment decisions.

Overview of Testimony

My testimony discusses how CalPERS benefits from a system that operates with accountable and transparent corporate governance, while at the same time promoting capital formation with the objective of achieving the best returns and value for shareowners over the long-term. Although my testimony does not capture all of our corporate governance and financial market regulatory concerns, I would like to highlight CalPERS' views about a number of key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1] and related Securities and Exchange Commission ("SEC") rulemaking activity. Among the issues I will discuss are executive compensation, corporate governance, and transparency, which we believe are crucial to strengthening the U.S. financial system for the benefit of long-term investors like CalPERS and the hundreds of thousands of retirees and employees that we serve.

The U.S. is home to the world's most dynamic and robust capital markets, and access to capital is critical to the effective functioning of these markets. Moreover, access to capital is crucially important to business and productivity growth, job and wealth creation, innovation, and sustainable community and economic development. CalPERS provides this much-needed capital by investing in public companies primarily as a long-term investor, without betting on market fluctuations. The benefits of access to capital accrue to the direct recipients of investments, and to the geographic areas in which they are located. As such, we have long supported efforts to promote capital formation and more liquid financial markets to spur sustainable growth in the real economy.

Although the U.S. economy has improved substantially since the 2008 financial crisis, another significant financial downturn could undermine the economic gains and retirement security of millions of hard-working Americans. Like many investors, CalPERS was hit hard by the crisis,

[1] Pub. L. No. 111-203 (July 21, 2010).

as $70 billion were wiped from our assets. We, therefore, strongly support the work of the SEC to implement reform in the wake of the crisis. With Dodd-Frank not yet fully implemented, there is unfinished business that is critical to protecting and strengthening shareowner rights and investor confidence in the financial markets. As reflected in my testimony of July 10, 2012 before this Subcommittee and my testimony of July 12, 2011 before the U.S. Senate Committee on Banking, Housing and Urban Affairs, CalPERS has strongly emphasized the need to complete the important work of ensuring smart regulation to protect both investors and the markets on which we and the broader public rely. Smart regulation promotes economic growth and is not duplicative, burdensome or designed without appropriate consideration of economic impact. Because we are a significant institutional investor with a long-term investment horizon, we fundamentally depend on the integrity and efficiency of our financial markets to provide the long-term sustainable, risk-adjusted returns that allow us to meet our liabilities. As such, my testimony also addresses the goal of ensuring that the SEC has the resources that it needs to carry out these responsibilities and to regulate our capital markets in a smart manner.

I will now address each of these issues in greater detail. First, we advocate executive compensation which is fully disclosed and aligns interests between executive management and shareowners. Accordingly, we strongly support SEC rulemakings related to “say-on-pay votes,” executive compensation “clawbacks,” and “pay ratio” disclosures.

Second, we firmly embrace accountable corporate governance. That is why we support renewal of an SEC rulemaking for proxy access. We are also in favor of the SEC clarifying the interpretation of Rule 14a-8(i)(9) to allow for the submission of alternate shareowner and management proposals. These positions are consistent with the underlying tenet of our Global Governance Principles: fully accountable corporate governance produces, over the long-term, the best returns to shareowners.

CalPERS also supports ensuring that proxy advisory firms are well-regulated and transparent but opposes efforts to create an unduly burdensome regulatory regime. Such firms and other data providers play a useful role in efficiently providing CalPERS and other institutional investors independent research and analysis to help inform voting decisions.

Third, corporate financial reporting plays a key role in capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Because we believe that operating, financial, and governance information must be transparent, we strongly support a review of the effectiveness of SEC disclosures, but such review should have a strong focus on the needs of investors. We encourage the SEC to consider improvements to its disclosure regime that acknowledge advancements in technology and enhance the capacity of issuers to be more transparent. We also encourage rules that would provide investors more useful information about climate risks and other sustainability issues for the long-term benefit of shareowners.

Fourth, to address these pressing issues, we also urge that the SEC be fully funded and be provided predictable funding levels. We are concerned about provisions of H.R. 5485, the “Financial Services and General Government Appropriations Act, 2017” (the “FSGG Appropriations Bill”) because the bill would fund the SEC at $226 million below the SEC’s request and it includes a number of problematic "policy riders."

Executive Compensation

Say-on-pay

CalPERS believes that executive compensation is a critical and visible aspect of a company's governance and that pay decisions are one of the most direct ways for shareowners to assess the performance of the board.

Consequently, we support Section 951 of Dodd-Frank relating to shareowner approval of executive compensation and "golden parachute" compensation arrangements. We submitted comments to the SEC urging the adoption of rules to specify that "say-on-pay votes" must occur at least once every three years and that companies are required to hold a "frequency" vote at least once every six years in order to allow shareowners to decide how often they would like to be presented with the say-on-pay vote. We are pleased that the SEC adopted final say-on-pay rules.

We believe that Section 951 provides shareowners the necessary disclosures to allow for a more informed vote as it relates to executive compensation and golden parachute compensation plans. CalPERS' Global Governance Principles address this as a critical right of shareowners and state that shareowners should be provided the opportunity to vote on executive compensation plans and have appropriate disclosures on which to base their decisions annually.

Claw backs

CalPERS submitted comments in support of the SEC's proposed rule to implement Section 954 of Dodd-Frank, which added Section 10D to the Securities Exchange Act of 1934. Section 10D requires the SEC to adopt rules that direct the national securities exchanges and national securities associations to establish listing standards that require issuers to develop and implement a policy for the recovery of incentive-based compensation based on revised financial information. The objective of Section 954 is an important one and is consistent with our Global Governance Principles, which request portfolio companies to develop executive compensation plans with a robust clawback policy. CalPERS believes that the proposed rule contains this crucial element.[2]

The premise of the SEC's proposed rule on clawbacks is supported by research. For example, a 2012 Harvard Law School study found that most firms lack a robust clawback policy – one that requires firms to recover extra pay by executives as a result of errors in performance measures. Notably, the study stated that "the absence of such a policy is likely to reduce firm value by leading to the systematic overpayment of executives and, more important, by weakening and distorting executives' incentives."[3]

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[2] Listing Standards for Recovery of Erroneously Awarded Compensation, Securities Act Release No. 9861, exchange Act Release No. 75,342. Investment Company Act Release NO. 31,702, 80 Fed. Reg. 41,144 (proposed July 14, 2015), available at https://www.sec.gov/rules/proposed/2015/33-9861.pdf.

[3] Jesse M. Fired, Professor of Law at Harvard Law School and Nitzan Shilon, S.J.D. candidate at Harvard Law School , "The Dodd-Frank Clawback and the Problem of Excess Pay," The Corporate Board, January/February 2012. http://www.law.harvard.edu/faculty/jfried/1201FriedShilon.pdf.

CalPERS believes that returning unearned compensation to shareowners clearly serves the interest of shareowners and better aligns the interests of executive officers and shareowners. We urge you to support implementation of Section 954 because it would address a deficiency in existing practice by providing a mechanism to finally compel executive officers to return unearned compensation. The SEC's proposed rule goes a long way in correcting this fundamental problem. It is not enough to require that only certain executives return unearned income. Recent reports about compensation awarded to a retiring Wells Fargo executive provide an example of why clawbacks should be more expansive.

Pay Ratio

We submitted comments to the SEC on its proposal to require public companies to disclose the ratio of the compensation of their chief executive officer to the median compensation of the company's employees ("pay ratio"), pursuant to Section 953(b) of Dodd-Frank. We are pleased that the SEC has adopted a final pay ratio rule and urge opposition to the amendment to the FSGG Appropriations Bill that recently passed the House to prohibit the SEC from finalizing, implementing, administering or enforcing pay ratio disclosures.

Corporate Governance

Proxy Access

We have been a long-time proponent of good corporate governance and believe proxy voting rights not only provide shareowners with the ability to hold accountable the stewards of their capital but also enhance the efficiency of global capital markets. In this regard, we have written the SEC urging renewal of an SEC rulemaking for proxy access by addressing the issues raised in the D.C. Circuit Court decision. We believe that proxy access is important to ensure that shareowners are able to nominate director candidates who can be considered on a level playing field with board or management candidates. CalPERS has been actively involved in the campaign to win proxy access at companies in the S&P 500 through private ordering. Voting tallies on proxy access proposals show that the majority of shareowners favor proxy access. Prohibiting the SEC from revisiting a rule favored by a majority of shareowners does not appear to benefit the interests of shareowners.

Universal Proxy Ballots

CalPERS believes that shareowners should have the ability to vote for any combination of director candidates in contested elections. As stated in our Global Governance Principles, "To facilitate the shareowner voting process in contested elections - opposing sides engaged in the contest should utilize a proxy card naming all management nominees and all dissident nominees, providing each nominee equal prominence on the proxy card." Unfortunately, the current proxy voting process does not provide shareowners with an efficient and cost-effective way to exercise this right.

We believe that achieving this ideal requires the SEC to adopt the necessary technical fixes to the bona fide nominee rule and to adopt a mandatory universal proxy card. Shareowners need a proxy voting system that works without the need of physical presence to vote for the full slate of director candidates. Universal proxy ballots would "level the playing field" and ensure shareowners voting by proxy have the same rights as if they had physically attended the meeting. We are confident that the SEC can address this issue without creating undue burden on companies.

To remain an effective fiduciary for our beneficiaries, we strongly encourage the SEC to move forward with adopting universal proxy ballots and making any technical fixes necessary to ensure efficient voting. We urge opposition to the amendment to the FSGG Appropriations Bill that recently passed the House to prohibit the SEC from proposing or implementing a rule that mandates the use of universal proxy ballots during proxy contests.

Alternative Management and Shareowner Proposals - SEC Rule 14a-8(i)(9)

Because we view matters of corporate governance as critical elements of our investment strategy, we urged the SEC to clarify the interpretation of SEC Rule 14a-8(i)(9) to allow for the submission of alternative shareowner and management proposals, unless neither alternative is precatory. CalPERS favors providing this clarification for all types of shareowner proposals and does not believe that it should be limited to proxy access proposals. We believe that it is essential that the SEC considers real world examples of alternative proxy access proposals recently presented to shareowners rather than the theoretical arguments presented by opponents of proxy access. Additionally, the SEC should evaluate the actual proxies and vote results consistent with its long-standing advice that Rule 14a-8(i)(9) be applied where multiple proposals "could provide inconsistent and ambiguous results."[4]

We believe that precatory proposals do not directly conflict with other proposals on the same subject since, even if passed, the precatory proposal does not prevent the company from implementing a binding proposal or considering another precatory proposal. Much has changed since the exclusion currently reflected in Rule 14a-8(i)(9) was adopted by the SEC in 1967. Shareowners now have access to more information and can intelligently provide input on a broad variety of matters that impact the corporations they own. Just as the SEC has been willing to evolve its view on other exclusions, most notably Rule 14a-8(i)(7) related to ordinary business, the SEC should recognize the increasing complexity of today's markets and shareowners' ability to keep pace with that complexity. Should the SEC adopt the logic of some in the corporate community, companies may continue to circumvent responsible shareowner requests on a variety of topics, not just proxy access. We joined with the California State Teachers' Retirement System in sending a letter to the SEC to convey these concerns.

Shareowner Proposals

There is no need to further restrict shareowner proposals, thus making it more difficult for shareowners to file proposals and have them appear in proxies. In 2016, there were fewer than 1,000 total proposals filed at all reporting companies in the U.S. The average company receives less than one shareowner proposal in a five year period. Only half of the proposals submitted by

[4] Letter from SEC, Div. of Enforcement, to Susan I. Permut, Senior Vice President, EMC Corp. (Feb. 24, 2009), available at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/steinerchevedden022409-14a8.pdf.

shareowners appear in companies' proxies, therefore, very few companies (fewer than 500 in 2016) held votes on shareowner submitted issues. Given the small number of shareowner proposals, there is no crisis that needs to be addressed. In fact, the current rules restrict shareowners and limit participation. Furthermore, small shareowners initiated many of the campaigns for enhancements that were eventually adopted as best corporate practices. Therefore, we oppose efforts to prevent such shareowners from filing proposals, which would deny the market the benefits of their input.

Proxy Advisory Legislation

We also have concerns about H.R. 5311, the "Corporate Governance Reform and Transparency Act," which recently passed the full House Financial Services Committee and was included in H.R. 5983, the "Financial CHOICE Act." We believe that H.R. 5311 would establish an unduly burdensome regulatory regime for proxy advisory firms. H.R. 5311 would also grant issuers undue influence over the proxy recommendation process through the ombudsman and draft recommendations requirements. Additionally, the conflicts of interest management requirement is duplicative of existing SEC authority in this area. The proposed regulatory regime will also create additional barriers to entry for new proxy advisory firms rather than enhance competition. Furthermore, H.R. 5311 would regulate the consultants on only one side of a transaction. Corporations also hire firms as consultants on proxies, yet such firms would evidently continue to be unregulated. Finally, the definition included in legislation makes it unclear whether the intent is to regulate the thousands of entities that provide advice to institutional investors or only the three or so that would actually be considered proxy advisory firms by the market. As an institutional investor that relies on proxy advisory services, we would welcome the opportunity to work with the Committee on these provisions.

Transparency

Disclosure Effectiveness

We support the SEC's decision to undertake a comprehensive review of its disclosure regime through the Disclosure Effectiveness Initiative, and recently provided comments to on the SEC's Concept Releases, Effectiveness of Financial Disclosures About Entities Other Than the Registrant – Regulation S-X and Business and Financial Disclosure Required by Regulation S-K. As long-term shareowners, effective disclosures are essential to enhancing the efficiency of global capital markets, to supporting informed decision-making as to how we vote our interests and allocate capital to achieve sustainable returns and to deliver promised retirement and health benefits. In support of these efforts, our Global Governance Principles outline areas which strengthen effective disclosures.

We strongly believe that all investors, whether large institutions or private individuals, should have access to financial reporting disclosures to allow providers of capital the ability to judge for themselves whether to buy, sell or hold a security. Further, we believe that financial reporting disclosures need to be meaningful, understandable, timely, comparable, and consistent to enable open and honest dialogue as well as informed decision-making. Without consistent, comparable disclosures, CalPERS and other investors are disadvantaged in their capital allocation decisions and in their decisions as asset owners in assessing corporate boards and management teams.

Although we strongly support the SEC's work to comprehensively review the disclosure requirements of Regulation S-X and Regulation S-K, we also support the consideration of all potential improvements to the current disclosure regime for the benefit of investors, such as clarifying the definition of materiality to reflect long-term investor needs, and including more decision-useful information in disclosures. In addition, we support the consideration of enhancements to the SEC's disclosure regime that would make better use of technological advances to efficiently provide greater and more precise disclosures on sustainability, including more robust reporting of board diversity information.[5] CalPERS also supports disclosures on corporate political spending. In short, disclosure effectiveness is the key to clear, concise financial reporting for investors, and we would like the investor voice to be heard and considered during the Disclosure Effectiveness Initiative.

Climate Change

We note that another key aspect of the SEC's work to provide more meaningful disclosures to investors is ensuring that investors have more detailed corporate disclosures regarding climate change. Embedded in our Global Governance Principles is the expectation that corporate boards disclose fair, accurate, and material information relevant to investment decisions enabling shareowners to evaluate risks, past and present performance, and to draw inferences regarding future performance relating to climate change.

Comprehensive disclosure of risk factors related to climate change should clearly reveal how registrants identify and manage risks, in order to generate sustainable economic returns. For this reason, both a detailed explanation about how each risk affects the registrant, as well as disclosure of exactly how the registrant is addressing the risk are needed to provide greater context to shareowners' assessment of risk and risk management. For stakeholders and investors, as the providers of the capital, knowing what measures boards take in managing and mitigating risks allows a growing sense of trust and confidence to be developed regarding their investments. These views are reflected in our recent comments to the SEC on the Regulation S-K concept release. We urge opposition to the amendment to the FSGG Appropriations Bill that recently passed the House to prohibit the SEC from implementing, administering, enforcing, or codifying into regulation the SEC's guidance related to "Commission Guidance Regarding Disclosure Related to Climate Change."

SEC Funding

Just as importantly, for any of these critical initiatives to be effective, the SEC must be well-managed and well-staffed. We urge that the SEC be fully funded at the FY 2017 requested level of $1.781 billion, which reflects the importance of the SEC's fundamental role of regulating the U.S. capital markets, and core mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. Accordingly, we are concerned about provisions of the FSGG Appropriations Bill that would fund the SEC at $1.5 billion, which is $226 million below the SEC's FY 2017 Budget Request and $50 million lower than the FY 2016 enacted level.

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[5] Petition for Amendment of Proxy Rule Regarding Board Nominee Disclosure - Chart/Matrix Approach, March 31, 2015 https//www.sec.gov/rules/petitions/2015/petn4-682.pdf.

As our capital markets grow increasingly fast and complex, it continues to be imperative that the SEC has the resources it needs to address emerging challenges and to promote investor confidence while also spurring capital formation and economic growth. It is important to note that the SEC's funding is deficit neutral because funds appropriated to the agency are offset by industry transaction fees and thereby do not impact the federal deficit or the availability of funding for other regulatory agencies. In addition, the SEC's appropriation does not count against the FY 2016 and FY 2017 caps established under the Bipartisan Budget Act of 2015. For these reasons, we urge your support of the SEC's FY 2017 funding request, without the problematic policy riders considered in the House.

In conclusion, accountable and transparent corporate governance serves to mitigate investment risk and also plays a vitally important role in promoting long-term capital formation, which can ensure a growing and vibrant economy. Thank you, Chairman Garrett and Ranking Member Maloney for inviting me to participate in this hearing. I look forward to the opportunity to respond to any questions.

THE CALIFORNIA PUBLIC EMPLOYEES'
RETIREMENT SYSTEM

GLOBAL GOVERNANCE PRINCIPLES

California Public Employees' Retirement System
Lincoln Plaza - 400 Q Street - Sacramento, CA 95811

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I. INTRODUCTION

The California Public Employees' Retirement System (CalPERS, System) is the largest U.S. public pension fund, with assets totaling approximately $300 billion spanning domestic and international markets as of June 30, 2014. Our mission is to provide responsible and efficient stewardship of the System to deliver promised retirement and health benefits, while promoting wellness and retirement security for members and beneficiaries. This mission was adopted by the CalPERS Board of Administration to guide us in serving our more than 1.6 million members and retirees.

The CalPERS Board of Administration is guided by the CalPERS Board's Investment Committee, Investment Beliefs[1] and Core Values: Quality, Respect, Accountability, Integrity, Openness, and Balance. CalPERS management and more than 380 Investment Office staff carry out the daily activities of the investment program. Our goal is to efficiently and effectively manage investments to achieve the highest possible return at an acceptable level of risk. In doing so, CalPERS has generated strong long-term returns.

CalPERS Global Governance Program has evolved since the mid-80's when it was solely reactionary: reacting to the anti-takeover actions of corporate managers that struck a dissonant chord with owners of the corporate entity concerned with accountability and fair play. The late 1980s and early 1990s represented a period in which CalPERS learned a great deal about the "rules of the game" – how to influence corporate managers, what issues were likely to elicit fellow shareowner support, and where the traditional modes of shareowner/corporation communication were at odds with current reality. Beginning in 1993, CalPERS turned its focus toward companies considered by virtually every measure to be "poor" financial performers. By centering its attention and resources in this way, CalPERS could demonstrate very specific and tangible results to those who questioned the value of corporate governance.

Over the years, we've learned that shareowners can be instrumental in encouraging responsible corporate citizenship. CalPERS believes that environmental, social, and corporate governance issues can affect the performance[2] of investment portfolios (to varying degrees across companies, sectors, regions, and asset classes through time.) In 2005, CalPERS joined 19 other institutional investors from 12 countries to develop and become a signatory to the United Nations supported Principles for Responsible Investment (Appendix A).

[1] In October 2013, CalPERS adopted a set of ten Investment Beliefs intended to guide decision-making, facilitate the management of a complex portfolio, and enhance consistency. The Investment Beliefs can be found at www.calpers-governance.org

[2] CalPERS launched the Sustainable Investment Research Initiative (SIRI) in 2013. SIRI was designed to promote innovative thought leadership that would advance and inform CalPERS understanding of environmental, social and governance factors and the impact they may have on companies, markets, and investment intermediaries. SIRI produced to The Review of Evidence: Bibliography of Academic Studies – an online searchable database of more than 700 studies on sustainability factors and investment spanning four decades. More information on SIRI can be found at www.calpers-governance.org.

In 2011, CalPERS Global Governance Program transitioned into an Investment Office-wide role to support the Total Fund; and, the CalPERS Board approved the adoption of a Total Fund process for integrating environmental, social, and governance (ESG) issues across the investment portfolio as a strategic priority. This transition recognizes CalPERS' ongoing effort[3] to integrate ESG factors into investment decision making across asset classes, grounded in the three forms of economic capital – financial, human, and physical – that are needed for long-term value creation. This work has also been integrated into CalPERS Investment Beliefs which address sustainable investment, risk management, and CalPERS engagement with companies, regulators, managers, and stakeholders.

What have we learned over the years? We have learned that (a) company managers want to perform well, in both an absolute sense and as compared to their peers; (b) company managers want to adopt long-term strategies and visions, but often do not feel that their shareowners are patient enough; and (c) all companies – whether governed under a structure of full accountability or not – will inevitably experience both ascents and descents along the path of profitability.

We have also learned, and firmly embrace the belief that good corporate governance – that is, accountable corporate governance – means the difference between wallowing for long periods in the depths of the performance cycle, and responding quickly to correct the corporate course.

> *"Long-term value creation requires effective management of three forms of capital: financial, physical and human – CalPERS Investment Belief 4." (October, 2013)*

[3] CalPERS discloses its progress of the System's efforts, sustainability work, and goals towards sustainable decision making in its publicly available report, *Towards Sustainable Investment & Operations*, which can be found at www.calpers-governance.org.

II. PURPOSE

The CalPERS Board, through its Investment Committee, has adopted the Global Governance Principles (Global Principles). The Global Principles create the framework by which CalPERS:

1. Executes its shareowner[4] proxy voting responsibilities.
2. Engages investee companies to achieve long-term sustainable risk-adjusted returns.
3. Requests internal and external managers of CalPERS capital to take into consideration when making investment decisions.

Inherent within the concept of prudence is the duty to monitor investment performance[5]. The U.S. Department of Labor (DOL), entrusted with oversight of the Employee Retirement Income and Security Act of 1974 (ERISA), has warned private pension fiduciaries that they may be held accountable for screening the performance of holdings, even those held under passive strategies[6]. In 1988, the DOL issued its so-called Avon Letter, putting private pension plan trustees on notice that proxy voting rights must be diligently exercised as an aspect of fiduciary duty[7]. In 1994 the DOL updated its Avon Letter in a bulletin that consolidates the voting requirements of ERISA fiduciaries. The DOL now advocates a corporate activist role for pension plan trustees, to include ". . . activities intended to monitor or influence corporate management."[8]

CalPERS implements its proxy voting responsibility and global governance initiatives in a manner that is consistent with the Global Principles unless such action may result in long-term harm to the company that outweighs all reasonably likely long-term benefit; or, unless such a vote is contrary to the interests of the beneficiaries of the System.

The execution of proxies and voting instructions is an important mechanism by which shareowners can influence a company's operations and corporate governance. It is therefore important for shareowners to exercise their right to participate and make their voting decisions based on a full understanding of the information and legal documentation presented to them. CalPERS will vote in favor of, or “For”, an individual or slate of director nominees up for election that the System believes will effectively oversee CalPERS interests as a shareowner consistent with the Global Principles. CalPERS will withhold its vote from, or vote “Against”, an individual or slate of director nominees at companies that do not effectively oversee CalPERS interests as a shareowner consistent with the Global Principles. CalPERS will also withhold its vote in limited circumstances where a company has consistently demonstrated long-term economic underperformance.

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[4] Throughout this document, CalPERS has chosen to adopt the term "shareowner" rather than "shareholder." This is to reflect a view that equity ownership carries with it active responsibilities and is not merely passively "holding" shares. “For corporate governance structures to work effectively, Shareowners must be active and prudent in the use of their rights. In this way, Shareowners must act like owners and continue to exercise the rights available to them.”(2005 CFA Institute: Centre for Financial Market Integrity, The Corporate Governance of Listed Companies: A Manual for Investors) CalPERS also has other rights via other forms of capital and investment vehicles with the Global Principles adapted accordingly.

[5] Richard H. Koppes and Maureen L. Reilly, An Ounce of Prevention: Meeting the Fiduciary Duty to Monitor and Index Fund, The J. Of Corp. Law, Univ. of Iowa (Summer 1995).

[6] See 29 C.F.R. sec. 2550.404a-1, DOL preamble to proposed regulations for the investment of plan assets, at fn. 7.

