



Business Roundtable

# Principles of Corporate Governance 2005

November 2005



## Business Roundtable

Business Roundtable ([www.businessroundtable.org](http://www.businessroundtable.org)) is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and \$4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

# Principles of Corporate Governance 2005



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## Foreword and Introduction

Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in corporate governance. Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and \$4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and the well-trained and productive U.S. workforce essential for future competitiveness.

Since May 2002, when Business Roundtable issued its *Principles of Corporate Governance*, U.S. public corporations have witnessed fundamental and accelerated changes in the area of corporate governance, beginning with the passage of the Sarbanes-Oxley Act of 2002 and continuing with the adoption of strengthened listing standards by the securities markets. We note that many of the best practices recommended in the principles are now embedded in the Sarbanes-Oxley Act and in securities market listing standards.

Following the publication of *Principles of Corporate Governance* (May 2002), Business Roundtable issued *Executive Compensation: Principles and Commentary* (November 2003), *The Nominating Process and Corporate Governance Committees: Principles and Commentary* (April 2004), and *Guidelines for Shareholder-Director Communications* (May 2005). Other publications from Business Roundtable that have addressed corporate governance include *Statement on Corporate Governance* (September 1997), *Executive Compensation/Share Ownership* (March 1992), *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).

Business Roundtable continues to believe, as we noted in *Principles of Corporate Governance* (2002), that the United States has the best corporate governance, financial reporting and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

Given the fundamental nature of the changes that have occurred during the past several years in the framework of laws and regulations related to corporate governance, as well as in best practices, Business Roundtable believes it is appropriate, once again, to restate our guiding principles of corporate governance. Although applicable legal requirements and securities market listing standards establish minimum requirements, these principles, we believe, should help guide the ongoing advancement of corporate governance practices and, thus, advance the ability of public corporations to compete, create jobs and generate economic growth.

Business Roundtable supports the following guiding principles:

First, the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and senior management in the competent and ethical operation of the corporation on a day-to-day basis.

Second, it is the responsibility of management to operate the corporation in an effective and ethical manner to produce value for shareholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. The CEO and board of directors should set a “tone at the top” that establishes a culture of legal compliance and integrity. Management and directors should never put personal interests ahead of or in conflict with the interests of the corporation.

Third, it is the responsibility of management, under the oversight of the audit committee and the board, to produce financial statements that fairly present the financial condition and results of operations of the corporation and to make the timely disclosures investors need to assess the financial and business soundness and risks of the corporation.

Fourth, it is the responsibility of the board, through its audit committee, to engage an independent accounting firm to audit the financial statements prepared by management, issue an opinion that those statements are fairly stated in accordance with Generally Accepted Accounting Principles and oversee the corporation’s relationship with the outside auditor.

Fifth, it is the responsibility of the board, through its corporate governance committee, to play a leadership role in shaping the corporate governance of the corporation. The corporate governance committee also should select and recommend to the board qualified director candidates for election by the corporation's shareholders.

Sixth, it is the responsibility of the board, through its compensation committee, to adopt and oversee the implementation of compensation policies, establish goals for performance-based compensation, and determine the compensation of the CEO and senior management.

Seventh, it is the responsibility of the board to respond appropriately to shareholders' concerns.

Eighth, it is the responsibility of the corporation to deal with its employees, customers, suppliers and other constituencies in a fair and equitable manner.

These responsibilities and others are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management.

Business Roundtable continues to believe that corporate governance should be enhanced through conscientious and forward-looking action by a business community that focuses on generating long-term shareholder value with the highest degree of integrity.

The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, as well as to serve as guideposts for the public dialogue on evolving governance standards.



# I. Key Corporate Actors

Effective corporate governance requires a clear understanding of the respective roles of the board and senior management and of their relationships with others in the corporate structure. The relationships of the board and management with shareholders should be characterized by candor; their relationships with employees should be characterized by fairness; their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.

The board of directors has the important role of overseeing management performance on behalf of shareholders. Its primary duties are to select and oversee a well-qualified and ethical chief executive officer who, with senior management, runs the corporation on a daily basis and to monitor management's performance and adherence to corporate and ethical standards. Effective corporate directors are diligent monitors, but not managers, of business operations.

Senior management, led by the CEO, is responsible for running the day-to-day operations of the corporation and properly informing the board of the status of these operations. Management's responsibilities include strategic planning, risk management and financial reporting.

Shareholders are not involved in the day-to-day management of corporate operations but have the right to elect representatives (directors) to look out for their interests and to receive the information they need to make investment and voting decisions. The board should be responsive to communications from shareholders and should address issues of concern to shareholders.

Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior management, all of whom must be committed to business success through the maintenance of the highest standards of responsibility and ethics. Although there are a number of legal and regulatory requirements that must be met, good governance is far more than a "check-the box" list of minimum board and management policies and duties. Even the most

thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal setting, effective decision making, and appropriate monitoring of compliance and performance. Through this vibrant and responsive structure, the CEO, the senior management team and the board of directors can interact effectively and respond quickly and appropriately to changing circumstances, within a framework of solid corporate values, to provide enduring value to the shareholders who invest in the enterprise.

