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Key Takeaways from the Commonsense Principles of Corporate Governance

In her regular column on corporate governance issues, Holly Gregory discusses the recently published *Commonsense Principles of Corporate Governance*, which describe a baseline for governance practices agreed to by a coalition of prominent CEOs and institutional investors.

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Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory, and listing rule requirements, and governance best practice.

In July 2016, a coalition of senior executives from major companies and institutional investors published the *Commonsense Principles of Corporate Governance* (Commonsense Principles) (available at *governanceprinciples.org*). The Commonsense Principles were developed to establish a basic framework for long-term oriented governance practices, as well as to encourage additional dialogue on the topic.

Counsel to boards of public companies should review the Commonsense Principles and be prepared to advise on how the company's practices compare to the Commonsense Principles and other recommended governance practices, bearing in mind that the needs and circumstances of each company are unique. This analysis can help inform the board and the governance committee in their annual review of the company's governance practices.

This article provides an overview of the Commonsense Principles. Specifically, it discusses:

- The context in which the Commonsense Principles emerged, including influential governance recommendations.

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Prominent Governance Recommendations

Prominent governance recommendations include:

- American Bar Association Committee on Corporate Laws, *Corporate Director's Guidebook* (6th ed. 2011).
- American Law Institute (ALI), *Principles of Corporate Governance: Analysis and Recommendations* (1994 and regularly supplemented).
- Business Roundtable, *The Role and Composition of Directors of the Large Publicly Owned Corporation* (July 1978); *Corporate Governance and American Competitiveness* (Mar. 1990); *Statement on Corporate Governance* (Sept. 1997); *Principles of Corporate Governance* (May 2002, most recently revised Aug. 2016).
- Council of Institutional Investors, *Corporate Governance Policies* (Mar. 1998, most recently revised Apr. 2015).
- National Association of Corporate Directors (NACD), *Report of the NACD Blue Ribbon Commission on Director Professionalism* (1996, most recently revised 2011); *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies* (2008).
- The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations, Part 1: Executive Compensation* (Sept. 2002), *Part 2: Corporate Governance* (Jan. 2003), and *Part 3: Audit & Accounting* (Jan. 2003).

Common to all of these governance recommendations is a focus on how to ensure that the board is positioned as an entity separate and distinct from corporate management to bring informed and objective judgment to its decision-making.

- Key elements of the Commonsense Principles.
- Actions that a board may want to consider in reviewing a company's governance practices.

INFLUENTIAL GOVERNANCE RECOMMENDATIONS

While interest in the objectivity of public company boards can be traced back to at least the 1930s (see William O. Douglas, *Directors Who Do Not Direct*, Harvard Law Review, 1934), the practice of including independent directors on boards did not begin to take hold until after the late 1970s. In settlements of enforcement actions arising from corporate bribery scandals, the Securities and Exchange Commission (SEC) required that boards of settling companies form committees composed wholly of independent directors to monitor compliance with SEC regulations on financial reporting.

Then, in 1977, the same year that Congress enacted the Foreign Corrupt Practices Act, the SEC approved a New York Stock Exchange (NYSE) rule requiring all listed US companies to form audit committees comprised of a majority of independent directors. Though it took another decade or so to accomplish, this new listing rule marked the beginning of the trend toward independent directors dominating listed company audit committees and boards.

The growth in the number of independent directors on boards coincided with an increase in the power of sophisticated institutional investors. This led to a greater focus on the role of the board as an accountability mechanism distinct from the senior management team and on the practices that would effectively position the independent board to be an objective oversight body.

In 1978, The Business Lawyer published a set of governance principles entitled *The Role and Composition of Directors of the Large Publicly Owned Corporation*. Since then, a number of legal, management, director, and investor organizations have published recommendations on improving practices and procedures in corporate governance that, to varying extents, are intended to provide the basis for increasing a board's ability and motivation to monitor managerial performance (see *Box, Prominent Governance Recommendations*).

The soft regulation provided by these governance recommendations is in keeping with a philosophy that there is not a one-size-fits-all solution to effective governance practices that can be applied to all companies. However, even though compliance with these principles is voluntary, reputation and market forces provide compliance pressures.