[7] DOL Op. Ltr. To Helmuth Fandl, Avon Products, Inc. (Feb. 29, 1988).

[8] DOL Interp. Bulletin 94-1 (July 1994).

CalPERS has a long history of constructively engaging companies that fail to meet CalPERS standards of conduct as defined by the Global Principles. CalPERS prefers constructive engagement to divesting as a means of affecting the conduct of entities in which it invests. Investors that divest lose their ability as shareowners to influence the company to act responsibly.

The Global Principles are broken down into three areas – Core, Domestic, and International Principles. Adopting the Global Principles in its entirety may not be appropriate for every company in the global capital marketplace due to differing developmental stages, competitive environment, regulatory or legal constraints. However, CalPERS does believe the criteria contained in the Core Principles should be adopted by companies across all markets - from developed to emerging – in order to establish the foundation for achieving long-term sustainable investment returns through accountable corporate governance structures.

For companies in the United States or listed on U.S. stock exchanges, CalPERS advocates the expansion of the Core Principles into the Domestic Principles. For companies outside the United States or listed on non-U.S. stock exchanges, CalPERS advocates the expansion of the Core Principles into the International Principles.

CalPERS expects all internal and external managers of CalPERS capital to integrate the Global Principles into investment decision making including proxy voting, consistent with fiduciary duty. CalPERS recognizes that countries and companies are in different developmental stages and that CalPERS investment managers will need to exercise their best judgment after taking all relevant factors, principles, and trends into account. CalPERS requires internal and external managers across the total fund to consider these Global Principles among the decision factors employed in the investment process.

III. GLOBAL GOVERNANCE PRINCIPLES

A. Core Principles

There are many features that are important considerations in the continuing evolution of corporate governance best practices. However, the underlying tenet for CalPERS Core Principles is that fully accountable governance structures produce, over the long term, the best returns to shareowners. CalPERS believes the following Core Principles should be adopted by companies and markets – from developed to emerging – in order to establish the foundation for achieving long-term sustainable investment returns through accountable corporate governance structures.

1. **Sustainability:** Companies and external managers in which CalPERS invests are expected to optimize operating performance, profitability and investment returns in a risk-aware manner while conducting themselves with propriety and with a view toward responsible conduct. Anchored by CalPERS Investment Beliefs, CalPERS believes long-term value creation requires the effective management of three forms of capital described as follows:

    a. **Financial Capital (Governance):** Governance is the primary tool to align interests between CalPERS and the managers of our financial capital – including companies and external managers. Good governance enhances a company's long-term value and protects investor interests.
    b. **Physical Capital (Environment):** Encouraging external managers, portfolio companies, and policy makers to engage in responsible environmental practices is important to identifying opportunities and risk management. This means making wise use of scarce resources, considering impact, and addressing systemic risks, such as climate change.
    c. **Human Capital (Social):** The success and long-term value of the companies we invest in will be impacted by their management of human capital. This includes fair labor practices, responsible contracting, workplace and board diversity, and protecting the safety of employees directly and through the supply chain.

2. **Director Accountability:** Directors should be accountable to shareowners, and management accountable to directors. To ensure this accountability, directors must be accessible to shareowner inquiry concerning their key decisions affecting the company's strategic direction.

3. **Transparency:** Operating, financial, and governance information about companies must be readily transparent to permit accurate market comparisons; this includes disclosure and transparency of objective globally accepted minimum accounting standards, such as the International Financial Reporting Standards ("IFRS").

4. **One-share/One-vote:** All investors must be treated equitably and upon the principle of one-share/one-vote.

5. **Proxy Materials:** Proxy materials should be written in a manner designed to provide shareowners with the information necessary to make informed voting decisions. Similarly, proxy materials should be distributed in a manner designed to encourage

shareowner participation. All shareowner votes, whether cast in person or by proxy, should be formally counted with vote outcomes formally announced.

6. **Code of Best Practices:** Each capital market in which shares are issued and traded should adopt its own Code of Best Practices to promote transparency of information, prevention of harmful labor practices, investor protection, and corporate social responsibility. Where such a code is adopted, companies should disclose to their shareowners whether they are in compliance.

7. **Long-term Vision:** Corporate directors and management should have a long-term strategic vision that, at its core, emphasizes sustained shareowner value and effective management of both risk and opportunities in the oversight of financial, physical, and human capital. In turn, despite differing investment strategies and tactics, shareowners should encourage corporate management to resist short-term behavior by supporting and rewarding long-term superior returns.

8. **Access to Director Nominations:** Shareowners should have effective access to the director nomination process.

9. **Political Stability:** Progress toward the development of basic democratic institutions and principles, including such things as: a strong and impartial legal system; and, respect and enforcement of property and shareowner rights.

   Political stability encompasses:

   a. **Political risk:** internal and external conflict; corruption; the military and religion in politics; law and order; ethnic tensions; democratic accountability; bureaucratic quality.
   b. **Civil liberties:** freedom of expression, association and organization rights; rule of law and human rights; free trade unions and effective collective bargaining; personal autonomy and economic rights.
   c. **Independent judiciary and legal protection**: an absence of irregular payments made to the judiciary; the extent to which there is a trusted legal framework that honors contracts, clearly delineates ownership and protects financial assets.

10. **Transparency:** Financial transparency, including elements of a free press, is necessary for investors to have truthful, accurate and relevant information.

    Transparency encompasses:

    a. **Freedom of the press:** structure of the news delivery system in a country; laws and their promulgation with respect to the influence of the news; the degree of political influence and control; economic influences on the news; the degree to which there are violations against the media with respect to physical violations and censorship.
    b. **Monetary and fiscal transparency:** the extent to which governmental monetary and fiscal policies and implementation are publicly available in a clear and timely manner, in accordance with international standards.
    c. **Stock exchange listing requirements:** stringency of stock exchange listing requirements with respect to frequency of financial reporting, the requirement of annual independent audits, and minimal financial viability.

d. **Accounting standards:** the extent to which U.S. Generally Accepted Accounting Principles, or International Accounting Standards is used in financial reporting; whether the country is a member of the International Accounting Standards Council.

11. **Productive Labor Practices:** No harmful labor practices or use of child labor. In compliance, or moving toward compliance, with the International Labor Organization (ILO) Declaration on the Fundamental Principles and Rights at Work.

    Productive Labor Practices encompasses:

    a. **ILO ratification:** whether the convention is ratified, not ratified, pending ratification or denounced.
    b. **Quality of enabling legislation:** the extent to which the rights described in the ILO convention are protected by law.
    c. **Institutional capacity:** the extent to which governmental administrative bodies with labor law enforcement responsibility exist at the national, regional and local level.
    d. **Effectiveness of implementation:** evidence that enforcement procedures exist and are working effectively; evidence of a clear grievance process that is utilized and provides penalties that have deterrence value.

12. **Corporate Social Responsibility – Eliminating Human Rights Violations**: Corporations should adopt maximum progressive practices toward the elimination of human rights violations in all countries or environments in which the company operates. Additionally, these practices should emphasize and focus on preventing discrimination and/or violence based on race, color, religion, national origin, age, disability, sexual orientation, gender identity, marital status, or any other status protected by laws or regulations in areas of a company's operation.

    Companies should operate in compliance, or moving toward compliance, with the Global Sullivan Principles (Appendix B), or the human rights and labor standards principles exemplified by the United Nations Global Compact Principles (Appendix C).

13. **Market Regulation and Liquidity:** Little to no repatriation risk. Potential market and currency volatility are adequately rewarded.

    Market regulation and liquidity encompasses:

    a. Market capitalization
    b. Change in market capitalization
    c. Average monthly trading volume
    d. Growth in listed securities
    e. Market volatility as measured by standard deviation
    f. Return/risk ratio

14. **Capital Market Openness:** Free market policies, openness to foreign investors, and legal protection for foreign investors.

    Capital market openness encompasses:

    a. **Foreign investment:** degree to which there are restrictions on foreign ownership of local assets, repatriation restrictions or un-equal treatment of foreigners and locals under the law.
    b. **Trade policy:** degree to which there are deterrents to free trade such as trade barriers and punitive tariffs.
    c. **Banking and finance:** degree of government ownership of banks and allocation of credit; freedom financial institutions have to offer all types of financial services; protectionist banking regulations against foreigners.

15. **Settlement Proficiency/Transaction Costs**: Reasonable trading and settlement proficiency and reasonable transaction costs.

    Settlement proficiency/transaction costs encompass:

    a. **Trading and settlement proficiency:** degree to which a country's trading and settlement is automated; success of the market in settling transactions in a timely, efficient manner.
    b. **Transaction costs:** the costs associated with trading in a particular market, including stamp taxes and duties; amount of dividends and income taxes; capital gains taxes.

16. **Disclosure:** Companies should adopt corporate reporting guidelines in order to measure, disclose, and be accountable to internal and external stakeholders for organizational performance.

    Disclosure reporting guidelines should include:

    a. The effect of environmental, social and governance impacts, risks and opportunities related to the company's stakeholders.
    b. Activities the company is undertaking to protect shareowner rights and investment capital.

17. **Financial Markets:** Policy makers and standards setters which impact investment portfolio risk and return should promote fair, orderly, and effectively regulated financial markets through the following:

    a. **Transparency:** To promote full disclosure so that the financial markets provide incentives that price risk and opportunity.
    b. **Governance:** To foster alignment of interest, protect investor rights and independence of regulators.
    c. **Systemic Risk:** For earlier identification by regulators of issues that give rise to overall market risk that threaten global markets and foster action that mitigates those risks.

B. Domestic Principles (United States)

CalPERS advocates the expansion of the Core Principles by companies domiciled in the United States or that list shares on U.S. stock exchanges into the Domestic Principles. CalPERS Domestic Principles embrace the Council of Institutional Investors Corporate Governance Policies (Appendix D) and represent an evolving framework for accountable corporate governance to be applied to the U.S. capital market.

In addition to encouraging portfolio companies to adopt the Core Principles, CalPERS implements its U.S. corporate governance initiatives and proxy voting responsibilities in a manner that is consistent with the following:

1. Board Independence & Leadership

Independence is the cornerstone of accountability. It is now widely recognized throughout the U.S. that independent boards are essential to a sound governance structure. Nearly all corporate governance commentators agree that boards should be comprised of at least a majority of "independent directors." But the definitional independence of a majority of the board may not be enough in some instances. The leadership of the board must embrace independence, and it must ultimately change the way in which directors interact with management. Independence also requires a lack of conflict between the director's personal, financial, or professional interests, and the interests of shareowners.

Accordingly, to instill board independence and leadership, CalPERS recommends:

1.1 Majority of Independent Directors: At a minimum, a majority of the board consists of directors who are independent. Boards should strive to obtain board composition made up of a substantial[9] majority of independent directors.

1.2 Independent Executive Session: Independent directors meet periodically (at least once a year) alone in an executive session, without the CEO. The independent board chair or lead (or presiding) independent director should preside over this meeting.

1.3 Independent Director Definition: Each company should disclose in its annual proxy statement the definition of "independence" relied upon by its board. The board's definition of "independence" should address, at a minimum, those provisions set forth in Appendix E.

1.4 Independent Board Chairperson: The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interest of

[9] The National Association of Corporate Directors' (NACD's) Blue Ribbon Commission on Director Professionalism released its report in November 1996. (Hereafter "NACD Report") The NACD Report calls for a "substantial majority" of a board's directors to be independent. The Business Roundtable's Principles of Corporate Governance (November 2005, hereafter "BRT Principles") is in general accord that a "substantial majority" of directors should be independent, both in fact and appearance, as determined by the board. (BRT Principles, p.14) Neither the NACD, nor BRT, define "substantial."

shareowners, and it should name a lead independent director to fulfill duties that are consistent with those provided in Appendix F.

1.5 **Board Member Tenure:** Boards should consider all relevant facts and circumstances to determine whether a director should be considered independent. These considerations include the director's years of service on the board – extended periods of service may adversely impact a director's ability to bring an objective perspective to the boardroom. Additionally, there should be routine discussions surrounding director refreshment to ensure boards maintain the necessary mix of skills and experience to meet strategic objectives.

1.6 **Examine Separate Chair/CEO Positions:** When selecting a new CEO, boards should re-examine the traditional combination of the "chief executive" and "chair" positions.

1.7 **Board Role of Retiring CEO:** Generally, a company's retiring CEO should not continue to serve as a director on the board and at the very least be prohibited from sitting on any of the board committees.

1.8 **Board Access to Management:** The board should have a process in place by which all directors can have access to senior management.

1.9 **Independent Board Committees:** Committees who perform the audit, director nomination and executive compensation functions should consist entirely of independent directors.

1.10 **Board Oversight:** The full board is responsible for the oversight function on behalf of shareowners. Should the board decide to have other committees (e.g. executive committee) in addition to those required by law, the duties and membership of such committees should be fully disclosed.

1.11 **Board Resources:** The board, through its committees, should have access to adequate resources to provide independent counsel advice, or other tools that allow the board to effectively perform its duties on behalf of shareowners.

1.12 **Board Responsibilities:** The Board should be responsible for reviewing, approving and guiding corporate strategy, capital discipline and allocation, major plans of action, risk policies, business plans, setting performance objectives, monitoring implementation and corporate performance, overseeing major capital expenditures, and acquisitions/divestitures. Further, shareowner approval should be required for any major transactions, issuance of additional shares, or any changes to the company's governing documents such as the bylaws and charter that would limit or reduce shareowner rights.

2. Board, Director, and CEO Evaluation

As a fiduciary, a director owes a duty of loyalty to the corporation and its shareowners and must exercise reasonable care in relation to his or her duties as a director. No board can truly perform its function of overseeing a company's strategic direction and monitoring management's success without a system of evaluating itself. CalPERS may seek director candidates for nomination to the board of a publicly traded corporation in which it invests where the board does not effectively oversee shareowner interests by failing to perform in accordance with the Global Principles or in circumstances where a company has consistently demonstrated long-term economic underperformance.

In CalPERS view, each director should fit within the skill sets identified by the board as necessary to focus board attention on optimizing company operating performance and returns to shareowners. No director can fulfill his or her potential as an effective board member without a personal dedication of time and energy. Boards should therefore have an effective means of evaluating itself and individual director performance.

With this in mind, CalPERS recommends that:

2.1 Corporate Governance Principles: The board adopts and discloses a written statement of its own governance principles, and re-evaluates them on at least an annual basis.

2.2 Board Talent Assessment and Diversity: The board should facilitate a process that ensures a thorough understanding of the diverse characteristics necessary to effectively oversee management's execution of a long-term business strategy. Board diversity should be thought of in terms of skill sets, gender, age, nationality, race, sexual orientation, gender identity, and historically under-represented groups.

Consideration should go beyond the traditional notion of diversity to include a more broad range of experience, thoughts, perspectives, and competencies to help enable effective board leadership. A robust process for how diversity is considered when assessing board talent and diversity should be adequately disclosed and entail:

a. **Director Talent Evaluation**: To focus on the evolving global capital markets, a board should disclose its process for evaluating the diverse talent and skills needed on the board and its key committees.

b. **Director Attributes**: Board attributes should include a range of skills and experience which provide a diverse and dynamic team to oversee business strategy, risk mitigation and senior management performance. The board should establish and disclose a diverse mix of director attributes, experiences, perspectives and skill sets that are most appropriate for the company. At a minimum, director attributes should include expertise in accounting or finance, international markets, business or management, industry knowledge, governance, customer-base experience or perspective, crisis response, risk assessment, leadership and strategic planning. Additionally, existing directors should receive continuing education surrounding a company's activities and operations to ensure they maintain the necessary skill sets and knowledge to meet their fiduciary responsibilities.

c. **Director Nominations**: With each qualified director nomination recommendation, the board should consider the issue of competence, independence, continuing director tenure, as well as board diversity, and take steps as necessary to ensure that the board maintains openness to new ideas, a willingness to re-examine the status quo, and able to exercise judgment in the best interests of the corporation free of any external influence that may attempt to be or may appear to be exerted upon them.

2.3 Board, Committee, and Director Expectations: The board establishes preparation, participation and performance expectations for itself (acting as a collective body), for the key committees and each of the individual directors. A process by which these established board, key committee and individual director expectations are evaluated on an annual basis should be disclosed to shareowners. Directors must satisfactorily perform based on the established expectations with re-nomination based on any other basis being neither expected nor guaranteed.

2.4 Director Time Commitment: The board adopts and discloses guidelines[10] in the company's proxy statement to address competing time commitments that are faced when directors, especially acting CEOs[11], serve on multiple boards.

2.5 Director Attendance: Directors should be expected to attend at least 75% of the board and key committee meetings on which they sit.

2.6 Board Size: The board periodically reviews its own size, and determines the size that is most effective toward future operations.

2.7 CEO Performance: Independent directors establish CEO performance criteria focused on optimizing operating performance, profitability and shareowner value creation; and regularly review the CEO's performance against those criteria.

2.8 CEO Succession Plan: The board should proactively lead and be accountable for the development, implementation, and continual review of a CEO succession plan. Board members should be required to have a thorough understanding of the characteristics necessary for a CEO to execute on a long-term strategy that optimizes operating performance, profitability and shareowner value creation.

At a minimum, the CEO succession planning process should:

a. Become a routine topic of discussion by the board.

b. Extend down throughout the company emphasizing the development of internal CEO candidates and senior managers while remaining open to external recruitment.

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[10] See NACD Report (p. 10-12) recommends that candidates who are CEOs or senior executives of public corporations be "preferred" if they hold no more than 1-2 public company directorships; other candidates who hold full-time positions be preferred if they hold no more than 3-4 public company directorships; and all other candidates be preferred if they hold no more than 5-6 other public company directorships.

[11] "The job of being the CEO of a major corporation is one of the most challenging in the world today. Only extraordinary people are capable of performing it adequately; a small portion of these will appropriately be able to commit some energy to directorship of one other enterprise. No CEO has time for more than that." (Robert A.G. Monks, "Shareholders and Director Section", DIRECTORS & BOARDS (Autumn 1996 p.158)

c. Require all board members be given exposure to internal candidates.

d. Encompass both a long-term perspective to address expected CEO transition periods and a short-term perspective to address crisis management in the event of death, disability or untimely departure of the CEO.

e. Provide for open and ongoing dialogue between the CEO and board while incorporating an opportunity for the board to discuss CEO succession planning without the CEO present.

f. Be disclosed to shareowners on an annual basis and in a manner that would not jeopardize the implementation of an effective and timely CEO succession plan.

2.9 Director Succession Plan: The board should proactively lead and be accountable for the development, implementation, and continual review of a director succession plan. Board members should be required to have a thorough understanding of the characteristics necessary to effectively oversee management's execution of a long-term strategy that optimizes operating performance, profitability, and shareowner value creation.

At a minimum, the director succession planning process should:

a. Become a routine topic of discussion by the board.

b. Encompass how expected future board retirements or the occurrence of unexpected director turnover as a result of death, disability or untimely departure is addressed in a timely manner.

c. Encompass how director turnover either through transitioning off the board or as a result of rotating committee assignments and leadership is addressed in a timely manner.

d. Provide for a mechanism to solicit shareowner input.

e. Be disclosed to shareowners on an annual basis and in a manner that would not jeopardize the implementation of an effective and timely director succession plan.

3. Executive & Director Compensation

Compensation programs are one of the most powerful tools available to the company to attract, retain, and motivate key employees to optimize operating performance, profitability and sustainable long-term shareowner return. CalPERS considers long-term to be five or more years for mature companies and at least three years for other companies. Well-designed compensation programs will be adequately disclosed and align management with the long-term economic interests of shareowners.

CalPERS believes shareowners should have an effective mechanism by which to periodically promote substantive dialogue, encourage independent thinking by the board, and stimulate healthy debate for the purpose of holding management accountable for performance through executive compensation programs. However, CalPERS does not generally believe that it is optimal for shareowners to approve individual contracts at the company specific level.

Implicit in CalPERS Domestic Principles related to executive compensation, is the belief that the philosophy and practice of executive compensation needs to be performance-based. Through its efforts to advocate executive compensation reform, CalPERS emphasizes improved disclosure, the alignment of interests between executive management and shareowners, and enhanced compensation committee accountability for executive compensation.

With this in mind, CalPERS recommends the following:

Executive Compensation

3.1 Structure and Components of Total Compensation

a. **Board Designed, Implemented, and Disclosed to Shareowners:** To ensure the alignment of interest with long-term shareowners, executive compensation programs are to be designed, implemented, and disclosed to shareowners by the board, through an independent compensation committee. Executive compensation programs should not restrict the company's ability to attract and retain competent executives.

b. **Mix of Cash and Equity:** Executive compensation be comprised of a combination of cash and equity based compensation.

c. **Shareowner Advisory Vote on Executive Compensation:** Companies submit executive compensation policies to shareowners for non-binding approval on an annual basis.

d. **Executive Contract Disclosure:** Executive contracts be fully disclosed, with adequate information to judge the "drivers" of incentive components of compensation packages.

e. **Targeting Total Compensation Components:** Overall target ranges of total compensation and components therein including base salary, short-term incentive and long-term incentive components should be disclosed.

f. **Peer Relative Analysis:** Disclosure should include how much of total compensation is based on peer relative analysis and how much is based on other criteria.

g. **Executive Compensation Alignment with Business Strategy:** Compensation committees should have a well articulated philosophy that links compensation to long-term business strategy.

h. **Sustainability Objectives and Executive Compensation:** Executive compensation plans should be designed to support sustainability performance objectives particularly with regard to risk management, environmental, health, and safety standards. Sustainability objectives that trigger payouts should be disclosed.

3.2 Incentive Compensation

a. **Performance Link:** A significant portion of executive compensation should be comprised of "at risk" pay linked to optimizing the company's operating performance and profitability that results in sustainable long-term shareowner value creation.

b. **Types of Incentive Compensation:** The types of incentive compensation to be awarded should be disclosed such as the company's use of options, restricted stock, performance shares or other types.

c. **Establishing Performance Metrics:** Performance metrics such as total stock return, return on capital, return on equity and return on assets, should be set before the start of a compensation period while the previous years' metrics which triggered incentive payouts should be disclosed.

d. **Multiple Performance Metrics:** Plan design should utilize multiple performance metrics when linking pay to performance.

e. **Performance Hurdles:** Performance hurdles[12] that align the interests of management with long-term shareowners should be established with incentive compensation being directly tied to the attainment and/or out-performance of such hurdles. Provisions by which compensation will not be paid if performance hurdles are not obtained should be disclosed to shareowners.

f. **Retesting Incentive Compensation:** Provisions for the resetting of performance hurdles in the event that incentive compensation is retested[13] should be disclosed.

g. **Clawback Policy:** Companies should recapture incentive payments that were made to executives on the basis of having met or exceeded performance targets during a period of fraudulent activity or a material negative restatement of financial results for which executives are found personally responsible.

3.3 Equity Compensation

a. **Equity Ownership:** Executive equity ownership should be required through the attainment and continuous ownership of a significant equity investment in the company. Executive stock ownership guidelines and holding requirements should be disclosed to shareowners on an annual basis. In addition to equity ownership, a company should make full disclosure of any pledging policies. Further, stock subject to the ownership requirements should not be pledged or otherwise encumbered.

b. **Hedging:** The use of derivatives or other structures to hedge director or executive stock ownership undermines the alignment of interest that equity compensation is intended to provide. Companies should therefore prohibit the activity and provide full disclosure of any hedging policies.

[12] Executive compensation should directly link the interests of senior management, both individually and as a team, to the long-term interests of shareholders. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk. (BRT Principles pg. 24)

[13] "Retested" means extending a performance period to enable initial performance hurdles to be achieved.

c. **Equity Grants Linked to Performance:** Equity based compensation plans should incorporate performance based equity grant vesting requirements tied to achieving performance metrics. The issuance of discounted equity grants or accelerated vesting are not desirable performance based methodologies.

d. **Unvested Equity Acceleration upon a Change-in-Control:** In the event of a merger, acquisition, or change-in-control, unvested equity should not accelerate but should instead convert into the equity of the newly formed company.

e. **Recapturing Dividend Equivalent Payouts:** Companies should develop and disclose a policy for recapturing dividend equivalent payouts on equity that does not vest. In addition, companies should ensure voting rights are not permitted on unvested equity.

f. **Equity Grant Vesting Period:** Equity grants should vest over a period of at least three years.

g. **Board Approval of Stock Options:** The board's methodology and corresponding details for approving stock options for both company directors and employees should be highly transparent and include disclosure of: 1) quantity, 2) grant date, 3) strike price, and 4) the underlying stock's market price as of grant date. The approval and granting of stock options for both directors and employees should preferably occur on a date when all corporate actions are taken by the board. The board should also require a report from the CEO stating specifically how the board's delegated authority to issue stock options to employees was used during the prior year.

h. **Equity Grant Repricing:** Equity grant repricing without shareowner approval should be prohibited.

i. **Evergreen or Reload Provisions:** "Evergreen"[14] or "Reload"[15] provisions should be prohibited.

j. **Distribution of Equity Compensation:** How equity-based compensation will be distributed within various levels of the company should be disclosed.

k. **Equity Dilution and Run Rate Provisions:** Provisions for addressing the issue of equity dilution, the intended life of an equity plan, and the expected yearly run rate of the equity plan should be disclosed.

l. **Equity Repurchase Plans:** If the company intends to repurchase equity in response to the issue of dilution, the equity plan should clearly articulate how the repurchase decision is made in relation to other capital allocation alternatives.

m. **Shareowner Approval:** All equity based compensation plans or material changes to existing equity based compensation plans should be shareowner approved.

n. **Cost of Equity Based Compensation:** Reasonable ranges which the board will target the total cost of new or material changes to existing equity based

[14] Evergreen provisions provide a feature that automatically increases the shares available for grant on an annual basis. Evergreen provisions include provisions for a set number of shares to be added to the plan each year, or a set percentage of outstanding shares.