## II. The Roles of the Board of Directors and Management

An effective system of corporate governance provides the framework within which the board and management address their respective responsibilities.

### The Board of Directors

- ▶ The business of a corporation is managed under the direction of the corporation's board. The board delegates to the CEO — and through the CEO to other senior management — the authority and responsibility for managing the everyday affairs of the corporation. Directors monitor management on behalf of the corporation's shareholders.
- ▶ Making decisions regarding the selection, compensation and evaluation of a well-qualified and ethical CEO is the single most important function of the board. The board also appoints or approves other members of the senior management team.
- ▶ Directors bring to the corporation a range of experience, knowledge and judgment. Directors should not represent the interests of particular constituencies.
- ▶ Effective directors maintain an attitude of constructive skepticism; they ask incisive, probing questions and require accurate, honest answers; they act with integrity and diligence; and they demonstrate a commitment to the corporation, its business plans and long-term shareholder value.
- ▶ In performing its oversight function, the board is entitled to rely on the advice, reports and opinions of management, counsel, auditors and expert advisers. The board should assess the qualifications of those it relies on and hold managers and advisers accountable. The board should ask questions and obtain answers about the processes used by managers and the corporation's advisers to reach their decisions and recommendations, as well as about the substance of the advice and reports received by the board. When appropriate, the board and its committees should seek independent advice.

- ▶ Given the board’s oversight role, shareholders and other constituencies can reasonably expect that directors will exercise vigorous and diligent oversight of a corporation’s affairs. However, they should not expect the board to micromanage the corporation’s business by performing or duplicating the tasks of the CEO and senior management team.
- ▶ The board’s oversight function carries with it a number of specific responsibilities in addition to that of selecting and overseeing the CEO. These responsibilities include:
  - *Planning for management development and succession.* The board should oversee the corporation’s plans for developing senior management personnel and plan for CEO and senior management succession. When appropriate, the board should replace the CEO or other members of senior management.
  - *Understanding, reviewing and monitoring the implementation of the corporation’s strategic plans.* The board has responsibility for overseeing and understanding the corporation’s strategic plans from their inception through their development and execution by management. Once the board reviews a strategic plan, it should regularly monitor implementation of the plan to determine whether it is being implemented effectively and whether changes are needed. The board also should ensure that the corporation’s incentive compensation program is aligned with the corporation’s strategic plan.
  - *Understanding and approving annual operating plans and budgets.* The board is responsible for understanding, approving and overseeing the corporation’s annual operating plans and for reviewing the annual budgets presented by management. The board should monitor implementation of the annual plans to assess whether they are being implemented effectively and within the limits of approved budgets.
  - *Focusing on the integrity and clarity of the corporation’s financial statements and financial reporting.* The board, assisted by its audit committee, should be satisfied that the financial statements and other disclosures prepared by management accurately present the corpora-

tion's financial condition and results of operations to shareholders and that they do so in an understandable manner. To achieve accuracy and clarity, the board, through its audit committee, should have an understanding of the corporation's financial statements, including why the accounting principles critical to the corporation's business were chosen, what key judgments and estimates were made by management, and how the choice of principles and the making of these judgments and estimates affect the reported financial results of the corporation.

- *Advising management on significant issues facing the corporation.* Directors can offer management a wealth of experience and a wide range of perspectives. They provide advice and counsel to management in formal board and committee meetings, and they are available for informal consultation with the CEO and senior management.
- *Reviewing and approving significant corporate actions.* As required by state corporate law, the board reviews and approves specific corporate actions, such as the election of executive officers, the declaration of dividends and (as appropriate) the implementation of major transactions. The board and senior management should have a clear understanding of what level or types of decisions require specific board approval.
- *Reviewing management's plans for business resiliency.* As part of its oversight function, the board should designate senior management who will be responsible for business resiliency. The board should periodically review management's plans to address this issue. Business resiliency can include such items as business risk assessment and management, business continuity, physical and cyber security, and emergency communications.
- *Nominating directors and committee members and overseeing effective corporate governance.* It is the responsibility of the board, through its corporate governance committee, to nominate directors and committee members and oversee the composition, independence, structure, practices and evaluation of the board and its committees.

- *Overseeing legal and ethical compliance.* The board should set a “tone at the top” that establishes the corporation’s commitment to integrity and legal compliance. The board should oversee the corporation’s compliance program relating to legal and ethical conduct. In this regard, the board should be knowledgeable about the corporation’s compliance program and should be satisfied that the program is effective in preventing and deterring violations. The board should pay particular attention to conflicts of interest, including related party transactions.