In addition, over time, many recommended practices have become the norm and in many instances the basis for minimum standards. Examples of this are the NYSE and NASDAQ listing rules that now require a majority of independent directors on the board and wholly independent audit, nominating and governance, and compensation committees. The standards set by governance principles may also come to influence judicial expectations about board behavior.

KEY ELEMENTS OF THE COMMONSENSE PRINCIPLES

While the Commonsense Principles recognize that no one set of governance practices will work for every public company, they describe a baseline set of guiding rules that the participating large public companies and large institutional investors generally agree on. They do not provide guidance on emerging or controversial topics such as proxy access, anti-takeover protections, sustainability reporting, board refreshment mechanisms, or gender and racial diversity on boards.

For the most part, the Commonsense Principles reflect corporate governance practices that are widely accepted. The

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Signatories to the Commonsense Principles

The following senior executives and institutional investors are signatories to the Commonsense Principles:

- Tim Armour, Capital Group
- Mary Barra, General Motors Company
- Warren Buffett, Berkshire Hathaway Inc.
- Jamie Dimon, JPMorgan Chase
- Mary Erdoes, J.P. Morgan Asset Management
- Larry Fink, BlackRock
- Jeff Immelt, General Electric
- Mark Machin, Canada Pension Plan Investment Board
- Lowell McAdam, Verizon Communications
- Bill McNabb, Vanguard
- Ronald O'Hanley, State Street Global Advisors
- Brian Rogers, T. Rowe Price
- Jeff Ubben, ValueAct Capital

vast majority of what is recommended is already practiced by a majority of S&P 500 companies and a fair amount is required for publicly traded companies by SEC regulations or stock exchange listing rules.

What is most important about the Commonsense Principles is that they were issued by a high-profile and varied coalition that included both representatives of well-known public companies and institutional investors (see *Box, Signatories to the Commonsense Principles*). The Commonsense Principles are organized around eight broad themes:

- Board of directors: composition and internal governance.
- Board of directors' responsibilities.
- Shareholder rights.
- Public reporting.
- Board leadership.
- Management succession planning.
- Compensation of management.
- Asset managers' role in corporate governance.

There is some overlap among these themes, and this article takes license in grouping the topics under these themes.

BOARD OF DIRECTORS: COMPOSITION AND INTERNAL GOVERNANCE

The Commonsense Principles provide a standard discussion of board composition and internal governance practices. What is most notable in this section is what is not included, because it provides an indication that while these topics are of high interest to certain shareholders and at governance conferences, there is apparently not yet widespread agreement among the members of the coalition on the value of gender and racial diversity to boards or on how best to encourage periodic board refreshment.

Key topics under this theme include:

- **Independence.** The Commonsense Principles emphasize the basic corporate law view that a director's loyalty should be to the shareholders and the company. Similarly, they note that a director must not be beholden to senior management. The Commonsense Principles also repeat the well-accepted guidance that a significant majority of a company's board should be independent under the NYSE rules or similar standards. In addition, directors should be "strong and steadfast, independent of mind and willing to challenge constructively but not be divisive or self-serving. Collaboration and collegiality also are critical for a healthy, functioning board" (Commonsense Principles, Section I(a)).
- **Industry experience.** Directors should possess high integrity and competence. In addition, a subset of directors should have professional experiences that are directly related to the company's business and the board should be regularly educated on the company's industry. "At the same time, however, it is important to recognize that some of the best ideas, insights and contributions can come from directors whose professional experiences are not directly related to the company's business" (Commonsense Principles, Section I(a)).
- **Board diversity.** To have a high-functioning board, directors should have complementary and diverse skill sets, backgrounds, and experiences. The Commonsense Principles state that "[d]irector candidates should be drawn from a rigorously diverse pool" (Commonsense Principles, Section I(a)). Notably, the Commonsense Principles do not provide a definition of diversity, and there is no reference to racial or gender diversity.
- **Board refreshment and tenure.** The Commonsense Principles emphasize that while considering board refreshment is important, so is balancing new perspectives with age and experience (Commonsense Principles, Section I(f)).
- **Term limits and retirement ages.** If a board has a policy regarding term limits or a mandatory retirement age for directors, and the board allows an exception to that policy, the board should explain the reasons for that exception (Commonsense Principles, Section I(f)). However, the Commonsense Principles are silent regarding whether a board should have term limits or a mandatory retirement age.
- **Commitment.** Board service requires substantial time and energy. Therefore, boards should assess a director's ability to focus on his role at the company and not be distracted by competing responsibilities, such as service on other boards (Commonsense Principles, Section I(a)).
- **Director evaluation and effectiveness.** The Commonsense Principles recommend that boards have robust procedures in place to evaluate themselves on a regular basis, as well as a willingness to replace ineffective directors (Commonsense

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Principles, Section I(g)). However, there is no mention of conducting formal individual director evaluations.