[15] Reload provisions allow an optionee who exercises a stock option using stock already owned to receive a new option for the number of shares used to exercise. The intent of reload options is to make the optionee whole in cases where they use existing shares they own to pay the cost of exercising options.

compensation plans should be disclosed. The cost of new or material changes to existing equity based compensation plans should not exceed that of the company's peers unless the company has demonstrated consistent long-term economic out-performance on a peer relative basis.

3.4 Use and Disclosure of Severance Agreements

a. **Severance Agreement Disclosure:** In cases where the company will consider severance agreements[16], the policy should contain the overall parameters of how such agreements will be used including the specific detail regarding the positions within the company that may receive severance agreements; the maximum periods covered by the agreements; provisions by which the agreements will be reviewed and renewed; any hurdles or triggers that will affect the agreements; a clear description of what would and would not constitute termination for cause; and disclosure of where investors can view the entire text of severance agreements.

b. **Severance Agreement Amendments:** Material amendments to severance agreements should be disclosed to shareowners.

c. **Shareowner Approval of Severance Payments:** Severance payments that provide benefits[17] with a total present value exceeding market standards[18] should be ratified by shareowners.

3.5 Use of "Other" Forms of Compensation: Compensation policies should include guidelines by which the company will use alternative forms[19] of compensation ("perquisites"), and the relative weight in relation to total compensation if perquisites will be utilized. To the degree that the company will provide perquisites, it should clearly articulate how shareowners should expect to realize value from these other forms of compensation.

3.6 Use of Retirement Plans, Defined Contribution/Benefit Plans: Defined contribution and defined benefit retirement plans should be clearly disclosed in tabular format showing all benefits available whether from qualified or non-qualified plans and net of any offsets.

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[16] Severance agreement means any agreement that dictates what an executive will be compensated when the company terminates employment without cause or when there is a termination of employment following a finally approved and implemented change in control.

[17] Severance benefits mean the value of all cash and non-cash benefits, including, but not limited to, the following: (i) cash benefits; (ii) perquisites; (iii) consulting fees; (iv) equity and the accelerated vesting of equity, (v) the value of "gross-up" payments; and (vi) the value of additional service credit or other special additional benefits under the company's retirement system. Severance benefits do not include already accrued pension benefits.

[18] The disclosed threshold in the United States should not exceed 2.99 times the sum of the executive's base salary plus target bonus.

[19] "Other" forms of compensation include, but are not limited to, pension benefits including terms of deferred pay, perquisites and loans.

3.7 Director Compensation

a. **Combination of Cash and Equity:** Director compensation should be a combination of cash and stock in the company.

b. **Equity Ownership:** Director equity ownership should be required through the attainment and continuous ownership of an equity investment in the company. Director stock ownership guidelines and holding requirements should be disclosed to shareowners on an annual basis.

4. Integrity of Financial Reporting

Financial reporting plays an integral role in the capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Effective financial reporting depends on high quality accounting standards, as well as consistent application, rigorous independent audit and enforcement of those standards. CalPERS is a strong advocate of reform that ensures the continual improvement and integrity of financial reporting.

4.1 Integrated Reporting: Companies should provide for the integrated representation of operational, financial, environmental, social, and governance performance in terms of both financial and non-financial results in order to offer investors a better information set for assessing risk.

4.2 Global Accounting Standards: Convergence to one set of high quality global accounting standards to ensure integrity of financial reporting without compromising quality is critical.

4.3 Role of the Auditor: Auditors should provide independent assurance and attestation to the quality of financial statements to instill confidence in the providers of capital.

4.4 Auditor Ratification by Shareowners: The selection of the independent external auditor should be ratified by shareowners annually.

4.5 Audit Opinion: Auditors should bring integrity, independence, objectivity, and professional competence to the financial reporting process. The audit opinion should state whether the financial statements and disclosures are complete, materially accurate, and free of material misstatement, whether caused by error or fraud.

4.6 Auditor's Enhanced Reporting to Investors: Auditors should provide a reasonable and balanced assurance on financial reporting matters to investors in narrative reports such as an Auditor's Discussion and Analysis (AD&A) or a Letter to the Shareowners Enhanced reporting should include:

a. Business, operational and risks believed to exist and considered;
b. Assumptions used in judgments that materially affect the financial statements, and whether those assumptions are at the low or high end of the range of possible outcomes;
c. Appropriateness of the accounting policies adopted by the company;

d. Changes to accounting policies that have a significant impact on the financial statements;
e. Methods and judgements made in valuing assets and liabilities;
f. Unusual transactions;
g. Accounting applications and practices that are uncommon to the industry;
h. Identification of any matters in the Annual Report that the auditors believe are incorrect or inconsistent, with the information contained in the financial statements or obtained in the course of their audit;
i. Audit issues and their resolution which the audit partner documents in a final audit memo to the Audit Committee;
j. Quality and effectiveness of the governance structure and risk management;
k. Completeness and reasonableness of the Audit Committee report.

4.7 Non-Audit Fees: Non-audit, consulting services can impair the objectivity of the auditor. The board, through its independent Audit Committee, should ensure that excessive non-audit fees are prohibited. The Audit Committee should explain why individual non-audit service engagements were provided by the company's independent auditor rather than by another party and how the auditor's independence is safeguarded. To limit the risk of possible conflicts of interest and independence of the auditor, non-audit services and fees paid to auditors for non-audit services should both be approved in advance by the Audit Committee and disclosed in the proxy statement on an annual basis.

4.8 Auditor Independence: The Audit Committee should assess the independence of the external auditing firm on an annual basis. Prior to acceptance of an external auditor engagement, the Audit Committee should require written disclosure from the external auditor of:

a. all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit clients or persons in a financial reporting oversight role that may have a bearing on independence;

b. the potential effects of these relationships on the independence in both appearance and fact of the registered public accounting firm;

c. the substance of the registered accounting firm's discussion with the audit committee.

4.9 Assertion of Internal Financial Controls: The Audit Committee should require the auditor's opinion to include commentary on any management assertion that the system of internal financial controls is operating effectively and efficiently, that assets are safeguarded, and that financial information is reliable as of a specific date, based on a specific integrated framework of internal controls.

4.10 Audit Committee Oversight: To ensure the integrity of audited financial statements, the corporation's interaction with the external auditor should be overseen by the audit committee on behalf of shareowners.

4.11 Audit Committee Expertise: Audit committee financial expertise at a minimum should include skill-sets as outlined by Section 407(d)(5)(i) of Regulation S-K and the Exchange listing requirements. Boards should consider the effectiveness of the audit committee and designated financial expert(s) in its annual assessment. Firms may be able to reduce their cost of capital as related to the quality of its financial reporting. The quality of financial reporting can be increased by appropriately structuring the audit committee with effective financial expertise.

4.12 Auditor Liability: To strengthen the auditor's objective and unbiased audit of financial reporting, audit committees should ensure that contracts with the auditor do not contain specific limits to the auditor's liability to the company for consequential damages or require the corporation to use alternative dispute resolution.

4.13 Auditor Selection: Audit committees should promote expanding the pool of auditors considered for the annual audit to help improve market competition and thereby minimize the concentration of only a small number of audit firms from which to engage for audit services. To allow audit committees a robust foundation to determine audit firm independence, auditors should provide 3 prior years of activities, relationships, and services (including tax services) with the company, affiliates of the company and persons in financial reporting oversight roles that may impact the independence of the audit firm.

4.14 Auditor Rotation: Audit committees should promote rotation of the auditor to ensure a fresh perspective and review of the financial reporting framework.

4.15 Audit Committee Disclosures: Disclosure regarding the content of Audit Committee discussions with external auditors provide better transparency, enhance audit quality and benefits investors. On an annual basis, the Audit Committee should be responsible for disclosing:

- **a.** Assessment of the independence and objectivity of the external auditor to assure the auditors and their staff have no financial, business, employment or family and other personal relationships with the company;
- **b.** Assessment of the appropriateness of total fees charged by the auditors;
- **c.** Assessment of non-audit services and fees charged including limitations or restrictions tied to the provision of non-audit services;
- **d.** Explanation of why non-audit services were provided by the auditor rather than by another party and how the auditor's independence has been safeguarded;
- **e.** Rational for recommending the appointment, reappointment or removal of the external auditor including information on tendering frequency, tenure, and any contractual obligations that acted to restrict the choice of external auditors;
- **f.** Auditor rotation period;
- **g.** Assessment of issues which resulted in auditor resignation.

4.16 Audit Committee Communication with Auditor: The auditor should articulate to the Audit Committee, risks and other matters arising from the audit that are significant to the oversight of the financial reporting process, including situations where the auditor is aware of disputes or concerns raised regarding accounting or auditing matters. The Audit Committee should consider providing to investors a summary document of its discussions with auditors to enhance investor confidence in the audit process.

5. Risk Oversight

In response to the turmoil in the financial markets and economic uncertainties, CalPERS has elevated the importance of risk oversight and management. The primary goal is to ensure companies adopt policies, operating procedures, reporting, and decision-making protocols to effectively manage, evaluate, and mitigate risk. The ultimate outcome is to ensure that companies function as "risk intelligent" organizations. CalPERS recommends the following:

5.1 The board is ultimately responsible for a company's risk management philosophy, organizational risk framework and oversight. The board should be comprised of skilled directors with a balance of broad business experience and extensive industry expertise to understand and question the breadth of risks faced by the company. Risk management should be considered a priority and sufficient time should be devoted to oversight.

5.2 The company should promote a risk-focused culture and a common risk management framework should be used across the entire organization. Frequent and meaningful communication should be considered the "cornerstone" for an effective risk framework. A robust risk framework will facilitate communication across business units, up the command chain and to the board.

5.3 The board should set out specific risk tolerances and implement a dynamic process that continuously evaluates and prioritizes risks. An effective risk oversight process considers both internal company related risks such as operational, financial, credit, liquidity, corporate governance, cyber-security, environmental, reputational, social, and external risks such as industry related, systemic, and macro economic.

5.4 Executive compensation practices should be evaluated to ensure alignment with the company's risk tolerances and that compensation structures do not encourage excessive risk taking.

5.5 At least annually, the board should approve a documented risk management plan and disclose sufficient information to enable shareowners to assess whether the board is carrying out its risk oversight responsibilities. Disclosure should also include the role of external parties such as third-party consultants in the risk management process.

5.6 While the board is ultimately responsible for risk oversight, executive management should be charged with designing, implementing and maintaining an effective risk program. Roles and reporting lines related to risk management should be clearly defined. At a minimum, the roles and reporting lines should be explicitly set out for the board, board risk committees, chief executive officer, chief financial officer, the chief risk officer, and business unit heads. The board and risk related committees should have appropriate transparency and visibility into the organization's risk management practices to carry out their responsibilities.

6. Corporate Responsibility

CalPERS believes that boards that strive for active cooperation between corporations and stakeholders[20] will be most likely to create wealth, employment and sustainable economies. With adequate, accurate and timely data disclosure of environmental, social, and governance practices, shareowners are able to more effectively make investment decisions by taking into account those practices of the companies in which the System invests. Therefore, CalPERS recommends the following:

6.1 Environmental Disclosure: To ensure sustainable long-term returns, companies should provide accurate and timely disclosure of environmental risks and opportunities through adoption of policies or objectives, such as those associated with climate change. Companies should apply the Global Framework for Climate Risk Disclosure[21] (Appendix G) when providing such disclosure. The 14 point Ceres Climate Change Governance Checklist (Appendix H) is recommended as a tool by companies to assist in the application of the Global Framework for Climate Risk Disclosure.

6.2 Sustainable Corporate Development: Corporations strive to measure, disclose, and be accountable to internal and external stakeholders for organizational performance towards the goal of sustainable development. It is recommended that corporations adopt the Global Reporting Initiative Sustainability Reporting Guidelines[22] to disclose economic, environmental, and social impacts.

6.3 Reincorporation: When considering reincorporation, corporations should analyze shareowner protections, company economic, capital market, macro economic, and corporate governance considerations.

6.4 Charitable and Political Contributions: Robust board oversight and disclosure of corporate charitable and political activity is needed to ensure alignment with business

[20] In accordance with the Global Reporting Initiative: Stakeholders are defined broadly as those groups or individuals: (a) that can reasonably be expected to be significantly affected by the organization's activities, products, and/or services; or (b) whose actions can reasonably be expected to affect the ability of the organization to successfully implement its strategies and achieve its objectives.
[21] Additional information on the Framework and a Guide for Using the Global Framework for Climate Risk Disclosure is available on the CalPERS website: www.calpers-governance.org.
[22] Adoption of the Guidelines will provide companies with a reporting mechanism through which to disclose, at a minimum, implementation of the Global Sullivan Principles and the Global Framework for Climate Risk Disclosure. The Guidelines along with additional information on GRI can be found at www.globalreporting.org.

strategy and to protect assets on behalf of shareowners. We recommend the following:

a. **Policy:** The board should develop and disclose a policy that outlines the board's role in overseeing corporate charitable and political contributions, the terms and conditions under which charitable and political contributions are permissible, and the process for disclosing charitable and political contributions annually.
b. **Board Monitoring, Assessment and Approval:** The board of directors should monitor charitable and political contributions (including trade association contributions directed for lobbying purposes) made by the company. The board should ensure that only contributions consistent with and aligned to the interests of the company and its shareowners are approved.
c. **Disclosure:** The board should disclose on an annual basis the amounts and recipients of monetary and non-monetary contributions made by the company during the prior fiscal year. If any expenditure earmarked or used for political or charitable activities were provided to or through a third-party to influence elections of candidates or ballot measures or governmental action, then those expenditures should be included in the report.

7. Shareowner Rights

Shareowner rights[23] – or those structural devices that define the formal relationship between shareowners and the directors to whom they delegate corporate control – should be featured in the governance principles adopted by corporate boards. Therefore, CalPERS recommends that corporations adopt the following shareowner rights:

7.1 Majority Vote Requirements: Shareowner voting rights should not be subject to supermajority voting requirements. A majority of proxies cast should be able to:

a. Amend the company's governing documents such as the Bylaws and Charter by shareowner resolution.
b. Remove a director with or without cause.

7.2 Majority Vote Standard for Director Elections: In an uncontested director election, a majority of proxies cast should be required to elect a director. In a contested election, a plurality of proxies cast should be required to elect a director. Resignation for any director that receives a withhold vote greater than 50% of the votes cast should be required. Unless the incumbent director receiving less than a majority of the votes cast has earlier resigned, the term of the incumbent director should not exceed 90 days after the date on which the voting results are determined.

[23] Lucian Bebchuk, Alma Cohen, and Allen Ferrell, "What matters in Corporate Governance," (2004), The John M. Olin Center for Law, Economics and Business of Harvard University: Found that portfolios of companies with strong shareowner-rights protections outperformed portfolios of companies with weaker protections by 8.5% per year.

7.3 Universal Proxy: To facilitate the shareowner voting process in contested elections – opposing sides engaged in the contest should utilize a proxy card naming all management nominees and all dissident nominees, providing every nominee equal prominence on the proxy card.

7.4 Special Meetings and Written Consent: Shareowners should be able to call special meetings or act by written consent.

7.5 Sponsoring and Implementation of Shareowner Resolutions: Shareowners should have the right to sponsor resolutions. A shareowner resolution that is approved by a majority of proxies cast should be implemented by the board.

7.6 Prohibit Greenmail: Every company should prohibit greenmail.

7.7 Poison Pill Approval: No board should enact nor amend a poison pill except with shareowner approval.

7.8 Annual Director Elections: Every director should be elected annually.

7.9 Proxy Confidentiality: Proxies should be kept confidential from the company, except at the express request of shareowners.

7.10 Broker Non-Votes: Broker non-votes should be counted for quorum purposes only.

7.11 Cumulative Voting Rights: Shareowners should have the right to cumulate[24] votes in a contested election of directors.

[24] Such a right gives shareowners the ability to aggregate their votes for directors and either cast all of those votes for one candidate or distribute those votes for any number of candidates.

C. International Principles

For companies not domiciled in the United States nor trade on U.S. stock exchanges, CalPERS advocates the expansion of the Core Principles into the International Principles, as adopted by the International Corporate Governance Network ("ICGN"). As a founding member of ICGN, CalPERS believes the ICGN Global Principles represent an evolving framework for accountable corporate governance to be applied outside of the United States. In addition to encouraging portfolio companies to adopt these principles, CalPERS implements its international corporate governance initiatives and proxy voting responsibilities in a manner that is consistent the ICGN Global Principles.

The ICGN Global Principles[25] are as follows:

Section A: Board

<u>1. Responsibilities</u>

1.1 **Duties:** The board should act on an informed basis and in the best long term interests of the company with good faith, care and diligence, for the benefit of shareholders, while having regard to relevant stakeholders.

1.2 **Responsibilities:** The board is accountable to shareholders and relevant stakeholders and responsible for protecting and generating sustainable value over the long term. In fulfilling their role effectively, board members should:

a. guide, review and approve corporate strategy and financial planning, including major capital expenditures, acquisitions and divestments;
b. monitor the effectiveness of the company's governance practices, environmental practices, and social practices, and adhere to applicable laws;
c. embody high standards of business ethics and oversee the implementation of codes of conduct that engender a corporate culture of integrity;
d. oversee the management of potential conflicts of interest, such as those which may arise around related party transactions;
e. oversee the integrity of the company's accounting and reporting systems, its compliance with internationally accepted standards, the effectiveness of its systems of internal control, and the independence of the external audit process;
f. oversee the implementation of effective risk management and proactively review the risk management approach and policies annually or with any significant business change;
g. ensure a formal, fair and transparent process for nomination, election and evaluation of directors;
h. appoint and, if necessary, remove the chief executive officer (CEO) and develop succession plans;
i. align CEO and senior management remuneration with the longer term interests of the company and its shareholders; and
j. conduct an objective board evaluation on a regular basis, consistently seeking to

[25] The ICGN Global Governance Principles were revised and ratified by membership in 2014. The Principles along with additional information on ICGN can be found at www.icgn.org.

enhance board effectiveness.

1.3 **Dialogue**: The board should make available communication channels for periodic dialogue on governance matters with shareholders and stakeholders as appropriate. Boards should clearly explain such procedures to shareholders including guidance relating to compliance with disclosure and other relevant market rules.

1.4 **Commitment:** The board should meet regularly to discharge its duties and directors should allocate adequate time to board meeting preparation and attendance. Board members should know the business, its operations and senior management well enough to contribute effectively to board discussions and decisions.

1.5 **Directorships:** The number, and nature, of board appointments an individual director holds (particularly the chair and executive directors) should be carefully considered and reviewed on a regular basis and the degree to which each individual director has the capacity to undertake multiple directorships should be clearly disclosed.

1.6 **Induction:** The board should have in place a formal process of induction for all new directors so that they are well-informed about the company as soon as possible after their appointment. Directors should also be enabled to regularly refresh their skills and knowledge to discharge their responsibilities.

1.7 **Committees:** The board should establish committees to deliberate on issues such as audit, remuneration and nomination. Where the board chooses not to establish such committees, the board should disclose the fact and the procedures it employs to discharge its duties and responsibilities effectively.

1.8 **Advice:** The board should receive advice on its responsibilities under relevant law and regulation, usually from the company secretary or an in-house general counsel. In addition, the board should have access to independent advice as appropriate and at the company's expense.

2. Leadership and Independence

2.1 **Chair and CEO:** The board should have independent leadership. There should be a clear division of responsibilities between the chairmanship of the board and the executive management of the company's business.

2.2 **Lead Independent Director:** The chair should be independent on the date of appointment. If the chair is not independent, the company should adopt an appropriate structure to mitigate any potential challenges arising from this, such as the appointment of a lead independent director. The board should explain the reasons why this leadership structure is appropriate and keep the structure under review. A lead independent director also provides shareholders and directors with a valuable channel of communication should they wish to discuss concerns relating to the chair.

2.3 **Succession:** If, exceptionally, the board decides that a CEO should succeed to become chair, the board should communicate appropriately with shareholders in advance setting out a convincing rationale and provide detailed explanation in the annual report. Unless extraordinary circumstances exist there should be a break in service between the roles, (e.g. a period of two years).

2.4 **Effectiveness:** The chair is responsible for leadership of the board and ensuring its effectiveness. The chair should ensure a culture of openness and constructive debate that allows a range of views to be expressed. This includes setting an appropriate board agenda and ensuring adequate time is available for discussion of all agenda items. There should also be opportunities for the board to hear from an appropriate range of senior management.

2.5 **Independence:** The board should identify in the annual report the names of the directors considered by the board to be independent and who are able to exercise independent judgement free from any external influence. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

a. is or has been employed in an executive capacity by the company or a subsidiary and there has not been an appropriate period between ceasing such employment and serving on the board;
b. is or has within an appropriate period been a partner, director or senior employee of a provider of material professional or contractual services to the company or any of its subsidiaries;
c. receives or has received additional remuneration from the company apart from a director's fee, participates in the company's share option plan or a performance-related pay scheme, or is a member of the company's pension scheme;
d. has or had close family ties with any of the company's advisers, directors or senior management;
e. holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
f. is a significant shareholder of the company, or an officer of, or otherwise associated with, a significant shareholder of the company;
g. is or has been a nominee director as a representative of minority shareholders or the state;
h. has been a director of the company for such a period that his or her independence may have become compromised.

2.6 **Independent Meetings:** The chair should regularly hold meetings with the non-executive directors without executive directors present. In addition, the non-executive directors (led by the lead independent director) should meet as appropriate, and at least annually, without the chair present.

3. Composition and Appointment

3.1 **Composition:** The board should comprise a majority of non-executive directors, the majority of whom are independent, noting that practice may legitimately vary from this standard in controlled companies where a critical mass of the board is preferred to be independent. There should be a sufficient mix of individuals with relevant knowledge, independence, competence, industry experience and diversity of perspectives to generate effective challenge, discussion and objective decision-making.

3.2 **Diversity:** The board should disclose the company's policy on diversity which should include measurable targets for achieving appropriate diversity within its senior management and board (both executive and non-executive) and report on progress made in achieving such targets.

3.3 **Tenure:** Non-executive directors should serve for an appropriate length of time to properly serve the board without compromising the independence of the board. The length of tenure of each director should be reviewed regularly by the nomination committee to allow for board refreshment and diversity.

3.4 **Appointment Process:** The board should disclose the process for director nomination and election / re-election along with information about board candidates which includes:

a. board member identities and rationale for appointment;
b. core competencies, qualifications, and professional background;
c. recent and current board and management mandates at other companies, as well as significant roles on non-profit/ charitable organisations;
d. factors affecting independence, including relationship/s with controlling shareholders;
e. length of tenure;
f. board and committee meeting attendance; and
g. any shareholdings in the company.

3.5 **Nominations:** The board should ensure that shareholders are able to nominate candidates for board appointment. Such candidacies should be proposed to the appropriate board committee and, subject to an appropriate nomination threshold, be nominated directly on the company's proxy.

3.6 **Elections:** Board members should be conscious of their accountability to shareholders. Accountability mechanisms may require directors to stand for election on an annual basis or to stand for election at least once every three years. Shareholders should have a separate vote on the election of each director, with each candidate approved by a simple majority of shares voted.

3.7 **Evaluation:** The nomination committee should evaluate the process for a rigorous review of the performance of the board, the company secretary (where such a position exists), the board's committees and individual directors prior to being proposed for re-election. The board should also periodically (preferably every three years) engage an independent outside consultant to undertake the evaluation. The non-executive directors, led by the lead independent director, should be responsible for performance evaluation of the chair, taking into account the views of executive officers. The board should disclose the process for evaluation and, as far as reasonably possible, any material issues of relevance arising from the conclusions and any action taken as a consequence.