## **The CEO and Management**

- ▶ It is the responsibility of the CEO and senior management, under the CEO’s direction, to operate the corporation in an effective and ethical manner. As part of its operational responsibility, senior management is charged with:
  - *Operating the corporation.* The CEO and senior management run the corporation’s day-to-day business operations. With a thorough understanding of how the corporation operates and earns its income, they carry out the corporation’s strategic objectives within the annual operating plans and budgets, which are reviewed and approved by the board. In making decisions about the corporation’s business operations, the CEO considers the long-term interests of the corporation and its shareholders and necessarily relies on the input and advice of others, including senior management and outside advisers. The CEO keeps the board apprised of significant developments regarding the corporation’s business operations.
  - *Strategic planning.* The CEO and senior management generally take the lead in strategic planning. They identify and develop strategic plans for the corporation; present those plans to the board; implement the plans once board review is completed; and recommend and carry out changes to the plans as necessary.

- *Annual operating plans and budgets.* With the corporation's overall strategic plans in mind, senior management develops annual operating plans and budgets for the corporation and presents the plans and budgets to the board. Once the board has reviewed and approved the plans and budgets, the management team implements the annual operating plans and budgets.
- *Selecting qualified management, and establishing an effective organizational structure.* Senior management is responsible for selecting qualified management and implementing an organizational structure that is efficient and appropriate for the corporation's particular circumstances.
- *Identifying and managing risks.* Senior management identifies and manages the risks that the corporation undertakes in the course of carrying out its business. It also manages the corporation's overall risk profile.
- *Accurate and transparent financial reporting and disclosures.* Senior management is responsible for the integrity of the corporation's financial reporting system and the accurate and timely preparation of the corporation's financial statements and related disclosures in accordance with Generally Accepted Accounting Principles and in compliance with applicable laws and regulations. It is senior management's responsibility — under the direction of the CEO and the corporation's principal financial officer — to establish, maintain and periodically evaluate the corporation's internal controls over financial reporting and the corporation's disclosure controls and procedures. In accordance with applicable law and regulations, the CEO and the corporation's principal financial officer also are responsible for certifying the accuracy and completeness of the corporation's financial statements and the effectiveness of the corporation's internal and disclosure controls.

- ▶ The CEO and senior management are responsible for operating the corporation in an ethical manner. They should never put individual, personal interests before those of the corporation or its shareholders. Business Roundtable believes that when carrying out this function, corporations should have:
  - *A CEO of integrity.* The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.
  - *A strong, ethical “tone at the top.”* The CEO and senior management should set a “tone at the top” that establishes a culture of legal compliance and integrity communicated to personnel at all levels of the corporation.
  - *An effective compliance program.* Senior management should take responsibility for implementing and managing an effective compliance program relating to legal and ethical conduct. As part of its compliance program, a corporation should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of seeking guidance and alerting management and the board about potential or actual misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

### III. How the Board Performs Its Oversight Function

Publicly owned corporations employ diverse approaches to board structure and operations within the parameters of applicable legal requirements and securities market listing standards. Although no one structure is right for every corporation, Business Roundtable believes that the corporate governance “best practices” set forth in the following sections provide an effective approach for corporations to follow.

#### **Board Composition and Leadership**

- ▶ Boards of directors of large, publicly owned corporations vary in size from industry to industry and from corporation to corporation. In determining board size, directors should consider the nature, size and complexity of the corporation as well as its stage of development. The experiences of many Business Roundtable members suggest that smaller boards often are more cohesive and work more effectively than larger boards.
- ▶ Business Roundtable believes that having directors with relevant business and industry experience is beneficial to the board as a whole. Directors with this experience can provide a useful perspective on significant risks and competitive advantages and an understanding of the challenges facing the business. A diversity of backgrounds and experience, consistent with the corporation’s needs, also is important to the overall composition of the board. Because the corporation’s need for particular backgrounds and experience may change over time, the board should monitor the mix of skills and experience that directors bring to the board against established board membership criteria to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function effectively.

- ▶ The board of a publicly owned corporation should have a substantial degree of independence from management. Board independence depends not only on directors' individual relationships but also on the board's overall attitude toward management. Providing objective independent judgment is at the core of the board's oversight function, and the board's composition should reflect this principle.
- ▶ A substantial majority of directors of the board of a publicly owned corporation should be independent, both in fact and appearance, as determined by the board. In accordance with the listing standards of the major securities markets, the board should make an affirmative determination as to the independence of each director annually and should have a process in place for making these determinations.
  - *Definition of "independence."* An independent director should not have any relationships with the corporation or its management — whether business, employment, charitable or personal — that may impair, or appear to impair, the director's ability to exercise independent judgment. The listing standards of the major securities markets define "independence" and enumerate specific relationships (such as employment with the corporation or its outside auditor) that preclude a director from being considered independent.
  - *Assessing independence.* The board should approve standards for determining directors' independence, taking into account the requirements of the federal securities laws, securities market listing standards, and the views of institutional investors and other relevant groups. These standards should be set forth in the corporation's corporate governance principles. When considering whether a director is independent, the board should consider not only whether the director has any of the relationships covered by the board's independence standards but also whether the director has any other relationships, either directly or indirectly, with the corporation, senior management or other board members that could affect the director's actual or perceived independence.

