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# Executive Group Publishes Statement of Commonsense Principles of Corporate Governance

## Principles Aim to Provide Basic Framework for Sound, Long-Term Public Company Governance and Stimulate Further Conversation; Acknowledge There Is No One-Size-Fits-All Approach

## SUMMARY

Yesterday a group of 13 executives from some of the largest U.S. public companies and asset managers, as well as shareholder activists, public pension funds and mutual fund companies, released a statement of corporate governance principles for public companies, their boards of directors and their shareholders. The Principles are intended to provide a framework to support strong and lasting corporate governance and recommend, among other concepts, competent, diverse and independent boards with appropriately aligned incentives and tenures, an emphasis on long-term strategy in public reporting including flexibility in whether a company provides earnings guidance, sensible use of non-GAAP measures and greater access by asset managers to companies and their key decision makers and vice versa.

Given the diversity of public companies in the United States, the group acknowledged that the application of every part of these Principles to every company in the same manner is unrealistic. Instead, the Principles are intended to serve as a starting point for further discussion on good corporate governance and be applied by companies taking into account their size, products/services, history and leadership.

## BACKGROUND

As discussed in the accompanying open letter, the Principles emerged from discussions that began among the group in 2015 regarding key issues surrounding corporate governance.[1] Recognizing that "there has been wide disagreement on what [good corporate governance] actually means," the group sought to "reach some consensus on what we think works in the real world."

The group comprised the following executives: Tim Armour, CEO of Capital Group; Mary Barra, CEO of General Motors; Warren Buffett, CEO of Berkshire Hathaway; Jamie Dimon, CEO of JPMorgan Chase; Mary Erdoes, CEO of JPMorgan Asset Management; Larry Fink, CEO of BlackRock; Jeff Immelt, CEO of General Electric; Mark Machin, CEO of Canada Pension Plan Investment Board; Lowell McAdam, CEO of Verizon; Bill McNabb, CEO of Vanguard; Ronald O'Hanley, CEO of State Street Global Advisors; Brian Rogers, Chairman and CIO of T. Rowe Price; and Jeff Ubben, CEO of ValueAct Capital.

The resulting Principles are organized into eight main topics: (1) Board of Directors—Composition and Internal Governance; (2) Board of Directors' Responsibilities; (3) Shareholder Rights; (4) Public Reporting; (5) Board Leadership (Including the Lead Independent Director's Role); (6) Management Succession Planning; (7) Compensation of Management; and (8) Asset Managers' Role in Corporate Governance.

## THE PRINCIPLES

Many of the Principles reflect best practices widely adopted by large-cap companies, as well as state law, Securities Exchange Commission and stock exchange requirements. Some notable items addressed include:

- ***Competent and diverse boards.*** To encourage knowledgeable involvement and oversight in board matters, at least some directors should have professional experiences directly related to the company's business. Additionally, the board should be educated on the company and relevant industries, with input from outside experts and advisors if productive and appropriate. Finally, the Principles note that board membership and director candidate pools should comprise diverse skill sets, backgrounds and experiences. SEC Chairman Mary Jo White recently noted that the SEC would propose a rule to elicit more information about the diversity of board members.[2]
- ***Appropriately aligned director compensation.*** In order to better align director incentives with the long-term performance of the company, companies should consider paying as much as 50% or more of director compensation in stock, performance stock units or comparable equity-like instruments and requiring retention of a significant portion of directors' equity compensation for the duration of their tenures. It is not clear whether the Principles contemplate stock units whose value will vary based on the achievement of performance metrics (which would not be common for directors) or whether they contemplate the restricted stock units that are a common feature of contemporary director compensation programs in the United States.
- ***Board refreshment.*** Companies should consider both regular board refreshment and periodic rotation of board committee leadership roles to balance fresh perspectives and the benefits of continuity, experience and expertise. The Principles do not endorse specific term limits or retirement ages but emphasize that companies should clearly explain their approach on these topics (including any exceptions made) to shareholders (ordinarily in their proxy statements).
- ***Director communications with shareholders.*** Communication between a board and the company's shareholders is important; however, there are different ways to achieve appropriately robust communication. The Principles recommend that directors should only speak with the

media about the company if authorized by the board and in accordance with company policy. In light of some well publicized incidents, many companies have adopted formal confidentiality policies that apply to directors.

