Statement on Corporate Governance

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The Business Roundtable
An Association of Chief Executive Officers Committed to Improving Public Policy

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A White Paper from THE BUSINESS ROUNDTABLE

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Foreword

The Business Roundtable is recognized as an authoritative voice on matters affecting large corporations and, as such, is keenly interested in a proper understanding of the purpose of corporate governance. Past publications of The Business Roundtable that have addressed corporate governance issues include The Business Roundtable's statement on Corporate Governance and American Competitiveness (March, 1990), Statement on Corporate Responsibility (October, 1981) and The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation (January, 1978). In the current publication, The Business Roundtable summarizes its current views on governance issues, thus updating and building on the work of the past.

The Business Roundtable notes with pride that, in the seven years since its last publication on corporate governance, many of the practices suggested for consideration by The Business Roundtable have become more common. This has been the result of voluntary action by the business community without new laws and regulations and reflects the positive impact of interested stockholders. The Business Roundtable believes it is important to allow corporate governance processes to continue to evolve in the same fashion in the years ahead.

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I. Introduction

The Business Roundtable wishes to emphasize that the principal objective of a business enterprise is to generate economic returns to its owners. Although the link between the forms of governance and economic performance is debated, The Business Roundtable believes that good corporate governance practices provide an important framework for a timely response by a corporation's board of directors to situations that may directly affect stockholder value. The absence of good corporate governance, even in a corporation that is performing well financially, may imply vulnerability for stockholders because the corporation is not optimally positioned to deal with financial or management challenges that may arise.

Many discussions of corporate governance focus on questions of form and abstract principle: Should a corporation have a non-executive chairman of the board? Should the board have a lead director? Should there be a limit on the number of boards on which a director serves? The Business Roundtable considers such questions important. Indeed, much of this Statement is devoted to discussing them. However, The Business Roundtable wishes to emphasize that the substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, and does not itself assure, good corporate governance.

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Examples of this point abound. A corporation with the best formal policies and processes for board involvement may be at risk if the chief executive officer is not genuinely receptive to relevant board input or if knowledgeable directors hesitate to express their views. A corporation can have excellent corporate governance structures and policies on paper, but if the CEO and the directors are not focused on stockholder value, it may be less likely the corporation will realize that value. Directors can satisfy the most demanding tests for independence, but if they do not have the personal stature and self-confidence to stand up to a non-performing CEO, the corporation may not be successful. On the other hand, a corporation that lacks many of the so-called "best practices" for corporate governance, or that does not memorialize its practices in formal documents, may nonetheless perform well if its directors and management are highly able people who are dedicated to advancing the interests of stockholders.

Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation.

One of the reasons why people focus on the formal, structural aspects of corporate governance is that doing so permits evaluations that appear to be objective and verifiable. Formal attributes of good corporate governance can be tabulated to compare corporate governance practices across the spectrum of companies. Such comparisons do have value, but it would be a mistake to lose sight of their limitations. The "soft," subjective factors in corporate governance — such as the quality of directors and the personalities of CEOs and directors — receive less attention from scholars and journalists but are critical in the real world of corporate behavior. Boards and management should not feel that they have discharged their responsibilities in regard to corporate governance just by putting in place a particular set of structures and formal processes. They must also periodically review these structures and processes to insure that they are achieving good corporate governance in substance.

Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation. There has been much debate in corporate governance literature about the parties to whom directors owe a duty of loyalty and in whose interest the corporation should be managed. Some say corporations should be managed purely in the interests of stockholders or, more precisely, in the interests of its present and future stockholders over the long-term. Others claim that directors should also take into account the interests of other "stakeholders" such as employees, customers, suppliers, creditors and the community.