- *Relationships with not-for-profit organizations.* The board's director independence standards should include standards for assessing directors' relationships with not-for-profit organizations that receive support from the corporation. In applying these standards, the board should take into account the size of the corporation's contributions and the nature of directors' relationships to the recipient organizations. Independence issues are most likely to arise when a director is an employee of the not-for-profit organization and when a substantial portion of the organization's funding comes from the corporation. It also may be appropriate to consider contributions from a corporation's foundation to organizations with which a director is affiliated.
- ▶ Most American corporations have been well served by a structure in which the CEO also serves as chairman of the board. The CEO serves as a bridge between management and the board, ensuring that both act with a common purpose. The decision concerning whether the CEO also should serve as chairman of the board often is part of the succession planning process, and the board should make that decision in light of the corporation's facts and circumstances.
- ▶ Although no one structure is right for every corporation, it is critical that the board has independent leadership. Some boards have found it useful to separate the roles of CEO and chairman of the board. Alternatively, there is a growing trend for boards to appoint a "lead" or "presiding" director. A lead director generally advises on board meeting schedules and agendas, chairs executive sessions of the board, oversees the flow of information to the board, and serves as a liaison between the independent directors and the CEO. The lead director also may play a key role in overseeing performance evaluations of the CEO and the board, be available for communication with shareholders, and lead the board in crisis situations.
- ▶ Still other boards have designated an independent director to preside over the executive sessions of a board's independent or nonmanagement directors that are required by securities market listing standards. Depending on the corporation, the so-called presiding director also may perform some or all of the other functions performed by the lead director.

## Board Organization

- ▶ Virtually all boards of directors of large, publicly owned corporations operate using committees to assist them. A committee structure permits the board to address key areas in more depth than may be possible in a full board meeting.
- ▶ Decisions about committee membership and chairs should be made by the full board based on recommendations from the corporate governance committee. Consideration should be given to whether periodic rotation of committee memberships and chairs would provide fresh perspectives and enhance directors' familiarity with different aspects of the corporation's business, consistent with applicable listing standards.
- ▶ Committees should apprise the full board of their activities on a regular basis. Processes should be developed and monitored for keeping the board informed through oral or written reports. For example, some corporations provide minutes of committee meetings to all members of the board.
- ▶ Business Roundtable believes that the functions generally performed by the audit, compensation and corporate governance committees are central to effective corporate governance. The listing standards of the major securities markets require corporations to have an audit committee that performs specific functions, and many corporations also are required to have committees that oversee executive compensation, director nominations and corporate governance matters. Business Roundtable does not believe that a particular committee structure is essential for all corporations. What is important is that key issues are addressed effectively by the independent members of the board. Thus, the references below to the functions performed by particular committees are not intended to preclude corporations from allocating these functions differently, consistent with applicable listing standards.
- ▶ Additional committees, such as finance or risk management committees, also may be used. Some corporations find it useful to establish committees to examine special problems or opportunities in greater depth than would otherwise be feasible.

- ▶ The responsibilities of each committee and the qualifications required for committee membership should be clearly defined and set out in a written charter that is approved by the board and publicly available. Each committee should review its charter annually and recommend changes to the board as appropriate.
- ▶ A more detailed discussion of particular committee functions appears in Business Roundtable's *Executive Compensation: Principles and Commentary* (November 2003) and *The Nominating Process and Corporate Governance Committees: Principles and Commentary* (April 2004).

### **Audit Committee**

- ▶ Every publicly owned corporation should have an audit committee of at least three members, who should all be independent directors.
- ▶ Audit committees typically consist of three to five members. The listing standards of the major securities markets require that all members of the audit committee qualify as independent directors under applicable listing standards, subject to limited exceptions, and that they meet additional, heightened independence criteria.
- ▶ Audit committee members should meet minimum financial literacy standards, as required by the listing standards of the major securities markets, and at least one member of the audit committee should be an audit committee financial expert, as determined by the board in accordance with regulations of the Securities and Exchange Commission. Just as important is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile and to apply their business experience and judgment with an independent and critical eye to the issues for which the committee is responsible.
- ▶ With the significant responsibilities imposed on audit committees under applicable law, regulations and listing standards, consideration should be given to whether it is appropriate to limit the number of public company audit committees on which a corporation's audit committee members may

serve. Some boards have adopted policies that audit committee members may not serve on the audit committees of more than three public corporations, in accordance with applicable securities market listing standards. Policies may permit exceptions to this limit when the corporation's board determines that the simultaneous service would not affect an individual's ability to serve effectively on the corporation's audit committee.