- ***Focus on creating long-term shareholder value and managing significant risks.*** Boards should focus attention on, among other areas, the creation of long-term shareholder value and an appropriate balance of risk (including reputational) and reward. The Principles suggest that boards avoid being "reflexively risk adverse."

- ***Director access to management.*** Directors should have unfettered access to management, as authorized and managed by the board, including individuals below the CEO's direct reports.

- ***Audit committee focus*****.** The Audit Committee's focus should include whether the preparation or disclosure of the company's financial statements would be materially different if the outside auditor were solely responsible for the preparation.

- ***Differing approaches to proxy access depending on market capitalization.*** The Principles do not take a position on proxy access but observe that larger companies with market capitalization of more than $2 billion generally provide for a minimum 3% threshold of ownership for three years in order to nominate 20-25% of a company's board seats. The Principles seem to note favorably that smaller market-cap companies may adopt a higher ownership threshold (typically 5%).

- ***Limited use of dual class voting.*** Dual-class voting, in which a shareholder with a privileged category of shares has more voting power than a regular shareholder, is not a best practice and should be disfavored. The Principles recommend that companies with dual-class voting should consider specific sunset provisions based upon time or a triggering event in order to eliminate the practice.

- ***Reasonable written consent and special meeting protections.*** While written consent and special meeting provisions can be important tools to facilitate shareholder action, the use of these tools should require a reasonable minimum number of outstanding shares in order to prevent a small shareholder minority from abusing their rights or wasting corporate time and resources.

- ***Suitable and realistic earnings guidance.*** Companies should not feel obligated to provide earnings guidance and should consider whether providing such guidance is more harmful than beneficial. Any such guidance that is provided should be realistic. A public company should strategize for the long term, acting as though it were private, and explain to investors how material decisions and actions are consistent with that view.

- ***Sensible use of non-GAAP measures.*** The use of non-Generally Accepted Accounting Principles (GAAP) measures in company reports should not obscure GAAP results. As an example, the Principles state that *all* compensation, including equity compensation, should be reflected in any non-GAAP measurement of earnings in the same manner it is reflected in GAAP earnings.

- ***Due consideration of leadership roles.*** A board should consider and decide whether it is appropriate to separate or combine the chair and CEO roles and then explain clearly to shareholders (ordinarily in the proxy statement) the basis for its decision.

- ***Appropriately aligned management incentives.*** Companies should ensure that management's compensation plans have continuity over multiple years and are aligned with a company's long-term performance. The Principles endorse paying as much as 50% or more of senior management's compensation in stock, performance stock units or comparable equity-like instruments and state that, with properly designed performance hurdles, stock options may be appropriate, particularly for the CEO. Finally, the Principles state that companies should maintain clawback policies for both cash and equity compensation.

- ***Flexibility and rationale behind compensation decisions.*** Compensation should not be entirely formula based; instead, a company should be allowed to retain discretion to take into account qualitative performance factors in its compensation decisions. At the same time, a company should be able to communicate exactly how those decisions align compensation with performance appropriately. Similarly, a company should evaluate large, special compensation awards carefully and be able to explain them clearly.

- ***Communication between asset managers and companies.*** To facilitate appropriate senior-level oversight by asset managers of proxy voting and corporate governance activities, asset managers should have access to the company, management and, in certain circumstances, the board. Correspondingly, a company should also be able to access the asset manager's decision makers on these issues. A constructive and proactive relationship between shareholders and their asset managers on the one hand and companies on the other is a laudable goal.
- ***Independence of asset managers.*** Although asset managers may rely on various sources to inform their decision-making processes, ultimately their votes should be independent and based on their own voting standards rather than relying too heavily on proxy advisors. Asset managers' proxy voting processes and standards should be made public and their engagement procedures should be clear.

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**ENDNOTES**

1 The Principles and open letter are available at http://www.governanceprinciples.org/.

2 Chairman White's speech is available at https://www.sec.gov/news/speech/chair-white-icgn-speech.html.

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