The Business Roundtable does not view these two positions as being in conflict, but it sees a need for clarification of the relationship between these two perspectives. It is in the long-term interests of stockholders for a corporation to treat its employees well, to serve its customers well, to encourage its suppliers to continue to supply it, to honor its debts, and to have a reputation for civic responsibility. Thus, to manage the corporation in the long-term interests of the stockholders, management and the board of directors must take into account the interests of the corporation's other stakeholders. Indeed, a number of states have enacted statutes that specifically authorize directors to take into account the interests of constituencies other than stockholders, and a very limited number of state statutes actually require consideration of the interests of other constituencies.

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In The Business Roundtable's view, the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders. The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors. It is, moreover, an unworkable notion because it would leave the board with no criterion for resolving conflicts between interests of stockholders and of other stakeholders or among different groups of stakeholders.

Good corporate governance is not a "one size fits all" proposition ...

While The Business Roundtable favors certain broad principles as generally contributing to good corporate governance, not all of these broad principles are necessarily right for all corporations at all times. Good corporate governance is not a "one size fits all" proposition, and a wide diversity of approaches to corporate governance should be expected and is entirely appropriate. Moreover, a corporation's practices will evolve as it adapts to changing situations.

II. Functions of the Board

The business of a corporation is managed under the direction of the board of directors, but the board delegates to management the authority and responsibility for managing the everyday affairs of the corporation. The extent of this delegation varies depending on the size and circumstances of the corporation. In a large corporation that is performing well and has strong management, the board may delegate more; in a smaller or closely-held corporation, or one facing critical challenges, more detailed involvement by the board in the business of the corporation may be appropriate. In a large publicly owned corporation that is not facing extraordinary difficulties, in addition to reviewing and approving specific corporate actions as required by law (e.g., declaration of dividends), the principal functions of the board are to:

(i) Select, regularly evaluate and, if necessary, replace the chief executive officer; determine management compensation; and review succession planning;

(ii) Review and, where appropriate, approve the major strategies and financial and other objectives and plans of the corporation;

(iii) Advise management on significant issues facing the corporation;

(iv) Oversee processes for evaluating the adequacy of internal controls, risk management, financial reporting and compliance, and satisfy itself as to the adequacy of such processes; and

(v) Nominate directors and ensure that the structure and practices of the board provide for sound corporate governance.

Management Selection and Compensation

- The selection and evaluation of the chief executive officer and concurrence with the CEO's selection and evaluation of the corporation's top management team is probably the most important function of the board. In its broader sense, "selection and evaluation" includes considering compensation, planning for succession and, when appropriate, replacing the CEO or other members of the top management team.

- The performance of the CEO should generally be reviewed at least annually without the presence of the CEO and other inside directors. The board should have an understanding with the CEO with respect to the criteria according to which he or she will be evaluated, and there should be a process for communicating the board's evaluation to the CEO.

- Boards have a responsibility to ensure that compensation plans are appropriate and competitive and properly reflect the objectives and performance of management and the corporation. Incentive plans will vary from corporation to corporation and should be designed to provide the proper balance between long- and short-term performance incentives. Stock options and other equity-oriented plans should be considered as a means for linking management's interests directly to those of stockholders.

Providing advice and counsel to management is a key element of the board's role.

Approval of Major Strategies And Financial Objectives

- Approving major strategies and financial objectives and tracking results is related to the function of selecting and evaluating the CEO. Insofar as the corporation develops and successfully executes sound long-range plans, the CEO and the corporation's management team will generally be deemed to be doing a good job. There may also be circumstances in which the CEO is deemed to be doing a good job even though financial results fall short of plans.

- A corporation may achieve its near-term financial objectives but may ultimately fail if it has not developed an appropriate business strategy. Accordingly, boards should consider financial objectives and results in the context of the wider business strategy of the corporation.

- When a corporation falls significantly short of its important objectives or when plans appear to be inadequate, more intensive board oversight of management is warranted. This kind of circumstance requires the best judgment of people highly experienced in business and management. Alternatives must be considered carefully and appropriate action taken.

Advising Management

- Providing advice and counsel to management is a key element of the board's role. It is fulfilled both in formal board and board committee meetings and also in informal, individual director contacts with the CEO and other members of management.