- ▶ The audit committee is responsible for supervising the corporation's relationship with its outside auditor. In performing this responsibility, the primary functions of the audit committee include:
  - *Retaining the auditor and approving in advance the terms of the annual audit engagement.* The selection of the outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence and reputation of the outside auditor and the performance of key members of the audit team. The committee should be mindful of the schedule, mandated by applicable law and regulations, for rotating the engagement and concurring partners and should begin the process of reviewing new partners sufficiently in advance of required rotations. The audit committee also should consider periodically whether it is appropriate for the corporation to change its outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits. In retaining the auditor, the audit committee should oversee the process of negotiating the annual audit engagement letter and should scrutinize the terms of the engagement carefully.
  - *Overseeing the independence of the outside auditor.* The audit committee should maintain an ongoing, open dialogue with the outside auditor about independence issues. The committee should consider its overall approach to using the outside auditor as a service provider and identify those services, beyond the annual audit engagement, that the outside auditor can provide to the corporation consistent with applicable law and regulations and with maintaining independence. In pre-approving all non-audit services to be provided by the outside auditor, as required

by applicable law and regulations, the audit committee should decide whether to adopt a pre-approval policy or approve services on an engagement-by-engagement basis.

- ▶ The audit committee also is responsible for overseeing the corporation's financial reporting process. The audit committee should review and discuss the corporation's annual financial statements with management and the outside auditor and should review the corporation's quarterly financial statements and related earnings press releases prior to issuance. As part of its reviews, the audit committee should review and discuss with management and the outside auditor the corporation's critical accounting policies, the quality of accounting judgments and estimates made by management, and any material written communications between the outside auditor and management.
- ▶ The audit committee should understand and be familiar with the corporation's system of internal controls over financial reporting and its disclosure controls and procedures, including the processes for producing the certifications required of the CEO and principal financial officer, and the audit committee should be comfortable that the corporation has appropriate controls in place. On a periodic basis, the committee should review with both the internal and outside auditors, as well as with management, the corporation's procedures for maintaining and evaluating the effectiveness of these systems. The committee should be promptly notified of any significant deficiencies or material weaknesses in internal controls and kept informed about the steps and timetable for correcting them.
- ▶ Unless the full board or another committee does so, the audit committee should oversee the corporation's program that addresses compliance with ethical and legal standards and important corporate policies, including the corporation's code of conduct and the mechanisms it has in place for employees to report compliance issues. In accordance with applicable legal requirements, the audit committee should establish procedures for receiving and handling complaints and concerns related to accounting, internal accounting controls and auditing issues, and the committee should evaluate these procedures periodically and revise them as appropriate. The audit

committee should be briefed regularly on the status of outstanding compliance issues, including concerns submitted through the committee's procedures for handling accounting and related concerns, and it should receive prompt notification of any significant compliance issues.

- ▶ The audit committee should understand the corporation's risk profile and oversee its risk assessment and risk management practices.
- ▶ The audit committee should oversee the corporation's internal audit function, including reviewing the scope of the internal audit plan, reports submitted by the internal audit staff and management's response, and the appointment and replacement of the senior internal auditing executive.
- ▶ The audit committee should implement a policy covering the hiring of personnel who previously worked for the corporation's outside auditor. At a minimum, this policy should incorporate the "cooling off" period mandated by applicable law and regulations.
- ▶ Audit committee meetings should be held frequently enough to allow the committee to monitor the corporation's financial reporting appropriately. Meetings should be scheduled with enough time to permit and encourage active discussions with management and the internal and outside auditors. The audit committee should meet privately with each of the internal and outside auditors and management on a regular basis, and in any event at least quarterly, and communicate with them between meetings as necessary. The audit committee also should hold private sessions with the corporation's chief legal officer on a regular basis to facilitate the communication of concerns regarding legal compliance matters and significant legal contingencies. The audit committee also may determine that it is appropriate to hold private sessions with other parties, such as outside counsel, from time to time.

## Corporate Governance Committee

- ▶ Every publicly owned corporation should have a committee composed solely of independent directors that addresses director nominations and corporate governance matters.
- ▶ The corporate governance committee (often combined with or referred to as a nominating committee) should have at least three members and should be composed solely of independent directors.
- ▶ The corporate governance committee recommends director nominees to the full board and the corporation's shareholders; oversees the composition, structure, operation and evaluation of the board and its committees; and plays a leadership role in shaping the corporate governance of the corporation. Depending on how the board has allocated responsibilities among its committees, the corporate governance committee also may oversee the compensation of the board if the compensation committee does not do so, or the two committees may share oversight responsibility for this area.
- ▶ In performing the core function of recommending nominees to the board, the corporate governance committee should establish criteria for board and committee membership and recommend these criteria to the board for approval. Based on these criteria, the committee should identify director candidates, review their qualifications and any potential conflicts with the corporation's interests, and recommend candidates to the board. The committee also should assess the contributions of current directors in connection with their renomination.
- ▶ In identifying director candidates, the corporate governance committee should take a proactive approach by soliciting ideas for potential candidates from a variety of sources. The committee should have the authority to retain search firms as appropriate to assist it in identifying candidates and should develop a process for considering shareholder recommendations for board nominees. Although it is appropriate for the CEO to meet with board candidates, the final responsibility for selecting director nominees should rest with the corporate governance committee and the board.