- **Nominations.** The Commonsense Principles state that a long-term shareholder should recommend a potential director if it knows the individual well and believes that the individual would strengthen the board (Commonsense Principles, Section I(c)).
- **Rotation of leadership roles.** The Commonsense Principles recommend that boards consider periodically rotating the board leadership roles. In doing so, the board should balance the benefits of rotation against the benefits of continuity, experience, and expertise. (Commonsense Principles, Section I(e).)

Search Corporate Governance Practices: Commentary for more on the issues that a company and its counsel should consider in evaluating and establishing corporate governance practices, including concerns relating to the board.

The Commonsense Principles avoid taking a position on proxy access and are silent on other matters of shareholder concern that are often the focus of shareholder proposals, such as sustainability disclosure and anti-takeover protections.

BOARD OF DIRECTORS' RESPONSIBILITIES

The Commonsense Principles provide a fairly simple discussion of board responsibilities. They address:

- **Engagement and third-party communications.** The Commonsense Principles emphasize the importance of robust communication with company shareholders. In appropriate circumstances and in coordination with management, directors may want to communicate directly with shareholders on governance and key shareholder issues, such as CEO compensation. The Commonsense Principles stress that directors should speak with the media about the company only if authorized by the board and in accordance with company policy. (Commonsense Principles, Section II(a).)
- **Delegation and access to management.** The Commonsense Principles note that a "company is more likely to attract and retain strong directors if the board focuses on big-picture issues and can delegate other matters to management" (Commonsense Principles, Section I(c)). In addition, as authorized and coordinated by the board, directors should have unfettered access to management, including those below the CEO's direct reports.
- **Board agenda.** The full board should have input into setting the agenda and should limit the time spent on non-essential matters. Meeting time should be reserved for providing perspectives and making decisions that build real value. (Commonsense Principles, Section II(b).)
- **Executive sessions.** The Commonsense Principles advocate that the board should meet in executive sessions without the CEO or other members of management present at every board meeting to ensure the opportunity for free and open discussion, and sufficient time should be reserved to do so properly (Commonsense Principles, Section II(b)).
- **Director compensation.** The Commonsense Principles recommend that companies consider paying a substantial portion of director compensation in equity and requiring directors to keep a significant portion of their equity compensation during their term (Commonsense Principles, Section VII(d)).
- **Audit committee responsibilities.** Among other things, the audit committee should focus on "whether the company's financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation" (Section II(b)). This recommendation borrows from Warren Buffett's 2002 *Letter to Shareholders of Berkshire Hathaway*, which sets out questions for audit committees to ask auditors (available at *berkshirehathaway.com*).

SHAREHOLDER RIGHTS

The Commonsense Principles avoid taking a position on proxy access and are silent on other matters of shareholder concern that are often the focus of shareholder proposals, such as sustainability disclosure and anti-takeover protections (for example, classified boards, supermajority voting requirements, and poison pills). However, they do address majority voting in director elections, which a majority of S&P 500 companies have adopted, and dual class voting structures, which is a more controversial topic.

Specifically, the Commonsense Principles discuss:

- **Proxy access.** The Commonsense Principles describe common features of proxy access, but do not advocate for proxy access or come out against it (Commonsense Principles, Section III(a)). Notably, in the span of about two years, close to 50% of S&P 500 companies have adopted proxy access and the trend shows little sign of abating.
- **Dual class voting.** The Commonsense Principles emphasize that dual class voting is not a best practice and companies that have it should consider implementing sunset provisions

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based on time or a triggering event. They also highlight the importance of treating all shareholders equally in any corporate transaction. (Commonsense Principles, Section III(b).)