3.8 **Nomination Committee:** The board should establish a nomination committee comprised of non-executive directors, the majority of whom are independent. The main role and responsibilities of the nomination committee should be described in the committee's terms of reference. This includes:

a. developing a skills matrix, by preparing a description of the desired roles, experience and capabilities required for each appointment, and then evaluating the composition of the board.
b. leading the process for board appointments and putting forward recommendations to shareholders on directors to be elected and re-elected;
c. upholding the principle of director independence by addressing conflicts of interest (and potential conflicts of interest) among committee members and between the committee and its advisors during the nomination process;
d. considering and being responsible for the appointment of independent consultants for recruitment or evaluation including their selection and terms of engagement and publically disclosing their identity and consulting fees; and
e. entering into dialogue with shareholders on the subject of board nominations either directly or via the board; and
f. board succession planning.

4. Corporate Culture

4.1 **Codes of Conduct/Ethics:** The board should adopt high standards of business ethics through codes of conduct/ethics (or similar instrument) and oversee a culture of integrity, notwithstanding differing ethical norms and legal standards in various countries. This should permeate all aspects of the company's operations, ensuring that its vision, mission and objectives are ethically sound and demonstrative of its values. Codes should be effectively communicated and integrated into the company's strategy and operations, including risk management systems and remuneration structures.

4.2 **Bribery and Corruption:** The board should ensure that management has implemented appropriately stringent policies and procedures to mitigate the risk of bribery and corruption or other malfeasance. Such policies and procedures should be communicated to shareholders and other interested parties.

4.3 **Whistleblowing**: The board should ensure that the company has in place an independent, confidential mechanism whereby an employee, supplier or other stakeholder can (without fear of retribution) raise issues of particular concern with regard to potential or suspected breaches of a company's code of ethics or local law.

4.4 **Political Lobbying**: The board should have a policy on political engagement, covering lobbying and donations to political causes or candidates where allowed under law, and ensure that the benefits and risks of the approach taken are understood, monitored, transparent and regularly reviewed.

4.5 **Employee Share Dealing**: The board should develop clear rules regarding any trading by directors and employees in the company's own securities. Individuals should not benefit directly or indirectly from knowledge which is not generally available to the market.

4.6 **Behavior and Conduct**: The board should foster a corporate culture which ensures that employees understand their responsibility for appropriate behavior. There should be appropriate board level and staff training in all aspects relating to corporate culture and ethics. Due diligence and monitoring programs should be in place to enable staff to understand relevant codes of conduct and apply them effectively to avoid company involvement in inappropriate behavior.

5. Risk Oversight

5.1 **Proactive Oversight:** The board should proactively oversee, review and approve the approach to risk management regularly or with any significant business change and satisfy itself that the approach is functioning effectively. Strategy and risk are inseparable and should permeate all board discussions and, as such, the board should consider a range of plausible outcomes that could result from its decision-making and actions needed to manage those outcomes.

5.2 **Comprehensive Approach**: The board should adopt a comprehensive approach to the oversight of risk which includes all material aspects of risk including financial, strategic, operational, environmental, and social risks (including political and legal ramifications of such risks), as well as any reputational consequences.

5.3 **Risk Culture**: The board should lead by example and foster an effective risk culture that encourages openness and constructive challenge of judgements and assumptions. The company's culture with regard to risk and the process by which issues are escalated and de-escalated within the company should be evaluated at intervals as appropriate to the situation.

5.4 **Dynamic Process**: The board should ensure that risk is appropriately reflected in the company's strategy and capital allocation. Risk should be managed accordingly in a rational, appropriately independent, dynamic and forward-looking way. This process of managing risks should be continual and include consideration of a range of plausible impacts.

5.5 **Risk Committee**: While ultimate responsibility for a company's risk management approach rests with the full board, having a risk committee (be it a stand-alone risk committee, a combined risk committee with nomination and governance, strategy, audit or other) can be an effective mechanism to bring the transparency, focus and independent judgment needed to oversee the company's risk management approach.

6. Remuneration

6.1 **Alignment:** Remuneration should be designed to effectively align the interests of the CEO and executive officers with those of the company and its shareholders. Remuneration should be reasonable and equitable and the quantum should be determined within the context of the company as a whole.

6.2 **Performance**: Performance measurement should integrate risk considerations so that there are no rewards for taking inappropriate risks at the expense of the company and its shareholders. Performance related elements should be rigorous and measured over timescales, and with methodologies, which help ensure that performance pay is directly correlated with sustained value creation. Companies should include provisions in their incentive plans that enable the company to with-hold the payment of any sum, or recover sums paid (‘clawback’), in the event of serious misconduct or a material misstatement in the company’s financial statements.

6.3 **Disclosure**: The board should disclose a clear, understandable and comprehensive remuneration policy which is aligned with the company’s long-term strategic objectives. The remuneration report should also describe how awards granted to individual directors and the CEO were determined and deemed appropriate in the context of the company’s underlying performance in any given year. This extends to non-cash items such as director and officer insurance, fringe benefits and terms of severance packages if any.

6.4 **Share Ownership**: The board should disclose the company policy concerning ownership of shares by the CEO and executive officers. This should include the company policy as to how share ownership requirements are to be achieved and for how long they are to be retained. The use of derivatives or other structures that enable the hedging of an individual’s exposure to the company’s shares should be discouraged.

6.5 **Shareholder Approval**: Shareholders should have an opportunity to vote on the remuneration policies, particularly where significant change to remuneration structures is proposed or where significant numbers of shareholders have opposed a remuneration resolution. In particular, share-based remuneration plans should be subject to shareholder approval before being implemented.

6.6 **Employee Incentives**: The board should ensure that the development of remuneration structures for company employees reinforce, and do not undermine, sustained value creation. Performance-based remuneration for staff should incorporate risk, including measuring risk-adjusted returns, to help ensure that no inappropriate or unintended risks are being incentivized. While a major component of most employee incentive remuneration is likely to be cash-based, these programs should be designed and implemented in a manner consistent with the company’s long-term performance drivers.

6.7 **Non-Executive Director Pay**: The board should ensure that pay for a non-executive director and/or a non-executive chair is structured in a way which ensures independence, objectivity, and alignment with shareholders' interests. Performance-based pay should not be granted to non-executive directors and non-executive chairs.

6.8 **Remuneration Committee**: The board should establish a remuneration committee comprised of non-executive directors, the majority of whom are independent. The main role and responsibilities of the remuneration committee should be described in the committee terms of reference. This includes:

- **a.** determining and recommending to the board the remuneration philosophy and policy of the company;
- **b.** designing, implementing, monitoring and evaluating short-term and long-term share-based incentives and other benefits schemes including pension arrangements, for all executive officers;
- **c.** ensuring that conflicts of interest among committee members and between the committee and its advisors are avoided;
- **d.** appointing any independent remuneration consultant including their selection and terms of engagement and disclosing their identity and consulting fees; and
- **e.** maintaining appropriate communication with shareholders on the subject of remuneration either directly or via the board.

7. Reporting and Audit

7.1 **Comprehensive Disclosure:** The board should present a balanced and understandable assessment of the company's position and prospects in the annual report and accounts in order for shareholders to be able to assess the company's performance, business model, strategy and long-term prospects.

7.2 **Materiality**: The board should disclose relevant and material information on a timely basis so as to allow shareholders to take into account information which assists in identifying risks and sources of wealth creation. Issues material to shareholders should be set out succinctly in the annual report, or equivalent disclosures, and approved by the board itself.

7.3 **Affirmation**: The board should affirm that the company's annual report and accounts present a true and fair view of the company's position and prospects. As appropriate, taking into account statutory and regulatory obligations in each jurisdiction, the information provided in the annual report and accounts should:

- a. be relevant to investment decisions, enabling shareholders to evaluate risks, past and present performance, and to draw inferences regarding future performance;
- b. enable shareholders, who put up the risk capital, to fulfil their responsibilities as owners to assess company management and the strategies adopted;
- c. be a faithful representation of the events it purports to represent;
- d. generally be neutral and report activity in a fair and unbiased way except where there is uncertainty. Prudence should prevail such that assets and income are not overstated and liabilities and expenses are not understated. There should be substance over form. Any off-balance sheet items should be appropriately disclosed;
- e. be verifiable so that when a systematic approach and methodology is used the

same conclusion is reached;

f. be presented in a way that enables comparisons to be drawn of both the entity's performance over time and against other entities; and
g. recognize the 'matching principle' which requires that expenses are matched with revenues.

7.4 **Solvency Risk:** The board should confirm in the annual report that it has carried out a robust assessment of the state of affairs of the company and any material risks, including to its solvency and liquidity that would threaten its viability. The board should state whether, in its opinion, the company will be able to meet its liabilities as they fall due and continue in operation for the foreseeable future, explaining any supporting assumptions and risks or uncertainties relevant to that and how they are being managed. In particular, disclosure on risk should include a description of:

a. risk in the context of the company's strategy;
b. risk to returns expected by shareholders with a focus on key consequences;
c. risk oversight approach and processes;
d. how lessons learnt have been applied to improve future outcomes; and
e. the principal risks to the company's business model and the achievement of its strategic objectives, including risks that could threaten its viability.

7.5 **Non-Financial Information**: The board should provide an integrated report that puts historical performance into context, and portrays the risks, opportunities and prospects for the company in the future, helping shareholders understand a company's strategic objectives and its progress towards meeting them. Such disclosures should:

a. be linked to the company's business model;
b. be genuinely informative and include forward-looking elements where this will enhance understanding;
c. describe the company's strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing strategy and the management of risks and opportunities;
d. be accessible and appropriately integrated with other information that enables shareholders to obtain a picture of the whole company;
e. use key performance indicators that are linked to strategy and facilitate comparisons;
f. use objective metrics where they apply and evidence-based estimates where they do not; and
g. be strengthened where possible by independent assurance that is carried out annually having regard to established disclosure standards.

7.6 **Internal Controls:** The board should oversee the establishment and maintenance of an effective system of internal control which should be measured against internationally accepted standards of internal audit and tested periodically for its adequacy. Where an internal audit function has not been established, full reasons for this should be disclosed in the annual report, as well as an explanation of how adequate assurance of the effectiveness of the system of internal controls has been obtained.

7.7 **Independent External Audit**: The board should publish the report from the external auditor which should provide an independent and objective opinion whether the accounts give a true and fair view of the financial position and performance of the company. The engagement partner should be named in the audit report and the company should publish its policy on audit firm rotation. If the auditor resigns then the reasons for the resignation should be publicly disclosed by the resigning auditor.

7.8 **Non-Audit Fees**: The audit committee should, as far as practicable, approve any non-audit services provided by the external auditor and related fees to ensure that they do not compromise auditor independence. The non-audit fees should be disclosed in the annual report with explanations where appropriate. Non-audit fees should normally be less than the audit fee and, if not, there should be a clear explanation as to why it was necessary for the auditor to provide these services and how the independence and objectivity of the audit was assured.

7.9 **Audit Committee**: The board should establish an audit committee comprised of non-executive directors, the majority of whom are independent. At least one member of the audit committee should have recent and relevant financial experience. The chair of the board should not be the chair of the audit committee, other than in exceptional circumstances which should be explained in the annual report. The main role and responsibilities of the audit committee should be described in the committee's terms of reference. This includes:

a. monitoring the integrity of the accounts and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgments contained in them;
b. maintaining oversight of key accounting policies and accounting judgments which should be in accordance with generally accepted international accounting standards, and disclosing such policies in the notes to the company's accounts;
c. agreeing the minimum scope of the audit as prescribed by applicable law and any further assurance that the company needs. Shareholders (who satisfy a reasonable threshold shareholding) should have the opportunity to expand the scope of the forthcoming audit or discuss the results of the completed audit should they wish to;
d. assuring itself of the quality of the audit carried out by the external auditors and assessing the effectiveness and independence of the auditor each year. This includes overseeing the appointment, reappointment and, if necessary, the removal of the external auditor and the remuneration of the auditor. There should be transparency in advance when the audit is to be tendered so that shareholders can engage with the company in relation to the process should they so wish;
e. having appropriate dialogue with the external auditor without management present and overseeing the interaction between management and the external auditor, including reviewing the management letter provided by the external auditors and overseeing management's response; and
f. reporting on its work and conclusions in the annual report.

8. General meetings

8.1 **Shareholder Identification:** The board should ensure that the company maintains a record of the registered owners of its shares or those holding voting rights over its shares. Registered shareholders, or their agents, should provide the company (where anonymity rules do not preclude this) with the identity of beneficial owners or holders of voting rights when requested in a timely manner. Shareholders should be able to review this record of registered owners of shares or those holding voting rights over shares.

8.2 **Notice**: The board should ensure that the general meeting agenda is posted on the company's website at least one month prior to the meeting taking place. The agenda should be clear and properly itemized and include the date and location of the meeting as well as information regarding the issues to be decided at the meeting.

8.3 **Vote Deadline**: The board should clearly publicize a date by which shareholders should cast their voting instructions. The practice of share blocking or requirements for lengthy share holdings should be discontinued.

8.4 **Vote Mechanisms**: The board should promote efficient and accessible voting mechanisms that allow shareholders to participate in general meetings either in person or remotely, preferably by electronic means or by post, and should not impose unnecessary hurdles.

8.5 **Vote Disclosure**: The board should ensure that equal effect is given to votes whether cast in person or in absentia and all votes should be properly counted and recorded via ballot. The outcome of the vote, the vote instruction (reported separately for, against or abstain) and voting levels for each resolution should be published promptly after the meeting on the company website. If a board-endorsed resolution has been opposed by a significant proportion of votes, the company should explain subsequently what actions were taken to understand and respond to the concerns that led shareholders to vote against the board's recommendation.

9. Shareholder rights

9.1 **Share Classes:** The board should disclose sufficient information about the material attributes of all of the company's classes and series of shares on a timely basis. Ordinary or common shares should feature one vote for each share. Divergence from a 'one-share, one-vote' standard which gives certain shareholders power disproportionate to their economic interests should be disclosed and explained. Dual class share structures should be kept under review and should be accompanied by commensurate extra protections for minority shareholders, particularly in the event of a takeover bid.

9.2 **Major decisions:** The board should ensure that shareholders have the right to vote on major decisions which may change the nature of the company in which they have invested. Such rights should be clearly described in the company's governing documents and include:

a. amendments to governing documents of the company such as articles or by-laws;
b. company share repurchases (buy-backs);
c. any new share issues. The board should be mindful of dilution of existing shareholders and provide full explanations where pre-emption rights are not offered;
d. shareholder rights plans (‘poison pills’) or other structures that act as anti-takeover mechanisms. Only non-conflicted shareholders should be entitled to vote on such plans and the vote should be binding. Plans should be time limited and put periodically to shareholders for re-approval;
e. proposals to change the voting rights of different series and classes of shares;
f. material and extraordinary transactions such as mergers and acquisitions.

9.3 **Conflicts of Interest:** The board should ensure that policies and procedures on conflicts of interest are established, understood and implemented by directors, management, employees and other relevant parties. If a director has an interest in a matter under consideration by the board, then the director should promptly declare such an interest and be precluded from voting on the subject or exerting influence.

9.4 **Related party transactions**: The board should disclose the process for reviewing and monitoring related party transactions which, for significant transactions, includes establishing a committee of independent directors. This can be a separate committee or an existing committee comprised of independent directors, for example the audit committee. The committee should review significant related party transactions to determine whether they are in the best interests of the company and, if so, to determine what terms are fair and reasonable. The conclusion of committee deliberations on significant related party transactions should be disclosed in the company’s annual report to shareholders.

9.5 **Shareholder Approval**: Shareholders should have the right to approve significant related party transactions and this should be based on the approval of a majority of disinterested shareholders. The board should submit the transaction for shareholder approval and disclose (both before concluding the transaction and in the company’s annual report):

a. the identity of the ultimate beneficiaries including, any controlling owner and any party affiliated with the controlling owner with any direct / indirect ownership interest in the company;
b. other businesses in which the controlling shareholder has a significant interest; and
c. shareholder agreements (e.g. commitments to related party payments such as license fees, service agreements and loans).

9.6 **Shareholder Questions:** The board should allow a reasonable opportunity for the shareholders as a whole at a general meeting to ask questions about or make comments on the management of the company, and to ask the external auditor questions related to the audit.

9.7 **Shareholder Resolutions**: The board should ensure that shareholders have the right to place items on the agenda of general meetings, and to propose resolutions subject to reasonable limitations. Shareholders should be enabled to work together to make such a proposal.

9.8 **Shareholder Meetings**: The board should ensure that shareholders, of a specified portion of its outstanding shares or a specified number of shareholders, have the right to call a meeting of shareholders for the purpose of transacting the legitimate business of the company.

9.9 **Thresholds**: Any threshold associated with shareholder resolutions, shareholder proposals or other such participation, should balance the need to ensure the matter under consideration is likely to be of importance to all shareholders and not only a small minority.

9.10 **Equality and Redress:** The board should ensure that shareholders of the same series or class are treated equally and afforded protection against abusive or oppressive conduct by the company or its management, including market manipulation, false or misleading information, material omissions and insider trading. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Proper remedies and procedural rules should be put in place to make the protection effective and affordable. Where national legal remedies are not afforded the board is encouraged to ensure that sufficient shareholder protections are provided in the company's bylaws.

Section B: Institutional Investors

1. Responsibilities

1.1 **Duties:**

a. Institutional investors should focus on delivering value by promoting and safeguarding the interests of beneficiaries or clients over an appropriate time-horizon. This is often expressed as a fiduciary duty, requiring prudence, care and loyalty on the part of all agents which are subject to such obligations.
b. Asset owners should actively consider which of their agents should be subject to the strictures of fiduciary duty and if such requirements are not applied what lower standards of behavior are appropriate. Asset owners cannot delegate their underlying fiduciary duties. Even when they employ agents to act on their behalf, asset owners need to ensure through contracts or by other means that the responsibilities of ownership are appropriately and fully delivered in their interests and on their behalf by those agents, who are to be held to account for doing so.
c. While different agents in the investment chain play different roles, each should focus on the needs of its beneficiaries or clients such that it is always seeking to deliver value over their required time-horizon. Benchmarks for measuring success should be tailored to the needs and risk exposures of beneficiaries or clients, with reporting designed to provide them with an understanding of success toward meeting those needs and managing related risks, in addition (as relevant) to providing applicable market-relative performance numbers.

1.2 **Responsibilities:** Asset owners should fully align the interests of their fund managers with their own obligations to beneficiaries by setting out their expectations in fund management contracts (or similar instruments) to ensure that the responsibilities of ownership are appropriately and fully delivered in their interests. This should include:

a. ensuring that the timescales over which investment risk and opportunity are considered match those of the client;
b. setting out an appropriate internal risk management approach so that material risks are managed effectively;
c. effectively integrating relevant environmental, social and governance factors into investment decision-making and ongoing management;
d. aligning interests effectively through appropriate fees and pay structures;
e. where engagement is delegated to the fund manager, ensuring adherence to the highest standards of stewardship recognising a spectrum of acceptable stewardship approaches;
f. ensuring commission processes and payments reward relevant and high quality research;
g. ensuring that portfolio turnover is appropriate, in line with expectations and managed effectively; and
h. providing appropriate transparency such that clients can gain confidence about all these issues.

1.3 **Reporting:** Institutional investors should adopt and disclose clearly stated, understandable and consistent policies to guide their approaches to stewardship and voting. Asset owners should report at least annually to those to whom they are accountable on their stewardship policy and its execution. Fund managers and other agents should seek a clear set of objectives and expectations from their clients and beneficiaries, in particular with regard to their investment time-horizon.

1.4 **Public Policy:** Institutional investors should engage as appropriate in the development of relevant public policy and good practice standards and be willing to encourage change where this is deemed helpful by beneficiaries or clients to the delivery of value over appropriate time horizons.

2. Leadership and independence

2.1 **Oversight:** Institutional investors should be led by boards or other governance structures that act independently and without bias, advancing beneficiary or client interests as their primary obligation. Governing bodies, and where relevant, individuals in a fiduciary position of responsibility for ultimate investors, such as pension fund trustees and representative boards, should be aware of their primary oversight role.

2.2 **Constitution**: All decisions should be taken in the interests of the beneficiaries or clients. The governing bodies of investment institutions should therefore have a structure and constitution that reflects this and should be disclosed to beneficiaries and clients, together with explanations as to how such arrangements address alignment with beneficiary interests. They should have mechanisms in place to solicit and receive ongoing feedback from beneficiaries and respond to their concerns.

2.3 **Review**: Institutional investors should also make use of regular independent reviews of their internal governance structures, and respond to any recommendations arising from them, to ensure that they meet expectations of accountability.

2.4 **Time horizons**: Governing bodies should clearly understand the objectives of their beneficiaries or clients, communicate such objectives to fund managers and other agents employed, and ensure they are being met. They should oversee the management of risk and the work of all their agents such that they deliver fully in the interests of the beneficiaries or clients over appropriate time-horizons. In considering what time-horizons are appropriate, institutional investors will need to consider the best interests of their clients and beneficiaries, and any issues of intergenerational fairness between them as well as where the ultimate risk-bearing lies. They should make clear which, if any, public or regulatory authorities have responsibility to monitor and enforce their fiduciary functioning.

2.5 **Appointments**: The way in which individuals are appointed to serve on the governing body should be disclosed to beneficiaries as well as the criteria that are applied to such appointments. Such criteria should always take account of the need for expertise and understanding of the matters for which the governing body is responsible. Governing bodies, particularly of institutional investors where the beneficiaries or clients face the underlying investment risk, should also include representatives of those beneficiaries or clients to build confidence in the collegiality of interests between them. They should reflect the diversity of interests of those whom they represent.

3. Capacity

3.1 **Experience:** Institutional investors should be led by governing bodies and staff with the appropriate capacity and experience to oversee effectively and manage all relevant activities in the interests of beneficiaries or clients. Decision-makers along all parts of the investment chain should be appropriately resourced and meet relevant standards of experience and skill in matters subject to deliberation. All should have appropriate training and induction processes made available to them, and should be able to allocate sufficient time both to that training and induction and to ongoing decision-making.

3.2 **Advice**: Governing bodies should have the right to outside advice, independent from any received by the sponsoring body; they need to have the capacity critically and prudently to evaluate any advice received and to take appropriate decisions themselves, not simply defer to that advice. Fund managers and others in a similar agency position should deploy sufficient, qualified resources properly to deliver on clients' expectations. Institutional investors should be able to justify to beneficiaries or clients specific actions taken on their behalf whether by themselves or by their agents. Institutional investors remain accountable for the delivery of actions even where they have delegated the day-to-day responsibility for carrying them out.

3.3 **Collaboration**: Where an investment institution is not of sufficient scale to have governance structures or internal resources to deliver effective oversight on behalf of beneficiaries or clients, it should consider ways to consolidate, collaborate or build scale such that it is capable of this necessary oversight. This may require dialogue with policymakers and government authorities to facilitate such developments.

4. Conflicts of interest

4.1 **Policies:** Institutional investors should have robust policies to clarify, minimize and help manage conflicts of interest to help ensure that they maintain focus on advancing beneficiary or client interests. In particular, policies should address how matters are handled when the interests of clients or beneficiaries diverge from each other. Any conflict should be promptly disclosed to those to whom the party is immediately accountable in the investment chain.

4.2 **Compliance:** Institutional investors should have effective programmes for dealing with compliance matters and should also consider their obligations to beneficiaries or clients in terms of broader ethical considerations. For example, they should manage appropriately and effectively the risks of bribery and corruption, money laundering and other like risks. They should have effective policies to deal with inside information, avoid market manipulation, and foster transparency and fairness in share trade execution and reporting.

5. Remuneration

5.1 **Alignment:** Institutional investors should reinforce their obligations to act fully in the interests of beneficiaries or clients by setting fee and remuneration structures that provide appropriate alignment over relevant time-horizons, and communicate this to beneficiaries or clients. In large part this will require the structure for fees paid to parties in the investment chain to be more associated with the long-term perspectives which will generate returns over the time-horizon that beneficiaries or clients are seeking. Collective investment vehicles may also seek transparency of the remuneration structures for individuals within the agents that they hire, in particular to gain assurance that these provide appropriate incentives to those individuals. In particular, they may wish to assure themselves that pay structures for individuals do not inappropriately incentivise risk-taking behaviours.

5.2 **Performance:** Consideration should be given to including a long-term performance incentive that reflects long-term investment results or is in the form of an interest in the fund that extends through the period of responsibility for the investments. Good practice is for institutional investors to disclose to their beneficiaries or clients an explanation of how their remuneration structures and performance horizons for individual staff members advance alignment with the interests of beneficiaries or clients. Asset owners may wish to ensure that remuneration frameworks do not unduly constrain their ability to attract and retain well-qualified personnel.