- ▶ The corporate governance committee should monitor and safeguard the independence of the board. An important function of a corporate governance committee, related to its core function of recommending nominees to the board, is to see that a substantial majority of the directors on the board meet appropriate standards of independence that are consistent with securities market listing standards and to see that these directors are independent in both fact and appearance. The corporate governance committee should develop and recommend standards of independence to the board, assess the independence of directors in light of these standards, and make recommendations to the board regarding determinations of director independence. In addition, the committee should be notified promptly of any change in a director's circumstances that may affect the director's independence.
- ▶ The corporate governance committee also recommends directors for appointment to committees of the board. The committee should periodically review the board's committee structure and annually recommend candidates for membership on the board's committees. The committee should see that the key board committees, including the audit, compensation and corporation governance committees, are composed of directors who meet applicable independence and qualification standards.
- ▶ The corporate governance committee should oversee the effective functioning of the board. The committee should review the board's policies relating to meeting schedules and agendas and the corporation's processes for providing information to the board. The corporate governance committee should assess the reporting channels through which the board receives information and see that the board obtains appropriately detailed information in a timely fashion.
- ▶ The corporate governance committee should develop and recommend to the board a set of corporate governance principles, review them annually, and recommend changes to the board as appropriate. The corporation's corporate governance principles should be publicly available and should address, at a minimum, board leadership, qualifications for directors (including independence standards), director responsibilities, the structure

and functioning of board committees, board access to management and advisers, director compensation, director orientation and continuing education, board evaluations, and management succession.

- ▶ The corporate governance committee should oversee the evaluation of the board and its committees. Specifics concerning the evaluation process are discussed under “Board and Committee Evaluation.”

### **Compensation Committee**

- ▶ Every publicly owned corporation should have a committee composed solely of independent directors that addresses compensation issues.
- ▶ The compensation committee should have at least three members and should be composed solely of independent directors. All committee members should have sufficient knowledge of executive compensation and related issues to perform their duties effectively.
- ▶ The compensation committee’s responsibilities include overseeing the corporation’s overall compensation structure, policies and programs; establishing or recommending to the board performance goals and objectives for the CEO and other members of senior management; and establishing or recommending to the independent directors compensation for the CEO and senior management. The compensation committee should see that the corporation’s compensation policies reflect the core principle of pay for performance and should establish meaningful goals for performance-based compensation.
- ▶ The compensation committee should have the authority to retain compensation consultants, counsel and other advisers to provide the committee with independent advice.
- ▶ The compensation committee should understand all aspects of an executive’s compensation package and should review and understand the maximum pay-out due under multiple scenarios (such as retirement, termination with or without cause, and severance in connection with business combinations or the sale of a business).

- ▶ The compensation committee should require senior management to build and maintain significant continuing equity investment in the corporation. The committee should establish requirements that senior management acquire and hold a meaningful amount of the corporation's stock. The committee also should consider whether to require senior management to hold for a period of time a specified amount of stock earned through incentive-based awards.
- ▶ In addition to reviewing and setting compensation for senior management, the compensation committee should look more broadly at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for management and employees at all levels. The committee should consider carefully and understand the incentives created by different forms of compensation. Incentives should further the corporation's long-term strategic plan and be consistent with the culture of the corporation and the overall goal of enhancing enduring shareholder value.
- ▶ 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.
- ▶ The compensation committee should consider whether the benefits and perquisites provided to senior management are proportional to the contributions made by management.
- ▶ The compensation committee should oversee the corporation's disclosures with respect to executive compensation. In particular, the committee should use the compensation committee report included in the corporation's annual proxy statement to provide shareholders with meaningful and understandable information about the corporation's executive compensation practices.

## Board Operations

- ▶ Serving on a board requires significant time and attention on the part of directors. Directors must participate in board meetings, review relevant materials, serve on board committees, and prepare for meetings and discussions with management. They must spend the time needed and meet as frequently as necessary to properly discharge their responsibilities. The appropriate number of hours to be spent by a director on his or her duties and the frequency and length of board meetings depend largely on the complexity of the corporation and its operations. Longer meetings may permit directors to explore key issues in depth, whereas shorter but more frequent meetings may help directors stay up-to-date on emerging corporate trends and business and regulatory developments. When arranging a meeting schedule for the board, each corporation should consider the nature and complexity of its operations and transactions, as well as its business and regulatory environment.
- ▶ Directors should receive incentives to focus on long-term shareholder value. Including equity as part of directors' compensation helps align the interests of directors with those of the corporation's shareholders. Accordingly, a meaningful portion of a director's compensation should be in the form of long-term equity. In this regard, corporations increasingly are providing the long-term equity component of directors' compensation in the form of restricted stock, rather than stock options, to better align directors' interests with those of shareholders. Corporations should establish a requirement that directors acquire a meaningful amount of the corporation's stock and hold that stock for as long as they remain on the board.
- ▶ Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold. However, service on too many boards can interfere with an individual's ability to satisfy his or her responsibilities, either as a member of senior management or as a director. 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. It also is good practice for directors to notify the chair of the corporate governance committee for each board on which

they serve before accepting a seat on the board of another corporation. Some corporations require the prior approval of the corporate governance committee. Similarly, the corporation should establish a process to review senior management service on other boards prior to acceptance.