- A board member who effectively fulfills his or her role of advising the CEO provides an important service to the corporation.

Risk Management, Controls and Compliance

- The Board must assure that an effective system of controls is in place for safeguarding the corporation's assets, managing the major risks faced by the corporation, reporting accurately the corporation's financial condition and results of operations, adhering to key internal policies and authorizations, and complying with significant laws and regulations that are applicable to it.

- In performing these functions, the board generally relies on the advice and reports of management, internal and external counsel, and internal and external auditors. The board's role should be to review reports from such experts, to provide them with guidance and to assure that management takes appropriate corrective actions when significant control problems are reported.

Selection of Board Candidates

- It is the board's responsibility to nominate directors. The board nominates a whole slate, which should encompass individuals with diverse talents, backgrounds, and perspectives who can work effectively together to further the interests of the corporation's stockholders, while preserving their ability to differ with each other on particular issues as policy is developed. Men and women of different ages, races and ethnic backgrounds can contribute different, useful perspectives.

Each director should represent the interests of all stockholders, not those of any single individual or group of stockholders or any single interest group.

- Each director should represent the interests of all stockholders, not those of any single individual or group of stockholders or any single interest group. Cumulative voting is generally not recommended for large publicly owned corporations because it may lead to the election of directors who represent particular groups of stockholders, which can in turn create factionalism and undermine the effectiveness of the board.
- Effective boards are composed of individuals who are highly experienced in their respective fields of endeavor and whose knowledge, background and judgment will be useful to the corporation. Directors must have the ability and willingness to learn the corporation's business and to express their personal views.
- Each person serving as a director must devote the time and attention necessary to fulfill the obligations of a director. Service on other boards often broadens and deepens the knowledge and experience of directors. In addition, CEOs who serve on other boards frequently gain valuable insight and experience which prove useful in the running of their own companies. However, service on too many boards can interfere with an individual's ability to perform his or her responsibilities. Before accepting an additional board position, a director should consider whether the acceptance of a new directorship will compromise the ability to perform present responsibilities. Similarly, it is advisable for an inside director to consult with his or her own board before accepting a new directorship on the board of another corporation. Because time demands from board to board and capacities of individual directors will vary, The Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold.

- Each nominating/governance committee should develop its own process for considering stockholder suggestions for board nominees. Should a stockholder desire to suggest a nominee to the board, most corporations request that a letter be written to the secretary of the company providing a resume of the suggested nominee.

Board Evaluation

- The board is responsible for its own evaluation from time to time. Such evaluations will provide the basis for the board's recommendation of a slate of directors to the stockholders. Boards also implicitly evaluate individual directors by endorsing them for re-nomination. Some boards formalize this process through evaluations of individual directors. Other boards formally address individual director performance only when it appears that a particular director is not contributing sufficiently to the performance of the board as a whole. While no particular approach to individual director evaluation is best for all companies at all times, each board should have a process, formal or informal, for discharging its responsibility to nominate good directors.

- The board should from time to time review its own structure, governance principles, composition, agenda, processes and schedule to consider whether it is functioning well in view of its responsibilities and the evolving situation of the corporation.

III. Structure and Operations of the Board

There are, and should be, diverse approaches to board structure and operations. In the following sections we describe approaches that The Business Roundtable considers generally useful for good corporate governance. However, these should not be regarded as rigid rules applicable to all corporations at all times.

It is important for the board of a large, publicly owned corporation to have a substantial degree of independence from management.

Board Composition

- Boards of directors of most large publicly owned corporations typically range in size from 8 to 16 individuals. Optimal board size will vary from corporation to corporation and industry to industry. In general, the experience of many Roundtable members suggests that smaller boards are often more cohesive and work more effectively than larger boards.