5.3 **Culture**: Remuneration plays a crucial role in establishing and maintaining an appropriate culture or ‘investment behaviour’ within an organisation. As such, institutional investors should consider whether pay is adequately aligned with performance, whether there is an appropriate balance between base pay and incentives, and whether the period over which performance is measured is both short term and longer term. . Having greater proportions of variable rewards deferred for longer periods of time and subject to performance adjustment mechanisms such as claw-back structures, particularly if the deferred awards are invested alongside beneficiaries or clients, is likely to help instil the right mind-set and culture. These measures are an appropriate context for the delivery of value over time for beneficiaries and clients.

6. Monitoring

6.1 **Monitoring Approach:** Institutional investors should regularly monitor investee companies in order to assess their individual circumstances, performance and long-term potential, and to consider whether there is value in intervening to encourage change. Investors should be clear what standards they are applying, and how they monitor investee companies. Monitoring should include:

a. maintaining awareness of the company's ongoing performance, as well as developments within and external to the company that might affect its value and the risks it faces;
b. all relevant factors including the company's approach to environmental and social matters;
c. assessing the effectiveness of the company's governance and leadership;
d. considering the quality of the company's reporting;
e. attending relevant meetings with senior company officers and board directors when appropriate; and
f. where practicable, attendance at general meetings.

6.2 **Company Dialogue:** Institutional investors should seek to identify, as early as possible, any problems that may put significant investment value at risk. If they have concerns they should seek to ensure that the appropriate members of the investee company's board or management are made aware of them as soon as possible. Institutional investors should carefully consider explanations given for any departure from relevant corporate governance codes and make reasoned judgements in each case. Where this could lead to a negative vote or an abstention at a general meeting, the investee company's board should, at least in respect of significant holdings, be contacted to discuss the issue and, if it remains unresolved, notified in writing of the reasons for the decision.

6.3 **Review:** Institutional investors should periodically measure and review the effectiveness of their monitoring and ownership activities and communicate the results to their clients or beneficiaries. Asset owners should monitor the activities and effectiveness of their fund managers and other agents, holding them to account for delivery of value over time according to relevant mandates.

7. Engagement

7.1 **Proactive Engagement:** Institutional investors should engage intelligently and proactively as appropriate with investee companies with the aim of preserving or enhancing value on behalf of beneficiaries or clients. This is particularly constructive in advance of general meetings, to work together to identify agreeable positions and enhance understanding around company strategy, financial performance, risk to long term performance, governance, operations and with respect to social and environmental matters. Engagement is most effective when investors have the adequate knowledge and skills to encourage and effect necessary change.

7.2 **Market Abuse:** Institutional investors should respect market abuse rules and not seek trading advantage through possession of price-sensitive information when engaging with companies. Where appropriate and feasible, investors should consider formally becoming insiders in order to support a process of longer term change, and the intention whether or not to become insiders should be made clear at the outset of the engagement. Companies should ensure that all sensitive information and decisions resulting from engagement are made public for the benefit of all shareholders at the appropriate time.

7.3 **Engagement Approach:** Institutional investors should have a clear approach to engagement which should be communicated to companies as part of an engagement policy. The spectrum of engagement activities may vary, for example depending on the nature of the investment or the size of shareholding, and this will affect the appropriateness of the engagement approach taken with investee companies. In situations where dialogue is not producing the desired result, additional engagement steps that may be taken by investors include:

a. expressing concerns to corporate representatives or non-executive directors, either directly or in a shareholders' meeting;
b. expressing their concern collectively with other investors;
c. making a public statement;
d. submitting shareholder resolutions;
e. speaking at general meetings;
f. submitting one or more nominations for election to the board as appropriate and convening a shareholders' meeting;
g. seeking governance improvements and/or damages through legal remedies or arbitration; and
h. exit or threat of exit from the investment as a last resort.

7.4 **Collective Engagement:** Institutional investors should act collectively as appropriate when engaging with investee companies where this would assist in advancing beneficiary or client interest, taking account of relevant law and regulation. Institutional investors should disclose their policy on collective engagement. Shareholders should not face regulatory barriers to discussions between themselves regarding forthcoming voting decisions or concerning other governance matters. Concert party rules and/or takeover regulations should not prevent shareholders from sharing perspectives about companies in which they have mutual interests and/or concerns.

8. Voting

8.1 Informed Voting: Institutional investors should seek to vote shares held and make informed and independent voting decisions at investee companies, applying due care, diligence and judgment. They should have a clear policy on voting made available to investee companies and beneficiaries or clients.

8.2 Proxy voting: Institutional investors should disclose the extent to which they use proxy research and voting services, including the identity of the service provider and the degree to which any recommendations are followed. Investors should clearly specify how they wish votes to be cast, noting that they cannot delegate their ownership responsibilities, and should ensure that votes cast by intermediaries are carried out in a manner consistent with their own voting policies.

8.3 Vote Decisions: Institutional investors should seek to reach a clear decision either for or against each resolution or, in specific cases, may wish to abstain. Voting decisions and the rationale taken should be made publicly available in due course and, where a vote is contrary to the company board's recommended position, should be communicated to the company in advance of the general meeting. Where an institutional investor chooses not to vote in specific circumstances, or in particular markets or where holdings are below a certain scale threshold, this should be disclosed to clients or beneficiaries in a clear policy.

8.4 Voting Records: Institutional investors should regularly disclose (e.g. quarterly or annually) a summary of their voting activity on a website or other appropriate means and, where possible, their full voting records Voting records should include an indication of whether the votes were cast for or against the recommendations of the company's board.

8.5 Stock Lending: Institutional investors should disclose their approach to stock lending and voting in a clear policy which should clarify the types of circumstances when shares would be recalled to vote. The policy should be communicated to relevant agents in the chain of the vote execution, and, in respect of shares out on loan, to the agent lender.

Institutional investors should recognize that if shares are lent out, they temporarily lose their voting rights for the duration of the loan because they are no longer the legal owner of those shares (unless contractual arrangements to the contrary are made). In order for the votes to be cast, lent stock must be recalled before the record date declared by the company. In order to preserve the integrity of the shareholders' meeting it is important that the shares never be borrowed or received as collateral for the primary purpose of voting them.

The results of stock lending should be transparent to the beneficial owners of shares. The portion of the return from a position due to lending activity should be made known in the regular reports. Similarly, the percentage and number of shares of a given security which were not voted due to stock lending should also be reported to beneficiaries.

D. Joint Venture Governance

Shareowners have a direct interest in the returns, risks, and governance of all wholly- and partly-owned assets that make up public companies. To date, the focus of CalPERS efforts on governance, and that of regulators and investors, has been on wholly-owned business units, subsidiaries, and affiliates of public companies. CalPERS believes that ensuring the effective governance of material equity joint ventures – a key asset class with well-documented and unique performance challenges where there has been historically less transparency than for similar-sized wholly owned businesses – is also an essential part of effective corporate governance.

To enhance investor confidence and to raise performance, CalPERS believes that companies need to raise the level of transparency, accountability, and discipline in the governance of their material joint ventures. As a minimum, any joint venture accounting for 10 percent or more of a publicly-traded parent company's total assets, invested capital, costs or revenues – or that is expected to account for 10 percent of the profit and loss of the corporation – should be viewed as material, as should smaller joint ventures that are strategically important, or that carry disproportionate risks. We believe that companies may wish to adopt a more inclusive standard for materiality, and, for instance, draw the line at joint ventures at or above $500 million in annual revenues or invested capital.

For this class of joint ventures, CalPERS believes that the Company Board – i.e., the Board of parent companies that have ownership interests in joint ventures – should ensure the adoption of certain practices related to these joint ventures:

1. **Corporate-Level Joint Venture Governance Practices**. For any publicly-held company with one or more material joint ventures, that parent company should:

   1.1 Require that the Audit Committee of the Company Board annually review the governance integrity and compliance policies of the company's material joint ventures[26]

   1.2 Designate a Corporate Board member to be responsible for ensuring that the Company's corporate-level strategic business review process includes the Company's material joint ventures, and this review process holds joint ventures to similar performance standards to one another and to similar-sized business units[27]

   1.3 Adopt and make available to the public a set of Joint Venture Governance Guidelines for the Company's material joint ventures (such as those in Appendix I, co-authored by CalPERS and Water Street Partners) which define a set of minimum expectations for overseeing such ventures

[26] Such a review would likely include: i) corporate audit processes, ii) financial reporting, iii) training and compliance programs, and iv) (potentially) Sarbanes Oxley compliance issues for large joint ventures. Note: this Audit Committee review is not intended as a broad-based strategic performance review of individual ventures, but a fact-based conversation about the corporate-level policies and implementation status of various controls related to joint ventures.

[27] It is the experience of the authors that joint ventures – even billion-dollar joint ventures – are routinely left outside the regular corporate-level review process, and are therefore not subject to the same "challenge process" or "restructuring conversations" as wholly-owned business units, which, in turn, drives financial underperformance.

1.4 Designate a Corporate Board member to be responsible for ensuring, on an annual basis, that the Company's material joint ventures are subject to a review of their adherence to these Joint Venture Governance Guidelines, and that the results of the review are discussed and approved by the Corporate Board[28]

2. **Public Disclosure and Transparency.** For any material joint venture that has at least one public company shareholder, that parent company should disclose to its public investors[29]:

2.1 The name, business scope and objectives, and current financial impact of each material joint venture of the Company

2.2 A list of the Lead Director of the Joint Venture Board of Directors of each material joint venture

2.3 Whether each material joint venture is complying with the guidelines outlined in Appendix I; to the extent that the venture is <u>not</u> meeting any of these governance standards, provide an explanation for why such governance standards are not being met[30]

IV. CONCLUSION

By adopting the Global Principles, CalPERS strives to advance corporate governance best practices for the purpose of creating sustainable long-term investment returns and protecting the System's rights as a shareowner. CalPERS encourages other investors to incorporate these Global Principles into ownership policies and practices as a basis for advancing a foundation for accountability between a corporation's board of directors, management and its owners. With continued experience and communication between the board, corporate managers and owners, the issue of accountability can become – if not resolved – more clear.

[28] This Board member may be the Chair of the Audit Committee (and thus link the JV Governance Guidelines into the broader JV compliance and financial integrity review process as described in 1.1), or the same individual as named in 1.2 above.

[29] This applies irrespective of the parent company's equity ownership interest in the venture, or whether the parent company consolidates to joint ventures on its financial statements

[30] Such a "comply and explain" approach - i.e., require that public companies disclose whether they are complying with a set of minimums and, if not, why – has been used in a number of corporate governance situations. For instance, in adopting the Cadbury Code (UK corporate governance guidelines similar to CalPERS guidelines in the US), the London Stock Exchange asked that listed companies reveal in their annual reports whether they were complying with it – and if not, why. We believe that this is a powerful alternative to a "corporate requirement" in JV situations, creating better governance behaviors while also allowing for flexibility across different ventures operating under different circumstances.

APPENDIX A

Principles for Responsible Investment

Launched in April 2006, The Principles for Responsible Investment (PRI) provides the framework for investors to give appropriate consideration to environment, social and corporate governance (ESG) issues. The PRI was an initiative of the UN Secretary-General and coordinated by UNEP Finance Initiative and the UN Global Compact. An international working group of 20 institutional investors was supported by a 70-person multi-stakeholder group of experts from the investment industry, intergovernmental and governmental organizations, civil society and academia. CalPERS is one of the original signatories.

The Principles

1. We will incorporate ESG issues into investment analysis and decision-making processes.

2. We will be active owners and incorporate ESG issues into our ownership policies and practices.

3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4. We will promote acceptance and implementation of the Principles within the investment industry.

5. We will work together to enhance our effectiveness in implementing the Principles.

6. We will each report on our activities and progress towards implementing the Principles.

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles.

Additional information can be found at www.unpri.org.

The Global Sullivan Principles
The Preamble

The Objectives of the Global Sullivan Principles are to support economic, social and political justice by companies where they do business, to support human rights and to encourage equal opportunity at all levels of employment, including racial and gender diversity on decision making committees and Boards; to train and advance disadvantaged workers for technical, supervisory and management opportunities; and to assist with greater tolerance and understanding among peoples, thereby, helping to improve the quality of life for communities, workers and children with dignity and equality.

I urge companies large and small in every part of the world to support and follow the Global Sullivan Principles of corporate social responsibility wherever they have operations.

The Reverend Leon H. Sullivan

The Principles

As a company which endorses the Global Sullivan Principles we will respect the law, and as a responsible member of society we will apply these Principles with integrity consistent with the legitimate role of business. We will develop and implement company policies, procedures, training and internal reporting structures to ensure commitment to these principles throughout our organization. We believe the application of these Principles will achieve greater tolerance and better understanding among peoples, and advance the culture of peace.

Accordingly, we will:

- Express our support for universal human rights and, particularly, those of our employees, the communities within which we operate, and parties with whom we do business.
- Promote equal opportunity for our employees at all levels of the company with respect to issues such as color, race, gender, age, ethnicity or religious beliefs, and operate without unacceptable worker treatment such as the exploitation of children, physical punishment, female abuse, involuntary servitude, or other forms of abuse.
- Respect our employees' voluntary freedom of association.
- Compensate our employees to enable them to meet at least their basic needs and provide the opportunity to improve their skill and capability in order to raise their social and economic opportunities.
- Provide a safe and healthy workplace; protect human health and the environment; and promote sustainable development.
- Promote fair competition including respect for intellectual and other property rights, and not offer, pay or accept bribes.
- Work with governments and communities in which we do business to improve the quality of life in those communities – their educational, cultural, economic and social well-being – and seek to provide training and opportunities for workers from disadvantaged backgrounds.
- Promote the application of these principles by those with whom we do business.

We will be transparent in our implementation of these principles and provide information which demonstrates, publicly, our commitment to them.

United Nations Global Compact Principles

The UN Global Compact's ten principles in the areas of human rights, labor, the environment and anti-corruption enjoy universal consensus and are derived from:

The Universal Declaration of Human Rights
The International Labor Organization's Declaration on Fundamental Principles and Rights at Work
The Rio Declaration on Environment and Development
The United Nations Convention against Corruption
The Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labor standards, the environment, and anti-corruption:

Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and
Principle 2: make sure that they are not complicit in human rights abuses.

Labor Standards

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
Principle 4: the elimination of all forms of forced and compulsory labor;
Principle 5: the effective abolition of child labor; and
Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment

Principle 7: Businesses should support a precautionary approach to environmental challenges;
Principle 8: undertake initiatives to promote greater environmental responsibility; and
Principle 9: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

Council of Institutional Investors
The Voice of Corporate Governance

Corporate Governance Policies (October 1, 2014)

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1.1 Nature and Purpose of the Council's Corporate Governance Policies: Council policies are designed to provide guidelines that the Council has found to be appropriate in most situations. They bind neither members nor corporations.

1.2 Federal and State Law Compliance: The Council expects that corporations will comply with all applicable federal and state laws and regulations and stock exchange listing standards.

1.3 Disclosed Governance Policies and Ethics Code: The Council believes every company should have written, disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement. The Council posts its corporate governance policies on its Web site (www.cii.org); it hopes corporate boards will meet or exceed these standards and adopt similarly appropriate additional policies to best protect shareowners' interests.

1.4 Accountability to Shareowners: Corporate governance structures and practices should protect and enhance a company's accountability to its shareowners, and ensure that they are treated equally. An action should not be taken if its purpose is to reduce accountability to shareowners.

1.5 Shareowner Participation: Shareowners should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation.

1.6 Business Practices and Corporate Citizenship: The Council believes companies should adhere to responsible business practices and practice good corporate citizenship. Promotion, adoption and effective implementation of guidelines for the responsible conduct of business and business relationships are consistent with the fiduciary responsibility of protecting long-term investment interests.

1.7 Governance Practices at Public and Private Companies: Publicly traded companies, private companies and companies in the process of going public should practice good governance. General members of venture capital, buyout and other private equity funds should encourage companies in which they invest to adopt long-term corporate governance provisions that are consistent with the Council's policies.

1.8 Reincorporation: U.S. companies should not reincorporate to offshore locations where corporate governance structures are weaker, which reduces management accountability to shareowners.

1.9 Judicial Forum: Companies should not attempt to restrict the venue for shareowner claims by adopting charter or bylaw provisions that seek to establish an exclusive forum. Nor should companies attempt to bar shareowners from the courts through the introduction of forced arbitration clauses.

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2.1 Annual Election of Directors: All directors should be elected annually. Boards should not be classified (staggered).

2.2 Director Elections: Directors in uncontested elections should be elected by a majority of the votes cast. In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats. To facilitate the shareholder voting franchise, the opposing sides engaged in a contested election should utilize a proxy card naming all management-nominees and all shareholder-proponent nominees, providing every nominee equal prominence on the proxy card.

Directors who fail to receive the support of a majority of votes cast should step down from the board and not be reappointed. A modest transition period may be appropriate under certain circumstances, such as for directors keeping the company in compliance with legal or listing standards. But any director who does not receive the majority of votes cast should leave the board as soon as practicable.

2.3 Independent Board: At least two-thirds of the directors should be independent; their seat on the board should be their only non-trivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer. The company should disclose information necessary for shareowners to determine whether directors qualify as independent. This information should include all of the company's financial or business relationships with and payments to directors and their families and all significant payments to companies, non-profits, foundations and other organizations where company directors serve as employees, officers or directors (*see Council definition of independent director, Section 7, below*).

2.4 Independent Chair/Lead Director: The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.

Other roles of the lead independent director should include chairing meetings of non-management directors and of independent directors, presiding over board meetings in the absence of the chair, serving as the principle liaison between the independent directors and the chair and leading the board/director evaluation process. Given these additional responsibilities, the lead independent director should expect to devote a greater amount of time to board service than the other directors.

2.5 All-independent Board Committees: Companies should have audit, nominating and compensation committees, and all members of these committees should be independent. The board (not the CEO) should appoint the committee chairs and members. Committees should be able to select their own service providers. Some regularly scheduled committee meetings should be held with only the committee members (and, if appropriate, the committee's independent consultants) present. The process by which committee members and chairs are selected should be disclosed to shareowners.

2.6 Board Accountability to Shareowners

a. **Majority Shareowner Votes**: Boards should take actions recommended in shareowner proposals that receive a majority of votes cast for and against. If shareowner approval is required for the action, the board should seek a binding vote on the action at the next shareowner meeting.

b. **Interaction with Shareowners**: Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters. To accomplish this goal, all companies should establish board-shareowner communications policies. Such policies should disclose the ground rules by which directors will meet with shareowners. The policies should also include detailed contact information for at least one independent director (but preferably for the independent board chair and/or the independent lead director and the independent chairs of the audit, compensation and nominating committees). Companies should also establish mechanisms by which shareowners with non-trivial concerns can communicate directly with all directors. Policies requiring that all director communication go through a member of the management team should be avoided unless they are for record-keeping purposes. In such cases, procedures documenting receipt and delivery of the request to the board and its response must be maintained and made available to shareowners upon request. Directors should have access to all communications. Boards should determine whether outside counsel should be present at meetings with shareowners to monitor compliance with disclosure rules.

   All directors should attend the annual shareowners' meetings and be available, when requested by the chair, to answer shareowner questions. During the annual general meeting, shareowners should have the right to ask questions, both orally and in writing. Directors should provide answers or discuss the matters raised, regardless of whether the questions were submitted in advance. While reasonable time limits for questions are acceptable, the board should not ignore a question because it comes from a shareowner who holds a smaller number of shares or who has not held those shares for a certain length of time.

2.7 Board's Role in Risk Oversight: The board has ultimate responsibility for risk oversight. The board should (1) establish a company's risk management philosophy and risk appetite; (2) understand and ensure risk management practices for the company; (3) regularly review risks in relation to the risk appetite; and (4) evaluate how management responds to the most significant risks. In determining the risk profile, the board should consider the dynamics of the company, its industry and any systemic risks. Council policies on other critical corporate governance matters, such as executive compensation (*see 5.1, the Council's policy on executive compensation, below*), reinforce the importance of the board's consideration of risk factors. Effective risk oversight requires regular, meaningful communication between the board and management, among board members and committees, and between the board and any outside advisers it consults, about the company's material risks and risk management processes. The board should disclose to shareowners, at least annually, sufficient information to enable them to assess whether the board is carrying out its oversight responsibilities effectively.

2.7 **Board/Director Succession Planning and Evaluation**

a. **Board Succession Planning**: The board should implement and disclose a board succession plan that involves preparing for future board retirements, committee assignment rotations, committee chair nominations and overall implementation of the company's long-term business plan. Boards should establish clear procedures to encourage and consider board nomination suggestions from long-term shareowners. The board should respond positively to shareowner requests seeking to discuss incumbent and potential directors.

b. **Board Diversity**: The Council supports a diverse board. The Council believes a diverse board has benefits that can enhance corporate financial performance, particularly in today's global market place. Nominating committee charters, or equivalent, ought to reflect that boards should be diverse, including such considerations as background, experience, age, race, gender, ethnicity, and culture.

c. **Evaluation of Directors**: Boards should review their own performance periodically. That evaluation should include a review of the performance and qualifications of any director who received "against" votes from a significant number of shareowners or for whom a significant number of shareowners withheld votes.

d. **Board and Committee Meeting Attendance**: Absent compelling and stated reasons, directors who attend fewer than 75 percent of board and board-committee meetings for two consecutive years should not be re-nominated. Companies should disclose individual director attendance figures for board and committee meetings. Disclosure should distinguish between in-person and telephonic attendance. Excused absences should not be categorized as attendance.

2.9 CEO Succession Planning: The board should approve and maintain a detailed CEO succession plan and publicly disclose the essential features. An integral facet of management succession planning involves collaboration between the board and the current chief executive to develop the next generation of leaders from within the company's ranks. Boards therefore should: (1) make sure that broad leadership development programs are in place generally; and (2) carefully identify multiple candidates for the CEO role specifically, well before the position needs to be filled.

2.10 Continuing Directors: Corporations should not adopt so-called "continuing director" provisions (also known as "dead-hand" or "no-hand" provisions, which are most commonly seen in connection with a potential change in control of the company) that allow board actions to be taken only by: (1) those continuing directors who were also in office when a specified event took place or (2) a combination of continuing directors plus new directors who are approved by such continuing directors.

2.11 Board Size and Service: Absent compelling, unusual circumstances, a board should have no fewer than five and no more than 15 members (not too small to maintain the needed expertise and independence, and not too large to function efficiently). Shareowners should be allowed to vote on any major change in board size.

Companies should establish and publish guidelines specifying on how many other boards their directors may serve. Absent unusual, specified circumstances, directors with full-time jobs should not serve on more than two other boards. Currently serving CEOs should not serve as a director of more than one other company, and then only if the CEO's own company is in the top half of its peer group. No other director should serve on more than five for-profit company boards.

2.12 Board Operations

a. **Informed Directors**: Directors should receive training from independent sources on their fiduciary responsibilities and liabilities. Directors have an affirmative obligation to become and remain independently familiar with company operations; they should not rely exclusively on information provided to them by the CEO to do their jobs. Directors should be provided meaningful information in a timely manner prior to board meetings and should be allowed reasonable access to management to discuss board issues.

b. **Director Rights Regarding Board Agenda**: Any director should be allowed to place items on the board's agenda.

c. **Executive Sessions**: The independent directors should hold regularly scheduled executive sessions without any of the management team or its staff present.

2.13 Auditor Independence

a. **Audit Committee Responsibilities Regarding Outside Auditors**: The audit committee should have the responsibility to hire, oversee and, if necessary, fire the company's outside auditor.

b. **Competitive Bids**: The audit committee should seek competitive bids for the external audit engagement at least every five years.

c. **Non-audit Services**: A company's external auditor should not perform any non-audit services for the company, except those, such as attest services, that are required by statute or regulation to be performed by a company's external auditor.

d. **Audit Committee Charters**: The proxy statement should include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter.

e. **Liability of Outside Auditors**: Companies should not agree to limit the liability of outside auditors.

f. **Shareowner Votes on the Board's Choice of Outside Auditor**: Audit committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor. Such provisions should state that if the board's selection fails to achieve the support of a majority of the for-and-against votes cast, the audit committee should: (1) take the shareowners' views into consideration and reconsider its choice of auditor and (2) solicit the views of major shareowners to determine why broad levels of shareowner support were not achieved.

g. **Disclosure of Reasons Behind Auditor Changes**: The audit committee should publicly provide to shareowners a plain-English explanation of the reasons for a change in the company's external auditors. At a minimum, this disclosure should be contained in the same Securities and Exchange Commission (SEC) filing that companies are required to submit within four days of an auditor change.