- ▶ The board's independent or nonmanagement directors should have the opportunity to meet regularly in executive session, outside the presence of the CEO and any other management directors, in accordance with applicable listing standards.
  - Time for an executive session should be placed on the agenda for every regularly scheduled board meeting.
  - To maximize the effectiveness of executive sessions, there should be follow-up with the CEO and other appropriate members of senior management.
- ▶ Many board responsibilities may be delegated to committees to permit directors to address key areas in more depth. Regardless of whether the board grants plenary power to its committees with respect to particular issues or prefers to take recommendations from its committees, committees should keep the full board informed of their activities. Corporations benefit greatly from the collective wisdom of the entire board acting as a deliberative body, and the interaction between committees and the full board should reflect this principle.
- ▶ The board's agenda must be carefully planned yet flexible enough to accommodate emergencies and unexpected developments. The chairman of the board should work with the lead director (when the corporation has one) in setting the agenda and should be responsive to individual directors' requests to add items to the agenda and open to suggestions for improving the agenda. It is important that the agenda and meeting schedule permit adequate time for discussion and a healthy give-and-take between board members and management.
- ▶ Board agendas should be structured to allow time for open discussion. Board members should have full access to senior management.

- ▶ The board must have accurate, complete information to do its job; the quality of information received by the board directly affects its ability to perform its oversight function effectively. Directors should receive and review information from a variety of sources, including management, board committees, outside experts, auditor presentations, and analyst and media reports. The board should be provided with information before board and committee meetings, with sufficient time to review and reflect on key issues and to request supplemental information as necessary.
- ▶ Corporations should have an orientation process for new directors that is designed to familiarize them with the corporation's business, industry and corporate governance practices. Common practices include briefings from senior management, on-site visits to the corporation's facilities, informal meetings with other directors and written materials. Corporations also should encourage directors to take advantage of educational opportunities on an ongoing basis to enable them to better perform their duties and to keep informed about developments in areas such as the corporation's industry, corporate governance and director responsibilities.
- ▶ Where appropriate, boards and board committees should seek advice from outside advisers independent of management with respect to matters within their responsibility. For example, there may be technical aspects of the corporation's business — such as risk assessment and risk management — or conflict of interest situations for which the board or a committee determines that additional expert advice would be useful. Similarly, many compensation committees engage their own compensation consultants. The board and its committees should have the authority to select and retain advisers and approve the terms of their retention and fees.

### **Management Development and Succession**

- ▶ Long-term planning for CEO and senior management development and succession is one of the board's most important functions. The board, its corporate governance committee or another committee of independent directors should identify and regularly update the qualities and characteristics necessary for an effective CEO. With these principles in mind, the

board or committee should periodically monitor and review the development and progression of potential internal candidates against these standards.

- ▶ Emergency succession planning also is critical. Working with the CEO, the board or committee should see that plans are in place for contingencies such as the departure, death or disability of the CEO or other members of senior management to facilitate the transition to both interim and longer-term leadership in the event of an untimely vacancy.
- ▶ Under the oversight of an independent committee or the lead director, the board should annually review the performance of the CEO and participate with the CEO in the evaluation of members of senior management. All nonmanagement members of the board should participate with the CEO in senior management evaluations. The results of the CEO's evaluation should be promptly communicated to the CEO in executive session by representatives of the independent directors and used by the compensation committee or board in determining the CEO's compensation.

### **Board and Committee Evaluation**

- ▶ The board should have an effective mechanism for evaluating performance on a continuing basis. Meaningful board evaluation requires an assessment of the effectiveness of the full board, the operations of board committees and the contributions of individual directors.
  - For some companies, securities market listing standards now require that the board and its audit, compensation and corporate governance committees conduct annual evaluations. Regardless of whether an evaluation is required, the performance of the full board should be evaluated annually, as should the performance of its committees. The board should use the annual self-evaluation to assess whether it is following the procedures necessary to function effectively. Each board committee should conduct an annual self-evaluation to assess its effectiveness, and the results of this evaluation should be reported to the full board.

- The board should have a process for evaluating whether the individuals sitting on the board bring the skills and expertise appropriate for the corporation and how they work as a group. Board positions should not be regarded as permanent. Directors should serve only so long as they add value to the board, and a director's ability to continue to contribute to the board should be examined by the corporate governance committee each time the director is considered for renomination.
- ▶ Planning for the departure of directors and the designation of new board members is essential. The board should plan ahead for changes in membership, and it should have written criteria for director candidates that should be re-evaluated periodically. The board also should establish procedures for the retirement or replacement of board members. These procedures may, for example, include a mandatory retirement age, a term limit and/or a requirement that directors who change their primary employment tender a board resignation, providing an opportunity for the governance committee to consider the desirability of their continued service on the board.