- It is important for the board of a large publicly owned corporation to have a substantial degree of independence from management. Accordingly, a substantial majority of the directors of such a corporation should be outside (non-management) directors. The degree of independence of an outside director may be affected by many factors, including the personal stature of the director and any business relationship of the director with the corporation or any business or personal relationship of the director with management. Directors, or firms in which they have an interest, are sometimes engaged to provide legal, consulting, accounting or other services to the corporation, or a director may have an interest in a customer, supplier or business partner of the corporation, or may at an earlier point in his or her career have been an employee or officer of the company. Depending on their significance to the director and to the corporation, such relationships may affect a director's actual or perceived independence. The Business Roundtable believes that, where such relationships exist, boards should be mindful of them and make a judgment about a director's independence based on his or her individual circumstances rather than through the mechanical application of rigid criteria. This would involve consideration of whether the relationships are sufficiently significant as to interfere with the director's exercise of independent judgment. If a particular director is not deemed sufficiently independent, the board may nevertheless conclude that the individual's role on the board remains highly desirable (as in the case of an inside director) in the context of a board composed of a majority of directors with the requisite independence. The overall result should be a board that, as a whole, represents the interests of stockholders with appropriate independence.

- For certain functions, such as membership on an audit or compensation committee, more specific standards of independence should be used. For example, Section 162(m) of the Internal Revenue Code prescribes certain standards that the compensation committee must meet to permit the deduction for federal income tax purposes of performance-based compensation exceeding $1 million paid to the CEO and the four other highest paid executive officers. There are other examples of prescribed standards for members of the compensation committee under Section 16 of the Securities Exchange Act of 1934 and for members of the audit committee under rules of the New York Stock Exchange. In addition, more particularized rules apply in certain industries, such as banking. It is recommended that the board, or a

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committee such as the nominating/governance committee, periodically confirm that the composition of the relevant committees meets the applicable requirements as well as any other criteria determined by the board.

- Inside directors will ordinarily include the chief executive officer and may also include other officers whose positions or potential for succession make it appropriate, in the judgment of the board, for them to sit on the board.
- There has been considerable discussion of mechanisms for providing board leadership independent of management. Such leadership is particularly important when a CEO dies or becomes incapacitated or when there are questions concerning the competence or conduct of management:
  - ▲ Most members of The Business Roundtable believe their corporations are generally well served by a structure in which the CEO also serves as chairman of the board. They believe that the CEO should set the agenda and the priorities for the board and for management and should serve as the bridge between management and the board, ensuring that management and the board are acting with common purpose.
  - ▲ Some corporations have separated the roles of CEO and chairman of the board, often in response to particular circumstances, such as to provide a smooth transition from one CEO to another.
  - ▲ Some other corporations have employed the concept of a lead director. The role of a lead

> director is sometimes designed with specific duties, such as consultation with the CEO on board agendas and chairing the executive sessions of the board. In other cases, the lead director has no special duties in ordinary situations, but assumes a leadership role in the event of the death or incapacity of the CEO or in other situations where it is not possible or appropriate for the CEO to take the lead.

Each corporation should be free to make its own determination of what leadership structure serves it best, given its present and anticipated circumstances. The Business Roundtable believes that most corporations will continue to choose, and be well served by, unifying the positions of chairman and CEO. Such a structure provides a single leader with a single vision for the company and most Business Roundtable members believe it results in a more effective organization. Where these positions are unified, The Business Roundtable also believes that it is desirable for directors to have an understanding as to how non-executive leadership of the board would be provided, whether on an ongoing basis or on a transitional basis if and when the need arose. In some boards, the presence of one strong figure might provide the natural leader. In other circumstances, there could be an understanding that leadership would fall to the committee chair responsible for the subject matter that gave rise to the need. In still others, it could be the responsibility of the committee chairs to recommend whether non-executive leadership is required, and if so, in what form. Whether the board's understanding of the process would be codified as a formal board action should be a matter for individual boards to determine.

A wide diversity of approaches in committee structure and function responds to the specific needs of companies facing different business challenges and having different corporate cultures, and reflects the need to allow organizational experimentation.