2.14 Charitable and Political Contributions

a. **Board Monitoring, Assessment and Approval**: The board of directors should monitor, assess and approve all charitable and political contributions (including trade association contributions) made by the company. The board should only approve contributions that are consistent with the interests of the company and its shareowners. The terms and conditions of such contributions should be clearly defined and approved by the board.

b. **Disclosure**: The board should develop and disclose publicly its guidelines for approving charitable and political contributions. The board should disclose on an annual basis the amounts and recipients of all monetary and non-monetary contributions made by the company during the prior fiscal year. Any expenditures earmarked for political or charitable activities that were provided to or through a third-party should be included in the report.

2.15 Directors with Conflicts: A director with a conflict of interest in a matter before the board should immediately communicate all facts about the conflict and abstain from voting on the matter. Deliberation on the matter should take place only among non-conflicted directors. The content of the deliberations, both verbal and written, should not be shared with the conflicted director. Prior to deliberation, the non-conflicted directors should have discretion to invite the conflicted director to share information that could help inform the vote. The conflicted director should comply if such communication is not prohibited by contract or law.

3. <u>Shareowner Voting Rights</u>

3.1 Right to Vote is Inviolate
3.2 Access to the Proxy
3.3 One Share, One Vote
3.4 Advance Notice, Holding Requirements and Other Provisions
3.5 Confidential Voting
3.6 Voting Requirements
3.7 Broker Votes
3.8 Bundled Voting

3.1 Right to Vote is Inviolate: A shareowners' right to vote is inviolate and should not be abridged.

3.2 Access to the Proxy: Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least three percent of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least two years. Company proxy materials and related mailings should provide equal space and equal treatment of nominations by qualifying investors.

To allow for informed voting decisions, it is essential that investors have full and accurate information about access mechanism users and their director nominees. Therefore, shareowners nominating director candidates under an access mechanism should adhere to the same SEC rules governing disclosure requirements and prohibitions on false and misleading statements that currently apply to proxy contests for board seats.

3.3 One Share, One Vote: Each share of common stock should have one vote. Corporations should not have classes of common stock with disparate voting rights. Authorized, unissued common shares that have voting rights to be set by the board should not be issued with unequal voting rights without shareowner approval.

3.4 Advance Notice, Holding Requirements and Other Provisions: Advance notice bylaws, holding requirements, disclosure rules and any other company imposed regulations on the ability of shareowners to solicit proxies beyond those required by law should not be so onerous as to deny sufficient time, limit the pool of eligible candidates, or otherwise make it impractical for shareowners to submit nominations or proposals and distribute supporting proxy materials.

3.5 Confidential Voting: All proxy votes should be confidential, with ballots counted by independent tabulators. Confidentiality should be automatic, permanent and apply to all ballot items. Rules and practices concerning the casting, counting and verifying of shareowner votes should be clearly disclosed.

3.6 Voting Requirements: A majority vote of common shares outstanding should be sufficient to amend company bylaws or take other action that requires or receives a shareowner vote. Supermajority votes should not be required. A majority vote of common shares outstanding should be required to approve:

a. Major corporate decisions concerning the sale or pledge of corporate assets that would have a material effect on shareowner value. Such a transaction will automatically be deemed to have a material effect if the value of the assets exceeds 10 percent of the assets of the company and its subsidiaries on a consolidated basis;

b. The corporation's acquisition of five percent or more of its common shares at above-market prices other than by tender offer to all shareowners;

c. Poison pills;

d. Abridging or limiting the rights of common shares to: (1) vote on the election or removal of directors or the timing or length of their term of office or (2) nominate directors or propose other action to be voted on by shareowners or (3) call special meetings of shareowners or take action by written consent or change the procedure for fixing the record date for such action; and

e. Issuing debt to a degree that would excessively leverage the company and imperil its long-term viability.

3.7 Broker Votes: Uninstructed broker votes and abstentions should be counted only for purposes of a quorum.

3.8 Bundled Voting: Shareowners should be allowed to vote on unrelated issues separately. Individual voting issues (particularly those amending a company's charter), bylaws or anti-takeover provisions should not be bundled.

4. Shareowner Meetings

4.1 Selection and Notification of Meeting Time and Location
4.2 Shareowner Rights to Call Special Meetings
4.3 Record Date and Ballot Item Disclosure
4.4 Timely Disclosure of Voting Results
4.5 Election Polls
4.6 Meeting Adjournment and Extension
4.7 Electronic Meetings
4.8 Director Attendance

4.1 Selection and Notification of Meeting Time and Location: Corporations should make shareowners' expense and convenience primary criteria when selecting the time and location of shareowner meetings. Appropriate notice of shareowner meetings, including notice concerning any change in meeting date, time, place or shareowner action, should be given to shareowners in a manner and within time frames that will ensure that shareowners have a reasonable opportunity to exercise their franchise.

4.2 Shareowner Rights to Call Special Meetings: Shareowners should have the right to call special meetings.

4.3 Record Date and Ballot Item Disclosure: To promote the ability of shareowners to make informed decisions regarding whether to recall loaned shares: (1) shareowner meeting record dates should be disclosed as far in advance of the record date as possible, and (2) proxy statements should be disclosed before the record date passes whenever possible.

4.4 Timely Disclosure of Voting Results: A company should broadly and publicly disclose in a timely manner the final results of votes cast at annual and special meetings of shareowners. Whenever possible, preliminary results should be announced at the annual or special meeting of shareowners.

4.5 Election Polls: Polls should remain open at shareowner meetings until all agenda items have been discussed and shareowners have had an opportunity to ask and receive answers to questions concerning them.

4.6 Meeting Adjournment and Extension: Companies should not adjourn a meeting for the purpose of soliciting more votes to enable management to prevail on a voting item. A meeting should only be extended for compelling reasons such as vote fraud, problems with the voting process or lack of a quorum.

4.7 Electronic Meetings: Companies should hold shareowner meetings by remote communication (so-called “virtual” meetings) only as a supplement to traditional in-person shareowner meetings, not as a substitute.

Companies incorporating virtual technology into their shareowner meeting should use it as a tool for broadening, not limiting, shareowner meeting participation. With this objective in mind, a virtual option, if used, should facilitate the opportunity for remote attendees to participate in the meeting to the same degree as in-person attendees.

4.8 Director Attendance: As noted in Section 2, “The Board of Directors,” all directors should attend the annual shareowners’ meeting and be available, when requested by the chair, to respond directly to oral or written questions from shareowners.

5. Executive Compensation

5.1 Introduction
5.2 Advisory Shareowner Votes on Executive Pay
5.3 Gross-ups
5.4 Shareowner Approval of Equity-based Compensation Plans
5.5 Role of Compensation Committee
5.6 Salary
5.7 Annual Incentive Compensation
5.8 Long-term Incentive Compensation
5.9 Dilution
5.10 Stock Option Awards
5.11 Stock Awards/Units
5.12 Perquisites
5.13 Employment Contracts, Severance and Change-of-control Payments
5.14 Retirement Arrangements
5.15 Stock Ownership

5.1 Introduction: The Council believes that executive compensation is a critical and visible aspect of a company’s governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term, consistent with a company’s investment horizon. “Long-term” is generally considered to be five or more years for mature companies and at least three years for other companies. While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid. It is the job of the board of directors and the compensation committee specifically to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance, industry considerations, risk considerations and compensation paid to other employees.

It is also the job of the compensation committee to ensure that elements of compensation packages are appropriately structured to enhance the company's short- and long-term strategic goals and to retain and motivate executives to achieve those strategic goals. Compensation programs should not be driven by competitive surveys, which have become excessive and subject to abuse. It is shareowners, not executives, whose money is at risk.

Since executive compensation must be tailored to meet unique company needs and situations, compensation programs must always be structured on a company-by-company basis. However, certain principles should apply to all companies.

5.2 Advisory Shareowner Votes on Executive Pay: All companies should provide annually for advisory shareowner votes on the compensation of senior executives.

5.3 Gross-ups: Senior executives should not receive gross-ups beyond those provided to all the company's employees.

5.4 Shareowner Approval of Equity-based Compensation Plans: Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). The Council strongly supports this concept and advocates that companies adopt conservative interpretations of approval requirements when confronted with choices. (For example, this may include material amendments to the plan.)

5.5 Role of Compensation Committee: The compensation committee is responsible for structuring executive pay and evaluating executive performance within the context of the pay structure of the entire company, subject to approval of the board of directors. To best handle this role, compensation committees should adopt the following principles and practices:

a. **Committee Composition**: All members of the compensation committee should be independent. Committee membership should rotate periodically among the board's independent directors. Members should be or take responsibility to become knowledgeable about compensation and related issues. They should exercise due diligence and independent judgment in carrying out their committee responsibilities. They should represent diverse backgrounds and professional experiences.

b. **Executive Pay Philosophy**: The compensation philosophy should be clearly disclosed to shareowners in annual proxy statements. In developing, approving and monitoring the executive pay philosophy, the compensation committee should consider the full range of pay components, including structure of programs, desired mix of cash and equity awards, goals for distribution of awards throughout the company, the relationship of executive pay to the pay of other employees, use of employment contracts and policy regarding dilution.

c. **Oversight**: The compensation committee should vigorously oversee all aspects of executive compensation for a group composed of the CEO and other highly paid executives, as required by law, and any other highly paid employees, including executives of subsidiaries, special purpose entities and other affiliates, as determined by the compensation committee. The committee should ensure that the structure of employee compensation throughout the company is fair, non-discriminatory and forward-looking, and that it motivates, recruits and retains a workforce capable of meeting the company's strategic objectives. To perform its oversight duties, the committee should approve, comply with and fully disclose a charter detailing its responsibilities.

d. **Pay for Performance**: Compensation of the executive oversight group should be driven predominantly by performance. The compensation committee should establish performance measures for executive compensation that are agreed to ahead of time and publicly disclosed. Multiple performance measures should be used in an executive's incentive program, and the measures should be sufficiently diverse that they do not simply reward the executive multiple times for the same performance. The measures should be aligned with the company's short- and long-term strategic goals, and pay should incorporate company-wide performance metrics, not just business unit performance criteria.

   Performance measures applicable to all performance-based awards (including annual and long-term incentive compensation) should reward superior performance—based predominantly on measures that drive long-term value creation—at minimum reasonable cost. Such measures should also reflect downside risk. The compensation committee should ensure that key performance metrics cannot be manipulated easily.

   The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid out to executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous due to fraud, financial results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. The mechanisms and policies should be publicly disclosed.

e. **Annual Approval and Review**: Each year, the compensation committee should review performance of individuals in the oversight group and approve any bonus, severance, equity-based award or extraordinary payment made to them. The committee should understand all components of executive compensation and annually review total compensation potentially payable to the oversight group under all possible scenarios, including death/disability, retirement, voluntary termination, termination with and without cause and changes of control. The committee should also ensure that the structure of pay at different levels (CEO and others in the oversight group, other executives and non-executive employees) is fair and appropriate in the context of broader company policies and goals and fully justified and explained.

f. **Committee Accountability**: In addition to attending all annual and special shareowner meetings, committee members should be available to respond directly to questions about executive compensation; the chair of the committee should take the lead. In addition, the committee should regularly report on its activities to the independent directors of the board, who should review and ratify committee decisions. Committee members should take an active role in preparing the compensation committee report contained in the annual proxy materials, and be responsible for the contents of that report.

g. **Outside Advice**: The compensation committee should retain and fire outside experts, including consultants, legal advisers and any other advisers when it deems appropriate, including when negotiating contracts with executives. Individual compensation advisers and their firms should be independent of the client company, its executives and directors and should report solely to the compensation committee. The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management. Companies should not agree to indemnify or limit the liability of compensation advisers or the advisers' firms.

h. **Disclosure Practices**: The compensation committee is responsible for ensuring that all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations. The compensation committee should disclose all information necessary for shareowners to understand how and how much executives are paid and how such pay fits within the overall pay structure of the company. It should provide annual proxy statement disclosure of the committee's compensation decisions with respect to salary, short-term incentive compensation, long-term incentive compensation and all other aspects of executive compensation, including the relative weights assigned to each component of total compensation.

   The compensation committee should commit to provide full descriptions of the qualitative and quantitative performance measures and benchmarks used to determine compensation, including the weightings and rationale for each measure. At the beginning of a period, the compensation committee should calculate and disclose the maximum compensation payable if all performance-related targets are met. At the end of the performance cycle, the compensation committee should disclose actual targets and details on final payouts. Companies should provide forward-looking disclosure of performance targets whenever possible. Other recommended disclosures relevant to specific elements of executive compensation are detailed below.

i. Benchmarking: Benchmarking at median or higher levels is a primary contributor to escalating executive compensation. Although benchmarking can be a constructive tool for formulating executive compensation packages, it should not be relied on exclusively. If benchmarking is used, compensation committees should commit to annual disclosure of the companies in peer groups used for benchmarking and/or other comparisons. If the peer group used for compensation purposes differs from that used to compare overall performance, such as the five-year stock return graph required in the annual proxy materials, the compensation committee should describe the differences between the groups and the rationale for choosing between them. In addition to disclosing names of companies used for benchmarking and comparisons, the compensation committee should disclose targets for each compensation element relative to the peer/benchmarking group and year-to-year changes in companies composing peer/benchmark groups.

5.6 Salary

a. **Salary Level**: Since salary is one of the few components of executive compensation that is not "at risk," it should be set at a level that yields the highest value for the company at least cost. In general, salary should be set to reflect responsibilities, tenure and past performance, and to be tax efficient—meaning no more than $1 million.

b. **Above-median Salary**: The compensation committee should publicly disclose its rationale for paying salaries above the median of the peer group.

5.7 Annual Incentive Compensation: Cash incentive compensation plans should be structured to align executive interests with company goals and objectives. They should also reasonably reward superior performance that meets or exceeds well-defined and clearly disclosed performance targets that reinforce long-term strategic goals that were written and approved by the board in advance of the performance cycle.

a. Formula Plans: The compensation committee should approve formulaic bonus plans containing specific qualitative and quantitative performance-based operational measures designed to reward executives for superior performance related to operational/strategic/other goals set by the board. Such awards should be capped at a reasonable maximum level. These caps should not be calculated as percentages of accounting or other financial measures (such as revenue, operating income or net profit), since these figures may change dramatically due to mergers, acquisitions and other non-performance-related strategic or accounting decisions.

b. Targets: When setting performance goals for "target" bonuses, the compensation committee should set performance levels below which no bonuses would be paid and above which bonuses would be capped.

c. Changing Targets: Except in extraordinary situations, the compensation committee should not "lower the bar" by changing performance targets in the middle of bonus cycles. If the committee decides that changes in performance targets are warranted in the middle of a performance cycle, it should disclose the reasons for the change and details of the initial targets and adjusted targets.

5.8 Long-term Incentive Compensation: Long-term incentive compensation, generally in the form of equity-based awards, can be structured to achieve a variety of long-term objectives, including retaining executives, aligning executives' financial interests with the interests of shareowners and rewarding the achievement of long-term specified strategic goals of the company and/or the superior performance of company stock.

But poorly structured awards permit excessive or abusive pay that is detrimental to the company and to shareowners. To maximize effectiveness and efficiency, compensation committees should carefully evaluate the costs and benefits of long-term incentive compensation, ensure that long-term compensation is appropriately structured and consider whether performance and incentive objectives would be enhanced if awards were distributed throughout the company, not simply to top executives.

Companies may rely on a myriad of long-term incentive vehicles to achieve a variety of long-term objectives, including performance-based restricted stock/units, phantom shares, stock units and stock options. While the technical underpinnings of long-term incentive awards may differ, the following principles and practices apply to all long-term incentive compensation awards. And, as detailed below, certain policies are relevant to specific types of long-term incentive awards.

a. **Size of Awards**: Compensation committees should set appropriate limits on the size of long-term incentive awards granted to executives. So-called “mega-awards” or outsized awards should be avoided, except in extraordinary circumstances, because they can be disproportionate to performance.

b. **Vesting Requirements**: All long-term incentive awards should have meaningful performance periods and/or cliff vesting requirements that are consistent with the company’s investment horizon but not less than three years, followed by pro rata vesting over at least two subsequent years for senior executives.

c. **Grant Timing**: Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards should be granted at the same time each year. Companies should not coordinate stock award grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock options should never be backdated.

d. **Hedging**: Compensation committees should prohibit executives and directors from hedging (by buying puts and selling calls or employing other risk-minimizing techniques) equity-based awards granted as long-term incentive compensation or other stock holdings in the company. And they should strongly discourage other employees from hedging their holdings in company stock.

e. **Philosophy/Strategy**: Compensation committees should have a well-articulated philosophy and strategy for long-term incentive compensation that is fully and clearly disclosed in the annual proxy statement.

f. **Award Specifics**: Compensation committees should disclose the size, distribution, vesting requirements, other performance criteria and grant timing of each type of long-term incentive award granted to the executive oversight group. Compensation committees also should explain how each component contributes to the company’s long-term performance objectives.

g. **Ownership Targets**: Compensation committees should disclose whether and how long-term incentive compensation may be used to satisfy meaningful stock ownership requirements. Disclosure should include any post-exercise holding periods or other requirements to ensure that long-term incentive compensation is used appropriately to meet ownership targets.

h. **Expiration Dates**: Compensation plans should have expiration dates and not be structured as “evergreen,” rolling plans.

5.9 Dilution: Dilution measures how much the additional issuance of stock may reduce existing shareowners’ stake in a company. Dilution is particularly relevant for long-term incentive compensation plans since these programs essentially issue stock at below-market prices to the recipients. The potential dilution represented by long-term incentive compensation plans is a direct cost to shareowners.

Dilution from long-term incentive compensation plans may be evaluated using a variety of techniques including the reduction in earnings per share and voting power resulting from the increase in outstanding shares.

a. Philosophy/Strategy: Compensation committees should develop and disclose the philosophy regarding dilution including definition(s) of dilution, peer group comparisons and specific targets for annual awards and total potential dilution represented by equity compensation programs for the current year and expected for the subsequent four years.

b. Stock Repurchase Programs: Stock buyback decisions are a capital allocation decision and should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans. The compensation committee should provide information about stock repurchase programs and the extent to which such programs are used to minimize the dilution of equity-based compensation plans.

c. Tabular Disclosure: The annual proxy statement should include a table detailing the overhang represented by unexercised options and shares available for award and a discussion of the impact of the awards on earnings per share.

5.10 Stock Option Awards: Stock options give holders the right, but not the obligation, to buy stock in the future. Options may be structured in a variety of ways. Some structures and policies are preferable because they more effectively ensure that executives are compensated for superior performance. Other structures and policies are inappropriate and should be prohibited.

a. Performance Options: Stock options should be: (1) indexed to peer groups or (2) premium-priced and/or (3) vest on achievement of specific performance targets that are based on challenging quantitative goals.

b. Dividend Equivalents: To ensure that executives are neutral between dividends and stock price appreciation, dividend equivalents should be granted with stock options, but distributed only upon exercise of the option.

c. Discount Options: Discount options should not be awarded.

d. Reload Options: Reload options should be prohibited.

e. Option Repricing: “Underwater” options should not be repriced or replaced (either with new options or other equity awards), unless approved by shareowners. Repricing programs, with shareowner approval, should exclude directors and executives, restart vesting periods and mandate value-for-value exchanges in which options are exchanged for a number of equivalently valued options/shares.

5.11 Stock Awards/Units: Stock awards/units and similar equity-based vehicles generally grant holders stock based on the attainment of performance goals and/or tenure requirements. These types of awards are more expensive to the company than options, since holders generally are not required to pay to receive the underlying stock, and therefore should be limited in size.

Stock awards should be linked to the attainment of specified performance goals and in some cases to additional time-vesting requirements. Stock awards should not be payable based solely on the attainment of tenure requirements.

5.12 Perquisites: Company perquisites blur the line between personal and business expenses. Executives, not companies, should be responsible for paying personal expenses—particularly those that average employees routinely shoulder, such as family and personal travel, financial planning, club memberships and other dues. The compensation committee should ensure that any perquisites are warranted and have a legitimate business purpose, and it should consider capping all perquisites at a *de minimis* level. Total perquisites should be described, disclosed and valued.

5.13 Employment Contracts, Severance and Change-of-control Payments: Various arrangements may be negotiated to outline terms and conditions for employment and to provide special payments following certain events, such as a termination of employment with/without cause and/or a change in control. The Council believes that these arrangements should be used on a limited basis.

a. **Employment Contracts**: Companies should only provide employment contracts to executives in limited circumstances, such as to provide modest, short-term employment security to a newly hired or recently promoted executive. Such contracts should have a specified termination date (not to exceed three years); contracts should not be "rolling" on an open-ended basis.

b. **Severance Payments**: Executives should not be entitled to severance payments in the event of termination for poor performance, resignation under pressure or failure to renew an employment contract. Company payments awarded upon death or disability should be limited to compensation already earned or vested.

c. **Change-in-control Payments**: Any provisions providing for compensation following a change-in-control event should be "double-triggered." That is, such provisions should stipulate that compensation is payable only: (1) after a control change actually takes place and (2) if a covered executive's job is terminated because of the control change.

d. **Transparency**: The compensation committee should fully and clearly describe the terms and conditions of employment contracts and any other agreements/arrangements covering the executive oversight group and reasons why the compensation committee believes the agreements are in the best interests of shareowners.

e. **Timely Disclosure**: New executive employment contracts or amendments to existing contracts should be immediately disclosed in 8-K filings and promptly disclosed in subsequent 10-Qs.

f. **Shareowner Ratification**: Shareowners should ratify all employment contracts, side letters or other agreements providing for severance, change-in-control or other special payments to executives exceeding 2.99 times average annual salary plus annual bonus for the previous three years.

5.14 Retirement Arrangements: Deferred compensation plans, supplemental executive retirement plans, retirement packages and other retirement arrangements for highly paid executives can result in hidden and excessive benefits. Special retirement arrangements—including those structured to permit employees whose compensation exceeds Internal Revenue Service (IRS) limits to fully participate in similar plans covering other employees—should be consistent with programs offered to the general workforce, and they should be reasonable.

a. **Supplemental Executive Retirement Plans (SERPs)**: Supplemental plans should be an extension of the retirement program covering other employees. They should not include special provisions that are not offered under plans covering other employees, such as above-market interest rates and excess service credits. Payments such as stock and stock options, annual/long-term bonuses and other compensation not awarded to other employees and/or not considered in the determination of retirement benefits payable to other employees should not be considered in calculating benefits payable under SERPs.

b. **Deferred Compensation Plans**: Investment alternatives offered under deferred compensation plans for executives should mirror those offered to employees in broad-based deferral plans. Above-market returns should not be applied to executive deferrals, nor should executives receive "sweeteners" for deferring cash payments into company stock.

c. **Post-retirement Exercise Periods**: Executives should be limited to three-year post-retirement exercise periods for stock option grants.

d. **Retirement Benefits**: Executives should not be entitled to special perquisites—such as apartments, automobiles, use of corporate aircraft, security, financial planning—and other benefits upon retirement. Executives are highly compensated employees who should be more than able to cover the costs of their retirement.

5.15 Stock Ownership

a. **Ownership Requirements**: Executives and directors should own, after a reasonable period of time, a meaningful position in the company's common stock. Executives should be required to own stock—excluding unexercised options and unvested stock awards—equal to a multiple of salary. The stock subject to the ownership requirements should not be pledged or otherwise encumbered. The multiple should be scaled based on position, for example: two times salary for lower-level executives and up to six times salary for the CEO.

b. **Stock Sales**: Executives should be required to sell stock through pre-announced 10b5-1 program sales or by providing a minimum 30-day advance notice of any stock sales. 10b5-1 program adoptions, amendments, terminations and transactions should be disclosed immediately, and boards of companies using 10b5-1 plans should: (1) adopt policies covering plan practices, (2) periodically monitor plan transactions and (3) ensure that company policies discuss plan use in the context of guidelines or requirements on equity hedging, holding and ownership.

c. **Post-retirement Holdings**: Executives should be required to continue to satisfy the minimum stock holding requirements for at least six months after leaving the company.

d. **Transparency**: Companies should disclose stock ownership requirements and whether any members of the executive oversight group are not in compliance.

6. Director Compensation

6.1 Introduction: Given the vital importance of their responsibilities, non-employee directors should expect to devote significant time to their boardroom duties.

Policy issues related to director compensation are fundamentally different from executive compensation. Director compensation policies should accomplish the following goals: (1) attract highly qualified candidates, (2) retain highly qualified directors, (3) align directors' interests with those of the long-term owners of the corporation and (4) provide complete disclosure to shareowners regarding all components of director compensation including the philosophy behind the program and all forms of compensation.

To accomplish these goals, director compensation should consist solely of a combination of cash retainer and equity-based compensation. The cornerstone of director compensation programs should be alignment of interests through the attainment of significant equity holdings in the company meaningful to each individual director. The Council believes that equity obtained with an individual's own capital provides the best alignment of interests with other shareowners. However, compensation plans can provide supplemental means of obtaining long-term equity holdings through equity compensation, long-term holding requirements and ownership requirements.