- **Ability to act by written consent and call special meetings.** The Commonsense Principles acknowledge that the ability of shareholders to act by written consent and call special meetings can be important. However, they also note that those rights should require shareholders to own a reasonable minimum amount of outstanding shares to prevent a small minority of shareholders from being able to abuse the rights or waste corporate time and resources. (Commonsense Principles, Section III(c).)
- **Majority vote standard in director elections.** The Commonsense Principles advocate that directors should be elected using majority voting. In one of the more specific provisions, the Commonsense Principles call for directors to be elected by a majority of the votes cast "for" and "against/withhold" so that abstentions and non-votes are not counted. (Commonsense Principles, Section I(b).)

PUBLIC REPORTING

The Commonsense Principles generally advocate that company disclosures support a long-term view, and suggest caution regarding the use of non-GAAP measures. Specifically, they provide recommendations addressing:

- **Non-GAAP measures.** Companies are required to report their results in accordance with Generally Accepted Accounting Principles (GAAP). While it is acceptable in certain instances to use non-GAAP measures to explain and clarify results for shareholders, non-GAAP measures should be sensible and should not be used to obscure GAAP results. In particular, "*all* compensation, including equity compensation ... should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings." (Commonsense Principles, Section IV(f).)
- **Quarterly reporting and earnings guidance.** Companies should frame quarterly reporting in the context of their articulated strategy and provide an appropriate outlook for trends and metrics that reflect progress (or not) on long-term goals. In determining whether to provide earnings guidance, companies should decide whether doing so would be more harmful than good. If a company does provide earnings guidance, the company should be realistic and avoid inflated projections. (Commonsense Principles, Section IV(b).)

Search Using Non-GAAP Financial Information, Giving Good Earnings Guidance: What Every Public Company Should Know, and Earnings Guidance FAQs for more on public reporting.

BOARD LEADERSHIP

The Commonsense Principles do not recommend a particular form of board leadership structure, but they do favor maintaining flexibility for independent directors to decide on a structure based on the circumstances facing the company. In particular, they discuss:

- **Leadership structure.** The decision regarding what form of leadership structure to have is one for the independent directors to make, based on the circumstances at the time. When the roles of the chair and the CEO are combined in one individual the board should have a strong designated lead independent director and governance structure. The board should also clearly disclose why it has combined or separated these positions. (Commonsense Principles, Section V(a) and (b).)
- **Lead director duties.** The duties of a lead director may include:
  - serving as liaison between the chair and the independent directors;
  - presiding over meetings of the board when the chair is not present, including executive sessions of the independent directors;

The Commonsense Principles do not recommend a particular form of board leadership structure, but they do favor maintaining flexibility for independent directors to decide on a structure based on the circumstances facing the company.

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Revised Business Roundtable Principles

In August 2016, the Business Roundtable issued a revised draft of its long-standing *Principles of Corporate Governance* (Revised BRT Principles) (available at *businessroundtable.org*).

The Revised BRT Principles cite changes to the environment in which corporations operate as adding to the costs and complexity of overseeing and managing the business. In addition to generally increased regulatory burdens, the Revised BRT Principles cite the abandonment of the "fundamental principle of *materiality* by Congress as a central tenet of disclosure requirements" in favor of using securities laws to address issues that are "immaterial to shareholders' investment or voting decisions." As examples, the Revised BRT Principles refer to required disclosures relating to conflict minerals and payments to foreign governments for resource extraction and mine safety.

In addition, the Revised BRT Principles express concerns about:

- Fundamental changes in shareholder engagement.
- Record-high levels of shareholder activism.
- Increased shareholder influence on strategy, capital allocation, and corporate social responsibility.
- Too much focus on short-term uses of corporate capital, such as share repurchases or special dividends.

The Revised BRT Principles note that boards face challenges in constantly assessing both long-term and short-term uses of capital and determining the appropriate allocation of that capital in keeping with the company's business strategy and the goal of long-term value creation.

For a resource that compares the Commonsense Principles to the Revised BRT Principles, as well as to the NACD's *Key Agreed Principles to Strengthen Corporate Governance for US Publicly Traded Companies* and Council of Institutional Investor viewpoints, see Sidley Austin LLP's *Comparison of Corporate Governance Best Practice Recommendations* (available at *americanbar.org*).