## IV. Relationships with Shareholders and Other Constituencies

Corporations are often said to have obligations to shareholders and other constituencies, including employees, the communities in which they do business and government, but these obligations are best viewed as part of the paramount duty to optimize long-term shareholder value. Business Roundtable believes that shareholder value is enhanced when a corporation treats its employees well, serves its customers well, fosters good relationships with suppliers, maintains an effective compliance program and strong corporate governance practices, and has a reputation for civic responsibility.

### Shareholders and Investors

- ▶ Corporations have a responsibility to communicate effectively and candidly with shareholders. The goal of shareholder communications should be to help shareholders understand the business, risk profile, financial condition and operating performance of the corporation and the board's corporate governance practices.
- ▶ Corporations communicate with investors and other constituencies not only in proxy statements, annual and other reports, and formal shareholder meetings, but in many other ways as well. All of these communications should provide consistency, clarity and candor.
- ▶ Corporations should have effective procedures for shareholders to communicate with the board and for directors to respond to shareholder concerns. The board, or an independent committee such as the corporate governance committee, should establish, oversee and regularly review and update these procedures as appropriate.
  - The board should respond in a timely manner to substantive communications from shareholders, and when appropriate, directors should meet with shareholders regarding issues of concern.

- ▶ A corporation's procedures for shareholder communications and its governance practices should be readily available to shareholders. Information about the board's structure and operations, committee composition and responsibilities, corporate governance principles, and codes of ethics should be widely disseminated to shareholders.
- ▶ The board should be notified of shareholder proposals, and the board or its corporate governance committee should oversee the corporation's response to these proposals.
- ▶ Directors should attend the corporation's annual meeting of shareholders, and the corporation should have a policy requiring attendance absent unusual circumstances. Time at the annual meeting should be set aside for shareholders to submit questions and for management or directors to respond to those questions.
- ▶ The board should seriously consider issues raised by shareholder proposals that receive substantial support and should communicate its response to proposals to the shareholder-proponents and to all shareholders.
- ▶ The board should respond appropriately when a director nominee receives a significant "withhold" or "against" vote with respect to his or her election to the board. The corporate governance committee should assess the reasons for the vote and recommend to the board the action to be taken with respect to the vote, which should be communicated to the corporation's shareholders.
- ▶ In planning communications with shareholders and investors, corporations should consider:
  - *Candor.* Directors and management should never mislead or misinform shareholders about the corporation's operations or financial condition.
  - *Need for timely disclosure.* In an age of instant communication, corporations increasingly are disclosing significant information closer to the time when it arises and becomes available. Business Roundtable supports prompt disclosure of significant developments.

- *Use of technology.* Technology makes communicating quicker, easier and less expensive. Corporations should take advantage of technological advances to enhance the dissemination of information to shareholders and employees.
- *Ultimate goal of shareholder communications.* Whatever the substance of the communication, the corporation's ultimate goal should be to furnish information that is honest, intelligible, meaningful, timely and broadly disseminated and that gives investors a realistic picture of the corporation's financial condition and results of operations through the eyes of management.

## **Employees**

- ▶ It is in a corporation's best interest to treat employees fairly and equitably.
- ▶ Corporations should have in place policies and practices that provide employees with compensation, including benefits, that is appropriate given the nature of the corporation's business and employees' job responsibilities and geographic locations.
- ▶ When corporations offer retirement, health care, insurance and other benefit plans, employees should be fully informed of the terms of those plans.
- ▶ Corporations should have in place and publicize mechanisms for employees to seek guidance and to alert management and the board about potential or actual misconduct without fear of retribution.
- ▶ Corporations should communicate honestly with their employees about corporate operations and financial performance.

## **Communities**

- ▶ Corporations have obligations to be good citizens of the local, national and international communities in which they do business. Failure to meet these obligations can result in damage to the corporation, both in immediate economic terms and in longer-term reputational value.

- ▶ A corporation should be a good citizen and contribute to the communities in which it operates by making charitable contributions and encouraging its directors, managers and employees to form relationships with those communities. A corporation also should be active in promoting awareness of health, safety and environmental issues, including any issues that relate to the specific types of business in which the corporation is engaged.

## **Government**

- ▶ Corporations, like all citizens, must act within the law. The penalties for serious violations of law can be extremely severe, even life-threatening, for corporations. Compliance is not only appropriate — it is essential. Management should take reasonable steps to develop, implement and maintain an effective legal compliance program, and the board should be knowledgeable about and oversee the program, including periodically reviewing the program to gain reasonable assurance that it is effective in deterring and preventing misconduct.
- ▶ Corporations have an important perspective to contribute to the public policy dialogue and should be actively involved in discussions about the development, enactment and revision of the laws and regulations that affect their businesses and the communities in which they operate and their employees reside.









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