Companies should have flexibility within certain broad policy parameters to design and implement director compensation plans that suit their unique circumstances. To support this flexibility, investors must have complete and clear disclosure of both the philosophy behind the compensation plan as well as the actual compensation awarded under the plan. Without full disclosure, it is difficult to earn investors' confidence and support for director and executive compensation plans.

Although non-employee director compensation is generally immaterial to a company's bottom line and small relative to executive pay, director compensation is an important piece of a company's governance. Because director pay is set by the board and has inherent conflicts of interest, care must be taken to ensure there is no appearance of impropriety. Companies should pay particular attention to managing these conflicts.

6.2 Role of the Compensation Committee in Director Compensation: The compensation committee (or alternative committee comprised solely of independent directors) is responsible for structuring director pay, subject to approval of all the independent directors, so that it is aligned with the long-term interests of shareowners. Because directors set their own compensation, the following practices should be emphasized:

a. **Total Compensation Review**: The compensation committee should understand and value each component of director compensation and annually review total compensation potentially payable to each director.

b. **Outside Advice**: Committees should have the ability to hire a compensation consultant for assistance on director compensation plans. In cases where the compensation committee does use a consultant, it should always retain an independent compensation consultant or other advisers it deems appropriate to assist with the evaluation of the structure and value of director compensation. A summary of the pay consultant's advice should be provided in the annual proxy statement in plain English. The compensation committee should disclose all instances where the consultant is also retained by the committee to provide advice on executive compensation.

c. **Compensation Committee Report**: The annual director compensation disclosure included in the proxy materials should include a discussion of the philosophy for director pay and the processes for setting director pay levels. Reasons for changes in director pay programs should be explained in plain English. Peer group(s) used to compare director pay packages should be fully disclosed, along with differences, if any, from the peer group(s) used for executive pay purposes. While peer analysis can be valuable, peer-relative justification should not dominate the rationale for (higher) pay levels. Rather, compensation programs should be appropriate for the circumstances of the company. The report should disclose how many committee meetings involved discussions of director pay.

6.3 Retainer

a. **Amount of Annual Retainer**: The annual retainer should be the sole form of cash compensation paid to non-employee directors. Ideally, it should reflect an amount appropriate for a director's expected duties, including attending meetings, preparing for meetings/discussions and performing due diligence on sites/operations (which should include routine communications with a broad group of employees). In some combination, the retainer and the equity component also reflect the director's contribution from experience and leadership. Retainer amounts may be differentiated to recognize that certain non-employee directors—possibly including independent board chairs, independent lead directors, committee chairs or members of certain committees—are expected to spend more time on board duties than other directors.

b. **Meeting Attendance Fees**: Directors should not receive any meeting attendance fees since attending meetings is the most basic duty of a non-employee director.

c. **Director Attendance Policy**: The board should have a clearly defined attendance policy. If the committee imposes financial consequences (loss of a portion of the retainer or equity) for missing meetings as part of the director compensation program, this should be fully disclosed. Financial consequences for poor attendance, while perhaps appropriate in some circumstances, should not be considered in lieu of examining the attendance record, commitment (time spent on director duties) and contribution in any review of director performance and in re-nomination decisions.

6.4 Equity-based Compensation: Equity-based compensation can be an important component of director compensation. These tools are perhaps best suited to instill optimal long-term perspective and alignment of interests with shareowners. To accomplish this objective, director compensation should contain an ownership requirement or incentive and minimum holding period requirements.

a. **Vesting of Equity-based Awards**: To complement the annual retainer and align director-shareowner interests, non-employee directors should receive stock awards or stock-related awards such as phantom stock or share units. Equity-based compensation to non-employee directors should be fully vested on the grant date. This point is a marked difference to the Council's policy on executive compensation, which calls for performance-based vesting of equity-based awards. While views on this topic are mixed, the Council believes that the benefits of immediate vesting outweigh the complications. The main benefits are the immediate alignment of interests with shareowners and the fostering of independence and objectivity for the director.

b. **Ownership Requirements**: Ownership requirements should be at least three to five times annual compensation. However, some qualified director candidates may not have financial means to meet immediate ownership thresholds. For this reason, companies may set either a minimum threshold for ownership or offer an incentive to build ownership. This concept should be an integral component of the committee's disclosure related to the philosophy of director pay. It is appropriate to provide a reasonable period of time for directors to meet ownership requirements or guidelines.

c. **Holding Periods**: Separate from ownership requirements, the Council believes companies should adopt holding requirements for a significant majority of equity-based grants. Directors should be required to retain a significant portion (such as 80 percent) of equity grants until after they retire from the board. These policies should also prohibit the use of any transactions or arrangements that mitigate the risk or benefit of ownership to the director. Such transactions and arrangements inhibit the alignment of interests that equity compensation and ownership requirements provide.

d. **Mix of Cash and Equity-based Compensation**: Companies should have the flexibility to set and adjust the split between equity-based and cash compensation as appropriate for their circumstances. The rationale for the ratio used is an important element of disclosures related to the overall philosophy of director compensation and should be disclosed.

e. **Transparency**: The present value of equity awards paid to each director during the previous year and the philosophy and process used in determining director pay should be fully disclosed in the proxy statement.

f. **Shareowner Approval**: Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). Companies should adopt conservative interpretations of approval requirements when confronted with choices.

6.5 Performance-based Compensation: While the Council is a strong advocate of performance-based concepts in executive compensation, we do not support performance measures in director compensation. Performance-based compensation for directors creates potential conflicts with the director's primary role as an independent representative of shareowners.

6.6 Perquisites: Directors should not receive perquisites other than those that are meeting-related, such as air-fare, hotel accommodations and modest travel/accident insurance. Health, life and other forms of insurance; matching grants to charities; financial planning; automobile allowances and other similar perquisites cross the line as benefits offered to employees. Charitable awards programs are an unnecessary benefit; directors interested in posthumous donations can do so on their own via estate planning. Infrequent token gifts of modest value are not considered perquisites.

6.7 Repricing and Exchange Programs: Under no circumstances should directors participate in or be eligible for repricing or exchange programs.

6.8 Employment Contracts, Severance and Change-of-control Payments: Non-employee directors should not be eligible to receive any change-in-control payments or severance arrangements.

6.9 Retirement Arrangements

a. **Retirement Benefits**: Since non-employee directors are elected representatives of shareowners and not company employees, they should not be offered retirement benefits, such as defined benefit plans or deferred stock awards, nor should they be entitled to special post-retirement perquisites.

b. **Deferred Compensation Plans**: Directors may defer cash pay via a deferred compensation plan for directors. However, such investment alternatives offered under deferred compensation plans for directors should mirror those offered to employees in broad-based deferral plans. Non-employee directors should not receive "sweeteners" for deferring cash payments into company stock.

6.10 Disgorgement: Directors should be required to repay compensation to the company in the event of malfeasance or a breach of fiduciary duty involving the director.

7. <u>Independent Director Definition</u>

7.1 Introduction
7.2 Basic Definition of an Independent Director
7.3 Guidelines for Assessing Director Independence

7.1 Introduction: A narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and shareowners' financial interest because:

a. Independence is critical to a properly functioning board;

b. Certain clearly definable relationships pose a threat to a director's unqualified independence;

c. The effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareowners or other board members; and

d. While an across-the-board application of *any* definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small and is far outweighed by the significant benefits.

Independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors, that may compromise the director's objectivity and loyalty to shareowners. Directors have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent.

Boards have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent. These considerations include the director's years of service on the board. Extended periods of service may adversely impact a director's ability to bring an objective perspective to the boardroom.

7.2 Basic Definition of an Independent Director: An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship. Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

7.3 Guidelines for Assessing Director Independence: The notes that follow are supplied to give added clarity and guidance in interpreting the specified relationships. A director will not be considered independent if he or she:

a. Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by the corporation or employed by or a director of an affiliate;

NOTES: An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 20 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, joint venture partners and general partners meet the definition of an affiliate, and officers and employees of joint venture enterprises and general partners are considered affiliated. A subsidiary is an affiliate if it is at least 20 percent owned by the corporation.

Affiliates include predecessor companies. A "predecessor" is an entity that within the last five years was party to a "merger of equals" with the corporation or represented more than 50 percent of the corporation's sales or assets when such predecessor became part of the corporation.

"Relatives" include spouses, parents, children, step-children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins, and anyone sharing the director's home.

b. Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee, director or greater-than-20-percent owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants or that receives revenue of at least $50,000 for being a paid adviser or consultant to an executive officer of the corporation;

NOTES: Advisers or consultants include, but are not limited to, law firms, auditors, accountants, insurance companies and commercial/investment banks. For purposes of this definition, an individual serving "of counsel" to a firm will be considered an employee of that firm.

The term "executive officer" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

c. Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by or has had a five percent or greater ownership interest in a third-party that provides payments to or receives payments from the corporation and either: (i) such payments account for one percent of the third-party's or one percent of the corporation's consolidated gross revenues in any single fiscal year; or (ii) if the third-party is a debtor or creditor of the corporation and the amount owed exceeds one percent of the corporation's or third party's assets. Ownership means beneficial or record ownership, not custodial ownership;

d. Has, or in the past five years has had, or whose relative has paid or received more than $50,000 in the past five years under, a personal contract with the corporation, an executive officer or any affiliate of the corporation;

NOTES: Council members believe that even small personal contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers—even if no other services from the director are specified in connection with this relationship;

e. Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation, one of its affiliates or its executive officers or has been a *direct* beneficiary of *any* donations to such an organization;

NOTES: A "significant grant or endowment" is the lesser of $100,000 or one percent of total annual donations received by the organization.

f. Is, or in the past five years has been, or whose relative is, or in the past five years has been, part of an interlocking directorate in which the CEO or other employee of the corporation serves on the board of a third-party entity (for-profit or not-for-profit) employing the director or such relative;

g. Has a relative who is, or in the past five years has been, an employee, a director or a five percent or greater owner of a third-party entity that is a significant competitor of the corporation; or

h. Is a party to a voting trust, agreement or proxy giving his/her decision making power as a director to management except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats.

The foregoing describes relationships between directors and the corporation. The Council also believes that it is important to discuss relationships between directors on the same board which may threaten either director's independence. A director's objectivity as to the best interests of the shareowners is of utmost importance and connections between directors outside the corporation may threaten such objectivity and promote inappropriate voting blocks. As a result, directors must evaluate all of their relationships with each other to determine whether the director is deemed independent. The board of directors shall investigate and evaluate such relationships using the care, skill, prudence and diligence that a prudent person acting in a like capacity would use.

DEFINITION OF INDEPENDENT DIRECTOR

"Independent director" means a director who:

1. Is not currently, or within the last five years[31] has not been, employed by the Company in an executive capacity.

2. Has not received more than $50,000[32] in direct compensation from the Company during any 12-month period in the last three[33] years other than:

a. Director and committee fees including bona fide expense reimbursements.
b. Payments arising solely from investments in the company's securities.

3. Is not affiliated with a company that is an adviser or consultant to the Company or a member of the Company's senior management during any 12-month period in the last three years that has received more than $50,000 from the Company.

4. Is not a current employee of a company (customer or supplier) that has made payments to, or received payments from the Company that exceed the greater of $200,000[34] or 2%[35] of such other company's consolidated gross revenues.

5. Is not affiliated with a not-for-profit entity (including charitable organizations) that receives contributions from the Company that exceed the greater of $200,000 or 2% of consolidated gross revenues of the recipient for that year.

6. Is not part of an interlocking directorate in which the CEO or other employee of the Company serves on the board of another company employing the director.

7. Has not had any of the relationships described above with any parent or subsidiary of the Company.

8. Is not a member of the immediate family[36] of any person described in Appendix E.

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[31] 5-year look back periods are consistent the Council of Institutional Investors 2006 director independence standards.
[32] $50,000 thresholds are consistent with the Council of Institutional Investors 2006 director independence standards.
[33] 3-year look back periods are consistent with the New York Stock Exchange and NASDAQ 2006 director independence standards.
[34] $200,000 thresholds are consistent with NASDAQ 2006 director independence standards.
[35] 2% thresholds are consistent with New York Stock Exchange director independence standards.
[36] CalPERS defines immediate family consistent with the New York Stock Exchange: spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone who shares such person's home.

INDEPENDENT CHAIR/LEAD-DIRECTOR POSITION DUTY STATEMENT

The independent chairperson is responsible for coordinating the activities of the board of directors including, but not limited to, those duties as follows:

1. Coordinate the scheduling of board meetings and preparation of agenda material for board meetings and executive sessions of the board's independent or non-management directors.

2. Lead board meetings in addition to executive sessions of the board's independent or non-management directors.

3. Define the scope, quality, quantity and timeliness of the flow of information between company management and the board that is necessary for the board to effectively and responsibly perform their duties.

4. Oversee the process of hiring, firing, evaluating, and compensating the CEO.

5. Approve the retention of consultants who report directly to the board.

6. Advise the independent board committee chairs in fulfilling their designated roles and responsibilities to the board.

7. Interview, along with the chair of the nominating committee, all board candidates, and make recommendations to the nominating committee and the board.

8. Assist the board and company officers in assuring compliance with and implementation of the company's Governance Principles.

9. Act as principal liaison between the independent directors and the CEO on sensitive issues.

10. Coordinate performance evaluations of the CEO, the board, and individual directors.

11. Recommend to the full board the membership of the various board committees, as well as selection of the committee chairs.

12. Be available for communication with shareowners.

Global Framework for Climate Risk Disclosure

While each sector and company may differ in its approach to disclosure, the most successful corporate climate risk disclosure will be transparent and make clear the key assumptions and methods used to develop it. Companies should directly engage investors and securities analysts in disclosing climate risk through both written documents and discussions.

Investors expect climate risk disclosure to allow them to analyze a company's risks and opportunities and strongly encourage that the disclosure include the following elements:

1. **Emissions –** As an important first step in addressing climate risk, companies should disclose their total greenhouse gas emissions. Investors can use this emissions data to help approximate the risk companies may face from future climate change regulations.

   Specifically, investors strongly encourage companies to disclose:

   a. Actual historical direct and indirect emissions since 1990;

   b. Current direct and indirect emissions; and

   c. Estimated future direct and indirect emissions of greenhouse gases from their operations, purchased electricity, and products/services.[37]

   Investors strongly encourage companies to report absolute emissions using the most widely agreed upon international accounting standard – Corporate Accounting and Reporting Standard (revised edition) of the Greenhouse Gas Protocol, developed by the World Business Council for Sustainable Development and the World Resources Institute.[38] If companies use a different accounting standard, they should specify the standard and the rationale for using it.

2. **Strategic Analysis of Climate Risk and Emissions Management –** Investors are looking for analysis that identifies companies' future challenges and opportunities associated with climate change. Investors therefore seek management's strategic analysis of climate risk, including a clear and straightforward statement about implications for competitiveness. Where relevant, the following issues should also be addressed: access to resources, the timeframe that applies to the risk and the firm's plan for meeting any strategic challenges posed by climate risk.

   Specifically, investors urge companies to disclose a strategic analysis that includes:

[37] These emissions disclosures correspond with the three "scopes" identified in the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard (revised edition) developed by the World Business Council for Sustainable Development and the World Resources Institute. Scope 1 includes a company's direct greenhouse gas emissions; Scope 2 includes emissions associated with the generation of electricity, heating/cooling, or steam purchased for a company's own consumption; and Scope 3 includes indirect emissions not covered by Scope 2. More information is available at http://www.ghgprotocol.org

[38] Available at http://www.ghgprotocol.org

a. **Climate Change Statement** – A statement of the company's current position on climate change, its responsibility to address climate change, and its engagement with governments and advocacy organizations to affect climate change policy.

b. **Emissions Management** – Explanation of all significant actions the company is taking to minimize its climate risk and to identify opportunities. Specifically, this should include the actions the company is taking to reduce, offset, or limit greenhouse gas emissions. Actions could include establishment of emissions reduction targets, participation in emissions trading schemes, investment in clean energy technologies, and development and design of new products. Descriptions of greenhouse gas reduction activities and mitigation projects should include estimated emission reductions and timelines.

c. **Corporate Governance of Climate Change** – A description of the company's corporate governance actions, including whether the Board has been engaged on climate change and the executives in charge of addressing climate risk. In addition, companies should disclose whether executive compensation is tied to meeting corporate climate objectives, and if so, a description of how they are linked.

3. **Assessment of Physical Risks of Climate Change –** Climate change is beginning to cause an array of physical effects, many of which can have significant implications for companies and their investors. To help investors analyze these risks, investors encourage companies to analyze and disclose material, physical effects that climate change may have on the company's business and its operations, including their supply chain.

   Specifically, investors urge companies to begin by disclosing how climate and weather generally affect their business and its operations, including their supply chain. These effects may include the impact of changed weather patterns, such as increased number and intensity of storms; sea-level rise; water availability and other hydrological effects; changes in temperature; and impacts of health effects, such as heat-related illness or disease, on their workforce. After identifying these risk exposures, companies should describe how they could adapt to the physical risks of climate change and estimate the potential costs of adaptation.

4. **Analysis of Regulatory Risks –** As governments begin to address climate change by adopting new regulations that limit greenhouse gas emissions, companies with direct or indirect emissions may face regulatory risks that could have significant implications. Investors seek to understand these risks and to assess the potential financial impacts of climate change regulations on the company.

   Specifically, investors strongly urge companies to disclose:

   a. Any known trends, events, demands, commitments, and uncertainties stemming from climate change that are reasonably likely to have a material effect on financial condition or operating performance. This analysis should include consideration of secondary effects of regulation such as increased energy and transportation costs. The analysis should incorporate the possibility that consumer demand may shift sharply due to changes in domestic and international energy markets.

b. A list of all greenhouse gas regulations that have been imposed in the countries in which the company operates and an assessment of the potential financial impact of those rules.

c. The company's expectations concerning the future cost of carbon resulting from emissions reductions of five, ten, and twenty percent below 2000 levels by 2015. Alternatively, companies could analyze and quantify the effect on the firm and shareowner value of a limited number of plausible greenhouse gas regulatory scenarios. These scenarios should include plausible greenhouse gas regulations that are under discussion by governments in countries where they operate. Companies should use the approach that provides the most meaningful disclosure, while also applying, where possible, a common analytic framework in order to facilitate comparative analyses across companies. Companies should clearly state the methods and assumptions used in their analyses for either alternative.

Ceres 14-Point Climate Change Governance Checklist

Board Oversight

1. Board is actively engaged in climate change policy and has assigned oversight responsibility to board member, board committee or full board.

Management Execution

2. Chairman/CEO assumes leadership role in articulating and executing climate change policy.
3. Top executives and/or executive committees assigned to manage climate change response strategies.
4. Climate change initiatives are integrated into risk management and mainstream business activities.
5. Executive officers' compensation is linked to attainment of environmental goals and GHG targets.

Public Disclosure

6. Securities filings disclose material risks and opportunities posed by climate change.
7. Public communications offer comprehensive, transparent presentation of response measures.

Emissions Accounting

8. Company calculates and registers GHG emissions savings and offsets from operations.
9. Company conducts annual inventory of GHG emissions and publicly reports results.
10. Company has an emissions baseline by which to gauge future GHG emissions trends.
11. Company has third-party verification process for GHG emissions data.

Strategic Planning

12. Company sets absolute GHG emission reduction targets for facilities, energy use, business travel and other operations (including direct emissions.)
13. Company participates in GHG emissions trading programs – up to 30.
14. Company pursues business strategies to reduce GHG emissions, minimize exposure to regulatory and physical risks, and maximize opportunities from changing market forces and emerging controls.

Joint Venture Governance Guidelines

> *Businesses used to grow in one of two ways: from grassroots up or by acquisition. In both cases, the manager had control.* ***Today businesses grow through alliances, all kinds of dangerous liaisons and joint ventures, which, by the way, very few people understand****.*
>
> *– Peter Drucker*[39]

Good governance matters to joint ventures – and joint ventures matter to many public companies and, therefore, their public shareowners.

Today there are more than 1000 joint ventures (JVs) with more than $1 billion in annual revenues or invested capital. The 8 largest publicly listed oil and gas companies and 6 metals and mining majors have more than $500 billion in assets in major joint ventures. More broadly, many public companies hold a dozen or more material JVs in their portfolios, and depend on JVs for 10-20 percent of total corporate revenues, assets, or income, using joint ventures as a key tool to access technology and innovation, gain scale and reduce costs, share risk, and build new businesses. In such industries as conventional petroleum, alternative energy, chemicals, basic materials, and aerospace, joint ventures account for upwards of 30-50 percent of many company's economic activity. Likewise, joint ventures are widely used in China, India, Russia, Korea, Latin America, and the Middle East.

More than 10 years ago, CalPERS established a set of governance principles for public companies at the corporate level with the underlying tenet that fully accountable corporate governance structures produce, over the long term, the best returns to shareowners.

We believe a similar level of scrutiny and focus should be extended to the largest joint ventures of public companies, and that shareowners will benefit by the application of more consistent standards of governance. These JV Governance Guidelines, co-authored by CalPERS and Water Street Partners[40], are an effort to promote such attention and, in time, drive improved performance and reduced risk within a large but relatively less-transparent asset class.

INTRODUCTION: THE JV GOVERNANCE CHALLENGE

Any joint venture warrants good governance.[41] Our focus – and that of these Guidelines – is on joint ventures that are financially large or strategically significant, and entail some degree of joint managerial decision-making and operational interdependence between the shareowners and the venture.[42]

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[39] The Post-Capitalist Executive: An Interview with Peter F. Drucker; Harvard Business Review; May-June 1993.
[40] Water Street Partners is an advisory firm based in Washington DC founded by David Ernst and James Bamford, widely-published experts on joint venture strategy and governance who founded and led the Alliance Practice at McKinsey & Company from 1990 to 2008.
[41] We define "joint venture" as a legal business entity owned by two or more separate corporate parents.
[42] To be clear, these guidelines are not aimed at certain types of joint ventures that do not demonstrate these characteristics – notably (1) joint ventures that are purely financial vehicles, such as are common in the real estate and other investment industries, or (2) joint ventures that are clearly operated by one partner and do not function as

The governance of these joint ventures introduces unique challenges. These challenges are an outgrowth of the way the corporate-parent shareholders inter-relate to the venture, most notably: shared oversight and control; significant economic and business flows between the shareholders and JV for various services, inputs or outputs; differing appetites for growth, investment, and cash returns from the shareholders (i.e., corporate parents); and changes in shareholder strategies and reactions to new market conditions that put pressure on the JV.

To understand why joint ventures are different, consider how the governance of joint ventures *compare to that of public companies*:

Board composition and decision making:

- Public Company Governance: Nonexecutive/independent Board members constitute a majority of the Board, and the Board is an agent for independent shareowners, who are aligned around the basic desire to maximize overall shareowner returns
- JV Governance: In JVs, there are typically no independent Board members from outside the JV and the parent companies; Board members represent parent companies which often have differing objectives, investment and risk preferences, and receive asymmetric benefits from the venture

Resource flows from the shareholders:

- Public Company Governance: The company does not depend on shareowners for operational inputs into the business -- or, if the company does, those transactions are conducted on a true arms-length basis, and subject to legal and governance protections against conflicts of interest
- JV Governance: Commercial relationships are not always easily conducted at arms-length market prices, and conflicts of interest cannot be completely avoided.

Management team:

- Public Company Governance: Members of the management team do not have past or future reporting relationships or employment opportunities with the companies of Board members
- JV Governance: The top JV executives are frequently current or former employees of one shareholder, and their future employment opportunities may be influenced by a parent-company executive who is a Board Director of the JV. In addition, especially for secondees, pension and other compensation elements may be tied to one shareholder *even while serving in the venture*.

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discreet organizational entities with a management team, board and assets, etc., such has been a hallmark structure of the classic upstream oil and gas joint venture.

While JVs hold some governance advantages to that of public companies,[43] on balance, joint venture governance is *pound for pound* more challenging than corporate governance, and is arguably just as important for public shareowners. CalPERS has long believed that good corporate governance represents “the grain in the balance” that “makes the difference between wallowing for long (and perhaps fatal) periods in the depths of the performance cycle, and responding quickly to correct the corporate course.” CalPERS and Water Street Partners believe that, in joint ventures, poor governance represents “an anvil at the end of the table” that can have enormous impact on the stability and performance of these ventures and, by extension, a meaningful impact to their public-company owner(s).