- ensuring that the board has proper input into meeting agendas and information;
- having the authority to call meetings of the independent directors;
- engaging or overseeing engagement with shareholders;
- guiding the annual board self-assessment;
- guiding the board's consideration of CEO compensation; and
- guiding the CEO succession planning process.

(Commonsense Principles, Section V(c).)

Search Chairman and CEO Split: Understanding the Pros and Cons and Lead Director: Understanding and Filling the Role for more on choosing a board leadership structure.

MANAGEMENT SUCCESSION PLANNING

The section in the Commonsense Principles on management succession planning provides recommendations that are generally non-controversial. However, there is a suggestion that shareholders should have greater involvement in assessing the strength of the management team.

Specifically, the Commonsense Principles provide recommendations on:

- **Evaluating bench strength.** The Commonsense Principles note that the bench strength of management "can be evaluated by the board and shareholders through an assessment of key company employees" and "direct exposure to those employees is helpful in making that assessment" (Commonsense Principles, Section VI(a)). However, it is unclear whether and to what degree they intended to suggest that shareholders should have direct exposure to employees. While providing shareholders with direct access to key employees for the purpose of evaluating succession bench strength may be a proper subject for shareholder engagement in certain circumstances, it is unclear that it rises to the level of a broadly recommended practice for a wide array of listed companies.
- **Disclosure.** Shareholders should be informed of the board's succession planning process (Commonsense Principles, Section VI(b)).
- **Emergency planning.** Companies should have a plan for emergency succession (Commonsense Principles, Section VI(b)).

Search CEO Succession Planning: Principles and Considerations and Planning for Leadership Succession and Unexpected CEO Transitions for more on leadership succession planning.

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COMPENSATION OF MANAGEMENT

The Commonsense Principles address the following executive compensation topics:

- **Alignment with long-term performance.** Executive compensation plans should be aligned with long-term performance. Companies should think about paying a substantial portion (for example, in some cases as much as 50% or more) of executive compensation in the form of stock, performance stock units, or similar equity-like instruments (Commonsense Principles, Section VII(d)).
- **Disclosure of metrics.** The Commonsense Principles recommend disclosing benchmarks and performance measurements to enable shareholders to assess the rigor of the company's goals and the goal-setting process (Commonsense Principles, Section VII(c)).

ASSET MANAGERS' ROLE IN CORPORATE GOVERNANCE

The Commonsense Principles direct their most pointed advice toward asset managers. Asset managers should:

- Exercise their voting rights thoughtfully and act in a way they believe will be in the long-term economic interests of their clients (Commonsense Principles, Section VIII).
- Give proper consideration to the company's rationale for its positions and vote based on their own voting guidelines and policies (Commonsense Principles, Section VIII(a) and (f)).
- Evaluate the performance of the boards at the companies in which they invest (Commonsense Principles, Section VIII(c)).

Given the focus of the Commonsense Principles on practices that for the most part are already widely adopted among the S&P 500, the reception from institutional investors has been mixed. For example, while the Council of Institutional Investors (CII) provided a statement that was largely supportive, it indicated that it would have liked the Commonsense Principles to go further regarding shareholder rights such as proxy access. In addition, the CII would also have liked the Commonsense Principles to support a board duty to act on advisory shareholder proposals that a majority of shareholders have voted in favor of.

BOARD ACTIONS TO CONSIDER

Shortly after the Commonsense Principles were published, in August 2016, the Business Roundtable issued a revised draft of its long-standing *Principles of Corporate Governance* (Revised BRT Principles) (see *Box, Revised Business Roundtable Principles*). The Revised BRT Principles emphasize:

- The need for board flexibility to determine governance structures and practices.
- The primacy of the board and management in making strategic decisions.

The board, through its key committees, should review the Commonsense Principles and the Revised BRT Principles and consider how their own practices measure up. In addition, the board should consider the guidance provided through the policies that proxy advisors apply in determining their vote recommendations on management and shareholder proposals.

In its annual review of the company's corporate governance practices, the board should:

- Be aware of the areas in which the company's governance practices do not align with the Commonsense Principles, as well as with other more aspirational guidance.
- Understand the rationale for the company following a different practice.
- Consider whether the company should disclose the board's rationale for departing from these or other common practices.

Some public companies may decide to disclose that they follow a particular set of principles or that they have assessed their governance practices against a set of principles and have determined that they align.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.

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