- It is now common practice to establish rules for the retirement or resignation of directors. These may, for example, include a mandatory retirement age for directors or a requirement that a director submit his or her resignation at such time as the director no longer occupies the position he or she held at the time of election, unless the change in position is as a result of normal retirement. Even in the absence of such provisions, a board should plan for its own continuity and succession — for the retirement of directors and the designation of new board members. Because the composition and circumstances of boards will vary, so too will the retirement policies of different corporations.
- The Business Roundtable recognizes that certain corporations may have histories or circumstances that make term limits desirable for them. However, The Business Roundtable generally does not favor the establishment of term limits for directors. Such limits often cause the loss of directors who have gained valuable knowledge concerning the company and its operations and whose tenure over time has given them an important perspective on long-term strategies and initiatives of the corporation.

Committee Structure

- Virtually all boards of directors of large publicly owned companies operate with a committee structure to permit the board to address certain key areas in more depth than may be possible in a full board meeting. A wide diversity of approaches in committee structure and function responds to the specific needs of companies facing different business challenges and having different corporate cultures, and reflects the need to allow organizational experimentation.

- It is recommended that each corporation have an audit committee, which is required under New York Stock Exchange rules, a compensation/personnel committee, and a nominating/governance committee and that membership in these committees be limited to outside directors. The board may also wish to establish other committees with other specific responsibilities. Other common committees include an executive committee to act for the board between meetings and to handle other specifically assigned duties, a finance committee, and a social responsibility or public policy committee. In some cases a board may wish to establish ad hoc committees to examine special problems or opportunities in greater depth than would otherwise be feasible.

- The number of committees will vary from corporation to corporation. Boards should also be conscious of the limitations inherent in having too much of their business handled in committees. Boards working as a whole on important strategic issues allow the corporation to take advantage of the collective wisdom of the board.

- The primary functions of the audit committee are generally to recommend the appointment of the public accountants and review with them their report on the financial reports of the corporation; to review the adequacy of the system of internal controls and of compliance with material policies and laws, including the corporation's code of ethics or code of conduct; and to provide a direct channel of communication to the board for the public accountants and internal auditors and, when needed, finance officers, compliance officers and the general counsel.

- The compensation/personnel committee is generally responsible for ensuring that a proper system of long- and short-term compensation is in place to provide performance-oriented incentives to management. The compensation committee will also evaluate the CEO's performance for compensation purposes and report on this subject to all of the outside directors, if this function is not performed by the entire board. Likewise, it authors the report on executive compensation required under the proxy rules. This committee is also often responsible for assuring that key management succession plans and managers are reviewed periodically. In some companies, succession planning and review of key personnel issues are handled by the nominating/governance committee. When CEOs serve on each other's boards, it is generally inadvisable for them to serve on each other's compensation committees because of the potential for conflicts of interest.

- The nominating/governance committee is typically responsible for advising the board as a whole on corporate governance matters, developing a policy on the size and composition of the board, reviewing possible candidates for board membership, performing board evaluations, and recommending a slate of nominees. The board should have the benefit of the CEO's involvement in the selection process, but the responsibility for selection of board nominees remains that of the board.

Board Compensation

- Board compensation should be competitive in view of industry practices and the extent of burdens placed on board members. The form of such compensation will vary from corporation to corporation and may depend on the circumstances of the directors that the board may be seeking to attract and retain.

- Boards should consider aligning the interests of directors with those of the corporation's stockholders by including some form of equity, such as stock grants or options, as a portion of each director's compensation.

- Some corporations may wish to establish a specific goal for equity ownership by directors; however, the desirability of setting such a goal is company specific and may depend on the circumstances of its directors. For example, some directors whose principal occupations are in public service or academic settings may prefer current cash compensation.

- Although there has recently been a trend away from retirement programs for directors, The Business Roundtable believes that the focus should be on the appropriate level of total compensation, rather than on the timing of payments.

Operations

- Boards must meet as frequently as needed in order for directors to discharge properly their responsibilities. According to surveys, the typical board of a large publicly owned corporation meets about eight times per year. Depending on the complexity of the organization, the degree of business success and stability, and the desires of the board, greater or lesser frequency may be appropriate. Many directors prefer to have fewer but longer meetings where subjects can be explored in depth.