Consider some data. Despite some compelling reasons to enter into joint ventures, the historic performance of JVs has been mixed. Research has shown that roughly 50 percent of JVs fail to meet the financial and strategic goals of the corporate parents, while 46 percent of joint venture announcements have a negative impact on the parent’s share price.[44]

Poor governance plays a role in this underperformance – and indeed is preventing many already successful JVs from delivering even better returns to their corporate parents. For instance, an ex post assessment of 49 large joint ventures showed that some 50 percent of failures were the result of poor governance and management. Likewise, some 80 percent of participants of a JV CEO and Directors Roundtable[45] stated that their JV Boards have not been a source of real strength for the JV, and some 60 percent did not have financial management systems in their JVs that were as good as those in their parent businesses.[46] Other research showed a very high correlation between good outcome performance (e.g., financial, operational and strategic results) and good governance performance and health.[47] Similarly, in more than 100 situations involving the restructuring of major joint ventures, the ventures were routinely

[43] For example, because JV Board members almost always come from one of the parent companies, tend to be quite experienced in the relevant business area or market; and, as senior managers, are more than willing to assert their views in Board meetings when appropriate to protect shareholder interests. JV Board members also frequently are in a position to do more to help the JV management succeed, e.g. by accessing resources and skills from the parent company.

[44] For more details on joint venture and alliance performance, please see Joel Bleeke and David Ernst, *Collaborating to Compete*, John Wiley & Sons, 1993; David Ernst and Tammy Halevy, “When to Think Alliance,” *McKinsey Quarterly*, Q4 2000; James Bamford and David Ernst, “Managing an Alliance Portfolio,” *McKinsey Quarterly*, Q3, 2002; and James Bamford and David Ernst, “Getting a Grip on Alliances,” *Corporate Dealmaker*, December 2004.

[45] JV CEO and Directors Roundtable (sponsored by McKinsey and led by James Bamford and David Ernst) in New York on October 13, 2004 (participants ran or oversaw more than 100 major JVs across 10 industries).

[46] A McKinsey survey of 34 companies showed that 53 percent of companies do not regularly incorporate joint ventures into their standard corporate planning and review process, and that 44 percent claim that senior parent executives are not sufficiently focused on joint ventures and other major alliances. (McKinsey survey of Conference Board participants in the 2004 Strategic Alliances Conference, April 2004). Anecdotally, numerous cases where companies leave even their largest joint ventures outside the corporate challenge process. For further details, see James Bamford, David Ernst, and David Fubini, “Launching a Worldclass Joint Venture,” *Harvard Business Review*, February 2004.

[47] Results from McKinsey Benchmarking of JV governance (2008), authored by James Bamford, David Ernst and Lois D’Costa, and presented to the Association of Strategic Alliance Professionals in February 2008. This research evaluated the performance and rigorously calibrated a broad set of governance and talent practices of 25 major joint ventures in the oil and gas, basic materials, financial services and other industries in the US, Europe, Asia and the Middle East.

able to capture 10-30 percent increases in annual profitability by making changes to the governance, scope, and structure of the JV.[48] [49]

Using the petroleum and basic materials industries as proxies, it is possible to estimate the amount of "value restoration" associated with improved JV good governance. For the top 8 petroleum companies and the top 6 basic and mining companies, material joint ventures today account for $72 billion in annual earnings (on a $503 billion asset base). Calculations by Water Street Partners indicate that, conservatively, there is $5-13 billion in improved annual earnings available collectively to these 14 companies. At current trading multiples, this represents roughly $50-130 billion in added market capitalization that could be created through better JV governance and enhanced performance in just these 14 companies. When we extrapolate to other companies in the petroleum and mining industries – and to other industries such as telecom, chemicals, aerospace and defense, industrial manufacturing, and high-tech – there is, at minimum, $15-36 billion in value restoration available from the improved governance and shareholder relationship of material joint ventures.[50]

Despite the importance of JV governance, companies under-invest in governance design. The established body of JV governance case law and accepted good practice are underdeveloped,[51] with little systematic benchmarking of JV governance practices or JV performance. While certain important governance provisions do get included in most JV legal contracts (e.g., Board composition, veto rights, dispute resolution), these provisions address only a narrow set of issues, and tend to focus on establishing a rudimentary framework for governance, plus legal protections against "extreme" events (e.g., material breach, parent bankruptcy). The key legal documents of most major JVs do not come close to meeting the real needs of (i) putting in place an effective ongoing JV governance system; (ii) ensuring that each JV is appropriately monitored by the parent companies; and (iii) triggering interventions on a timely basis, based on appropriate transparency, accountability, and engaged Board members.

We believe that it is useful for corporate and JV Boards to adopt a set of JV governance guidelines – that is, a set of standards or "minimums" for JV governance – against which companies and their public shareholders can assess the governance of their largest JVs. In proposing these guidelines, our hope is to help improve the performance of these ventures that today serve as a vital – but often challenging – engine for corporate growth.

While our focus is on the material joint ventures of public companies, we believe many of these concepts are equally relevant to JVs that have private or government ownership, as well as smaller joint ventures and complex non-equity partnership structures. We encourage

[48] For further details on the value associated with restructuring large joint ventures, see David Ernst and James Bamford, "Your Alliances are Too Stable," *Harvard Business Review*, June 2005.

[49] For other significant work on joint ventures, see: Stephen I. Glover and Craig M. Wasserman (editors and co-authors), *Partnerships, Joint Ventures and Strategic Alliances*, Law Journal Press (2007); Kathryn Rudie Harrigan, *Managing for Joint Venture Success*, Lexington Books (1986); Pierre Dussauge and Bernard Garrette, *Cooperative Strategy: Competing Successfully through Strategic Alliances*, John Wiley (1999); Benjamin Gomes-Casseres *The Alliance Revolution*, Harvard University Press (1996); John Child, David Faulkner and Stephen Tallman, Strategies for Cooperation: Managing Alliances, Networks, and Joint Ventures, Oxford University Press (2005).

[50] For details of this analysis, see Water Street Partners website, waterstreetpartners.net.

[51] A few groups in the oil and gas industry have developed guidelines for auditing certain types of JVs. See, for example, *Guidelines for Joint Venture Audit Standards*, Australian Petroleum Production & Exploration Association Limited, February 2000.

companies to have a discussion about where and how to apply these guidelines in their portfolio of equity joint ventures and non-equity partnerships.

DESIGN OBJECTIVES AND PRINCIPLES

The purpose of these guidelines is to improve the performance and reduce the risks associated with material joint ventures, and to do so by putting in place a set of governance practices that:

1. Raise the level of performance management discipline and accountability, which has often proven inconsistent in joint ventures

2. Improve decision making speed and the ability of joint ventures to respond rapidly to changes in the market

3. Increase transparency overall – within the venture and its board structures, within the corporate parents who own these ventures, and ultimately within the public shareowners of these parent companies

4. Promote alignment among the parent companies and put in place mechanisms to deal with the inherent tensions and conflicts that arise between joint venture parent companies

5. Create a mechanism for JV Boards to assess the health of governance on a regular basis, promoting proactive adjustments to avoid major issues that can build over time

6. Provide a set of guidelines that are *complementary* to existing requirements (e.g., financial disclosure, accounting, compliance, legal, etc.) to which joint ventures are already exposed

JV GOVERNANCE GUIDELINES

CalPERS and Water Street Partners recommend that the Boards of material joint ventures adopt the following guidelines, and put into place practices to support them[52]:

A. Board Mandate and Structure

1. The Joint Venture Board of Directors is the primary means for governing the joint venture, and the JV CEO reports directly and only to the JV Board. Shareholder input to the JV CEO and JV CFO should be channeled through the Board (and not communicated in an uncoordinated manner to JV management).

2. The JV Board has an explicit charter and delegation of authority framework that defines its role in relation to JV Management, JV Board Committees, and the Boards and Management of the Parent Companies. This charter and framework specifically spells out where venture management has the power to act on its own and where the parents

[52] These guidelines are aimed at financially large or strategically significant joint ventures that entail some degree of joint managerial decision-making and operational interdependence between the shareholders and the venture. As such, they are not aimed at joint ventures that are, for instance, purely financial vehicles, such as are common in the real estate and other investment industries, or joint ventures that are clearly operated by one partner and do not function as a discreet organizational entities with a management team, board and assets, etc.. Likewise, these guidelines relate to the governance of joint ventures – and not to other important aspects of these business structures, including ownership and financial arrangements, legal issues, including dispute resolution and exit provisions, and human resource and staffing policies.

(individually or through the JV Board) will have control, influence or close involvement.[53] The framework also identifies decisions that require separate approval by the Parent Company Boards or Parent Company Management – where approval by the JV Board is not sufficient. The scope of the framework should include matters to fiscal authority, operations, personnel decisions, and strategy (such as changes to the venture's product, pricing or market positioning). The Board periodically reassesses this delegation of authority framework, and takes measures to adjust approval levels based on JV performance and business conditions.

3. The JV Board is responsible for performing the roles of a traditional Corporate Board, including: (i) setting strategy and direction; (ii) approving major capital investments; (iii) ensuring strong performance management and managing financial risk; (iv) protecting shareholder and public interests, including legal, safety, ethics and environmental considerations; and (v) overseeing CEO and top-management hiring, evaluation, compensation and succession planning. In addition, the JV Board is responsible for JV-specific roles, including:

    a. Securing needed resources and organizational commitments from the corporate parents, on a timely basis. This includes facilitating staff rotations as needed between the JV and parent companies

    b. Overseeing the negotiation of major commercial agreements between JV and parent, and shielding the JV CEO and management team from negotiating with parent stakeholders on issues where parent interests are misaligned

    c. Periodically assessing the need for major change in the venture strategy, scope, ownership/financial structure and operating model within the strategic confines defined by the parent company – much as a corporation would challenge the strategy, structure, and, if needed, continued corporate ownership of a business unit

4. The Board has established and maintains an active Audit Committee, which meets more than once a year, and is responsible for reporting and oversight of compliance, financial statement integrity, and overall risk management.[54] At least one Board member has significant financial expertise and is the chair of the Audit Committee.

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[53] Areas where the Board could comment on its level of ongoing involvement include: second-level staffing decisions and performance reviews, product pricing decisions, negotiation of commercial and service agreements between the venture and one of the parents, and development of new growth opportunities. This level of clarity will almost certainly go beyond what is written in the joint venture legal agreement, which typically only spell out matters that require super-majority or unanimous approval, or where one shareholder has veto rights (e.g., hiring of a new CEO or CFO, approval of capital investments above $20M, settlements of litigation against the company, dissolution of the business). While there is some early evidence that less operational involvement by the shareholders / Board is linked to stronger outcome performance, the above governance guideline only aims for the Board to clarify its posture toward the venture, rather than recommend what that posture should be.

[54] One US company that is a highly-experienced user of joint ventures has taken this practice one step further: As a way to promote good financial disciplines and controls, it requires its major JVs to comply with Sarbanes Oxley, and for the JV CEO and JV CFO to provide a written "Sarbanes Oxley Attestation" on a quarterly basis to the company. This attestation is not a legally binding document, but is a powerful signifier of shareholder expectations and driver of individual accountability among the JV management team. The approach is notable because it is above what is required from a legal standpoint: Sarbanes Oxley, as a piece of regulation, applies only to publicly-traded US companies, and therefore is not something that joint venture companies must per se comply with.

5. The Board has established and maintains an active Compensation Committee[55], which meets regularly and is responsible for: (i) approving the compensation and incentive framework for the venture's top management team, including developing an annual Performance Contract for the JV CEO; (ii) nominating, evaluating, and determining compensation for the CEO; (iii) overseeing succession planning for the JV CEO and other members of venture top management; and (iv) assisting the JV CEO in ensuring access to skills and people, as needed, from the parent companies.

6. The JV Board conducts an annual audit of the joint venture's governance performance, which would include compliance with these governance guidelines and a view of the overall health of the governance system [56]. Related to this:

   a. The JV Board has designated at least one Board member (likely a Lead Director, as described in section B.4) to lead such a review and discussion

   b. The review involves a level of rigor and seriousness similar to other major reviews, and includes a set of criteria against which the shareholders agree to evaluate the venture, a summary of performance, and a discussion of opportunities to improve how the shareholders relate to each other and the venture

B. Board Composition and Individual Roles

1. Absent compelling, unusual circumstances, the JV Board should range from 4 to 10 members. If outside that range, the number of members should be justified.

2. The JV Board has established – and at least annually updates – a set of skills it seeks from Director candidates. Minimally, these skills, across the Board, should include general management experience, finance expertise, experience in the JV industry and with the geographic markets in which the JV operates, and prior experience with other JVs. In selecting members of the Board, the parent companies explicitly account for the desired mix of skills and personal dynamics within the Board overall.

3. Each shareholder has appointed to the JV Board *at least one representative* who is a senior executive of the parent company, and who is able to truly represent the interests of the parent company and command internal resources to support the venture. The following test is to be used to determine if such authority level exists: that Board member has the proven authority to: (i) sign-off on the JV's annual budget and operating plan, within limits consistent with the parent company strategy, budget, and operating plan; (ii) approve the JV's material supply or service contracts; and (iii) approve the JV CEO's annual performance contract and, when needed, the selection of a new CEO of the joint venture.

4. Each parent has designated a Lead Director. The Lead Director is a senior executive of the parent company who:

   a. Spends at least 20 days per year in an active non-executive capacity overseeing and supporting the venture[57]

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[55] This committee may operate under different names, such as Human Resource, People or Talent Committee.

[56] Assessments of governance health would likely relate to decision making speed and effectiveness, the delivery of resources and people between the shareholders and parents, the level of transparency and rigor in the reporting and challenge processes, and other factors that the Board deems important to a well-working joint venture governance system.

b. Performs the following roles: (i) coordinates other Directors from his or her parent company – i.e., ensure opinions heard, consistent voice presented to JV and partner; (ii) accesses resources from inside the parent company in support of the JV; (iii) works with the other Lead Director(s) and JV CEO between Board meetings to resolve issues that do not require full Board approval; (iv) shields the JV from excessive parent company information requests and bureaucracy (e.g., duplicative reporting requirements, slow capex approval processes); and (v) supports the parent executive team and parent board in ensuring that the JV is meeting governance, compliance, risk management and transparency requirements; and, ideally, (vi) explains the JV's strategy, performance, risks and prospects at corporate-level reviews in the parent company.

5. Each Lead Director has an element of his or her annual performance review and short-term variable compensation tied to the performance of the joint venture, and his or her performance as the Lead Director. In no circumstances does the JV account for less than 10 percent of his or her total performance review and short-term variable compensation calculation.

6. The JV Board has designated a Chairperson (who may be the Lead Director from one parent company) to be additionally responsible for: (i) managing the overall Board agenda (including syndication prior to Board meetings of key issues and decisions); and (ii) overseeing the quality, quantity and timeliness of the flow of information to the Board from venture management; and, (iii) unless assigned to another Board member or committee, ensuring the integrity of the governance system, including being responsible for an annual assessment and discussion about governance performance, underlying health, and potential changes to the governance, scope or structure venture to improve its performance.

7. No member of the Joint Venture Management Team is a member of the JV Board.[58]

8. The JV Board ensures that it has a strong independent perspective, preferably by the inclusion of an Independent Director, with stature in the industry.[59] An Independent Director would not be expected to hold a swing vote in Board decisions, and may be a non-voting member of the Board. To additionally promote independence, the Board should: (i) endorse the principle that Board members and full-time venture staff (including secondees) are first and foremost to promote the interests of the venture as a whole (rather than the singular interests of one shareholder), and (ii) periodically invite independent outsiders (e.g., industry experts, customers) to Board meetings to share

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[57] Our research indicates that such 20-days-per-year Director commitment is in the upper quartile of large joint ventures today; however, we do not believe that this represents exceptional or unrealistic commitment. For comparison purposes, in Corporate Boards, directors spend an average of 24 days (190 hours) per year preparing for and attending Company Board and Board Committee meetings. [Source: Jeremy Bacon, Corporate Boards and Corporate Governance, 22-24 (New York, The Conference Board, 1993).

[58] It is expected that the JV CEO, JV CFO, and other members of the JV management team may be present at JV Board meetings, and may make specific presentations to the Board on the business, operational and financial affairs of the joint venture company.

[59] We define an "Independent Director" as a Board Member not currently an employee of any of the parent companies, and who does not receive compensation for goods and services performed, excluding director fees, for any parent. Despite very limited usage in joint ventures today, we believe that Independent Directors have the potential to be an extremely powerful lever to improve governance performance – creating an independent perspective that is often missing from joint ventures.

their perspectives and challenge the Board.[60] To function effectively, an Independent Director needs to have a professional stature and personality that allows him or her to raise issues to and influence the shareholders.

C. Board Processes and Evaluation

1. Working with executives in the parent companies if need be, the JV Board establishes and periodically updates a set of guiding principles defining the parents' shared philosophy toward the venture.[61] These principles include statements regarding the desired level of independence from the parents, whether the venture is to be run as a business or an operating asset,[62] and the evolution path and, if possible, planned end-game of the venture.

2. The Board has established *performance criteria* for itself as a collective body, and periodically reviews its performance against these criteria.

3. The Board has established performance criteria for its individual Board members, including *individual behavioral expectations*. Minimally, these criteria address the level of Board member attendance, preparedness, participation, and candor. To be re-nominated, directors must satisfactorily perform based on the established criteria; re-nomination on any other basis is neither expected nor guaranteed.

4. Each director has an attendance rate of at least 75 percent at Board meetings and 75 percent of Board Committee meetings of which they are members, and the Board has established a minimum standard to that effect.

D. Management Incentives and Reporting Relationships

1. The JV CEO reports *solely* to the JV Board, which alone reviews his or her performance and determines his or her compensation.[63] [64]

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[60] Another – and more aggressive – approach to fostering independence (and a strong performance culture) within the JV is to bring in an outside investor (e.g., venture capital or private equity firm) as a 5-10 percent owner of the JV.

[61] As an illustration, one joint venture adopted a set of ten guiding principles that included the following statements: "No Slots – best people for available jobs", "JV Board Members must promote the interests of the JV *as a whole* – not merely advance their own parent's interests," and "Equal Communication – information available to one parent is available to all parents."

[62] By "operating asset" we mean an entity whose purpose is to perform specific operating activities at worldclass levels but is not judged based on its ability to grow into new areas or to drive bottom-line profits. This distinction from a "business" is especially important in the energy, basic materials, and semiconductor industries, where we have seen numerous production joint ventures encounter significant inefficiencies because the management team or one shareholder believed that the venture was to operate as a business, while one or more shareholders believed that the venture was a narrow-purpose production asset.

[63] One allowable exception to this guideline would be joint ventures that are clearly operated by one partner, depend on that partner to supply significant numbers of loaned employees to perform the work of the joint venture, and are essentially run as business units of that parent company.

[64] This practice, which WaterStreet Partners strongly endorse, is a matter of some controversy. An argument is sometimes made that when a JV CEO is a seconded – or loaned – employee from one shareholder, that it is impractical to expect that the JV CEO will have no objectives or interests outside the scope of the joint venture, and it is unrealistic to believe that the JV CEO truly reports solely to the JV Board. This argument is based on a view individuals seconded in as JV CEOs tend to be high-potential individuals who have career goals greater than the specific JV they are running, and that acting solely based on the joint venture's interests – rather than protecting their long-term employer's vested interests when in conflict with the joint venture's interests – turn out to be "career-limiting moves." Our view is that while this may be the unfortunate reality in some cases, it should not be an excuse

2. The JV Board has collectively endorsed an annual “performance contract” for the JV CEO, which includes a balanced set of key performance indicators.

3. The JV CEO compensation package is structured to *promote the interests of the joint venture as a whole*, and not asymmetrically advance the interests of a subset of parent companies. The details of this compensation package (including determinants and actual payout) are disclosed to all members of the Board even if the JV CEO is a loaned /seconded employee from one parent company.

4. The JV CEO, working in consultation with the Compensation Committee, has the freedom to offset any compensation disadvantages associated with the joint venture structure (e.g., lack of stock options, reduced career headroom relative to larger global companies, added career risk) with other forms of remuneration. [65] [66]

E. Financial and Compliance Policies

1. The parents have explicitly established – and collectively endorsed and updated – specific financial hurdle rates for additional investments, dividend repatriation policies, and other key financial policies of the joint venture. (Note: Defining these hurdle rates is typically the job of the parent companies, and therefore JV Board members, depending on their role in the parent company, may or may not have the authority to do this on their own.)

2. The Board subjects the JV to a “challenge process” of equal intensity to similar-sized 100%-owned business units in the corporate parents, and does not allow the JV to be subject to a lower performance bar.[67] However, the JV is **not** subject to “double jeopardy” – i.e., full and separate reporting to both corporate parents where the JV must comply with different data and format requirements.[68] [69]

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for a poor practice that drives added misalignment into the system and likely leads over the log-run to suboptimal returns for all shareholders as a group

[65] In one financial services industry JV, members of the JV management team (direct reports to the CEO) were paid annual base salaries of 25 percent higher than similar positions inside the parent companies of the venture, and annual bonuses on par with parent company employees. The rationale for higher base and annual bonus pay relative to the owner banks was that the JV employees, who did not have stock options, had significantly lower opportunities for long-term wealth creation. Similarly, in a multi-billion dollar downstream oil industry venture, the JV pegged employee base pay at the 50th industry percentile benchmark, and the performance-based short-term bonus at the 75th industry percentile benchmark as a way to compensate for some inherent long-term incentive disadvantages of its JV structure.

[66] This problem generally does not exist in joint ventures that are either (i) partially floated on public stock exchanges, or (ii) where the JV employees have phantom equity options based on JV performance.

[67] A number of different approaches can be used to ensure that the JV Board has access to the performance and other information that it needs. In one industrial JV, the parent created a small “affiliate analysis unit” of 4-6 finance staff whose sole job was to make sure that the Board members of three major JVs got the data and analysis they needed (beyond what the JV CEO was providing). In another case, a US-Japanese joint venture made a very deliberate decision to staff the JV itself with very strong finance talent *and* build the financial systems within the JV to create these insights.

[68] There are many different ways to do this. For example, in one 70-30 JV, the approach taken to avoid double jeopardy was for the JV to report to the senior parent management team of the 70% owner in a way that was similar to any business unit, with the key difference being that the Board members from the 30% partner participated in these meetings, challenging the JV from its perspective. In a multi-billion dollar oil industry JV with 50-50 ownership, the JV Board established an independent review process, including a separate and very strong finance and audit committee, as well as aggressive use of outside auditors to benchmark venture performance.

3. The joint venture service and supply agreements with the shareholders are disclosed and made available to all JV Board members, are actively monitored and governed, and ideally, unless there are compelling business reasons otherwise, are set up on an arms-length basis with externally-sourceable specifications, with market-based pricing, and with the JV having the option to source externally.

4. In the event that a Parent Company provides significant and strategically sensitive services to the venture (e.g., potential for leakage of intellectual property, or compromise of customer data or relationships), that parent company provides "compliance training" to those individuals within its own organization who are involved in providing those services to the venture. This training includes what information can – and cannot – be shared, how to prioritize work for the venture relative to internal requests, treatment of cost allocations, and reporting of potential incidence, etc. The Parent Company also reinforces these compliance policies through regular communications regarding the importance of complying with these guidelines and variations.

5. The JV Board takes active and regular steps to ensure compliance with all applicable safety, environmental, anti-corruption (e.g., FCPA), and other regulatory and social requirements of responsible corporate citizenship. A recommended medium for disclosing economic, environmental, and social risks and impacts is the Global Reporting Initiative Sustainability Reporting Guidelines. In particular, the joint venture adopts practices to ensure that the JV does not commit or support human rights violations in countries in which the venture operates.

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Today, there are few if any JVs that follow all of the above governance guidelines, and indeed relatively few companies that have adopted *any* explicit governance guidelines for JVs. Nonetheless, we believe that each of these guidelines is relevant to all material joint ventures of public companies, and that each has the potential to improve venture performance and reduce risk. A decade ago, a growing chorus of commentators began to forcefully make the case that good governance was a key contributor to corporate performance. As one wrote:

> *"Darwin learned that in a competitive environment an organism's chance of survival and reproduction is not simply a matter of chance. If one organism has even a tiny edge over the others, the advantage becomes amplified over time. In 'The Origin of the Species,' Darwin noted, `A grain in the balance will determine which individual shall live and which shall die.'* ***I suggest that an independent, attentive board is the grain in the balance that leads to a corporate advantage****. A performing board is most likely to respond effectively to a world where the pace of change is accelerating. An inert board is more likely to produce leadership that circles the wagons."*[70]

We assert that good governance matters at least as much in joint ventures – and that there is a significant performance opportunity for public companies. The first step toward capturing the

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[69] This form of double jeopardy occurs when a JV is forced to comply with both / multiple parents' planning and review processes for the operating plan, budget, and/or capex approval. We believe that in well-governed JVs, the JV Board will coordinate and align these information requests from the parents.
[70] Ira M. Millstein, *New York Times*, April 6, 1997.

performance upside is for corporate and JV Boards to adopt a set of guidelines to serve as a measuring-stick.