- There should be an opportunity for the board to meet periodically, at least annually, outside the presence of the CEO and other inside directors. This may be a portion

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of a normally scheduled board meeting, and the CEO's annual performance evaluation is a good opportunity for such a meeting.

- A carefully planned agenda is important for effective board meetings, but it must be flexible enough to accommodate crises and unexpected developments. In practice, the items on the agenda are typically determined by the chairman in consultation with the board, with subjects also being suggested by various outside board members. A CEO should be responsive to a director's request to add a specific subject to a future agenda.
- To ensure continuing effective board operations, the CEO should periodically ask the directors for their evaluation of the general agenda items for board meetings and any suggestions they may have for improvement. In particular, the board should ensure that adequate time is provided for full discussion of important corporate items and that management presentations are scheduled in a manner that permits a substantial proportion of board meeting time to be available for open discussion.
- The board must be given sufficient information to exercise fully its governance functions. This information comes from a variety of sources, including management reports, personal observation, a comparison of performance to plans, security analysts' reports, articles in various business publications, etc. Generally, board members should receive information prior to board meetings so they will have an opportunity to reflect properly on the items to be considered at the meeting.
- Board members should have full access to senior management and to information about the corporation's

operations. Except in unusual circumstances, the CEO should be advised of significant contacts with senior management.

- Because the information and expertise relevant to the board's regular decision-making will normally be found within the corporation, the main responsibility for providing assistance to the board rests on the internal organization. There may, however, be occasions when it is appropriate for the board to seek legal or other expert advice from a source independent of management, and generally this would be with the knowledge and concurrence of the CEO.

- In general, the corporation's management should speak for the corporation. Communications with the public at large, the press, customers, securities analysts and stockholders should typically flow through, and be coordinated by, the CEO or other management. From time to time outside directors may be requested by the board or management to meet or speak with other parties that are involved with the corporation.

- It is important that each board consider its policies and practices on corporate governance matters. Whether or not a board will formalize its board practices in written form will vary depending on the particular circumstances. Some corporations have found that overformalization leads to a rigid structure which emphasizes form over substance, while others have found that insufficient formalization leads to lack of clarity.

IV. Stockholder Meetings

… matters brought to stockholder attention through the proxy statement should be matters of significance to the business of the corporation and to stockholders as a whole.

Meetings of stockholders provide an important forum for the consideration of management and stockholder proposals. An orderly discussion of the corporation's affairs is facilitated by following a specific agenda and by adhering to a code that governs the conduct of the meeting.

Agendas and Conduct of the Meeting

- To facilitate an orderly meeting of stockholders, it is desirable that there be a written agenda made available to all attendees.
- Principal rules for the conduct of the meeting should be set forth in writing and also made available to every attendee. The rules may address matters such as the procedures for moving resolutions and asking questions of the chair, and include any limits on time or number of speakers for matters under discussion.

Management and Stockholder Proposals

- The consideration of management and stockholder proposals and board nominations is largely conducted through the proxy process rather than through proposals raised at stockholder meetings. This gives all stockholders, rather than only those who attend the meeting, the opportunity to consider relevant matters. Although the rules governing inclusion of stockholder proposals in proxy statements have changed over the years and are likely to continue to evolve, certain underlying principles should govern the process. Most importantly, matters brought to stockholder attention through the proxy statement should be matters of significance to the business of the corporation and to stockholders as a whole. Other matters, such as those relating to personal grievances and political or social issues are more appropriately discussed in other forums. Matters pertaining to the conduct of the ordinary business operations of the corporation should be governed by management and the stockholder-elected board of directors.

- Reasonable notice of topics permits all interested parties to participate in the process in a considered way. As a result, The Business Roundtable recommends that corporations consider advance notice requirements in by-laws because such requirements generally promote good corporate governance.
- Adequate measures to assure the integrity, accuracy and timeliness of the voting tabulation process are highly important.

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