TESTIMONY OF TED WHITE

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CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Before the U.S. House of Representatives

Committee on Financial Services

March 13, 2002

Chairman Oxley, Ranking Member LaFalce and distinguished members of the committee, my name is Ted White and I am the director of corporate governance for the California Public Employees' Retirement System (CalPERS). On behalf of CalPERS' Board and myself, I thank you for the opportunity to testify before the committee today to discuss issues that are so important to our capital markets.

CalPERS is the largest public pension system in the world, with an investment portfolio of more than $155 billion. These assets are all held in trust for the benefit of over 1.2 million current and retired public servants from our state, and their families. CalPERS' assets are allocated among fixed income instruments, real estate, equities and other investments. Our investments in the US stock market alone are currently valued at some $67 billion.

CalPERS has long been a vocal and leading advocate of effective corporate governance. We strongly believe that, as owners of the corporations in which we invest, shareholders have both the right and a duty to hold corporate boards and managers accountable for their performance. Concepts of accountability and transparency are widely recognized as being the cornerstone of a successful corporate governance model, and as being the foundation of this country's financial markets. Unfortunately, the events of these past months have also demonstrated that basic ethics – something that we all may have presumed was built into our business cultures – must also be a concern for today's investors.

With this background, I would like to focus on two key legislative issues and several other regulatory matters. The two legislative issues concern auditor independence and oversight of the accounting industry.

CalPERS was pleased to see that both Chairman Oxley's bill and Ranking Member LaFalce's bill include provisions on these important topics. Thank you, both, for recognizing the need for Congress to address these issues. We look forward to working with the committee as these proposals are debated in the weeks ahead.

AUDITOR INDEPENDENCE

On the issue of auditor independence, CalPERS believes that there is currently a crisis of confidence with the accounting industry. The independence of accounting firms that audit the financial statements of public companies must be beyond reproach. Investors, large and small alike, must be able to trust that when an auditor says a company's books are accurate, then they are accurate. The Enron-Andersen situation has prompted this erosion of investor confidence, due in large part, to the obvious conflict of interest created when an external auditor is simultaneously receiving fees from the company for non-audit work – fees which in most cases dwarf the firm's audit revenues. How can we trust that the auditor's sign off on the company's financial statements – in its exercise of the discretion that is inherent in evaluating the aggressiveness of management's numbers – is not at least unconsciously influenced by a desire to keep a well-paying client happy?

We understand that there has been, and will continue to be, much debate over where to draw the line between "audit" and "non-audit" services. As one investor, CalPERS believes the line should be drawn so as to place a bright line ban on external auditors simultaneously providing consulting or internal audit services to a client. A firm should be an auditor or a consultant; not both to the same client.

Of course, by eliminating lucrative consulting fees, auditors may become even more reliant on audit fees. For this reason, CalPERS believes there should be a system of mandatory rotation of a company's external auditors. CalPERS has suggested a five- to seven-year limit. Although we recognize that there is a cost to the inherent training curve for a newly-retained auditor, we believe this cost is more than outweighed by the benefits of both "fresh eyes" and renewed investor confidence. In this context let me note that, under California state law, CalPERS is required to change its external auditor every five years. This is not easy for a financial institution of our size and complexity, but we do it.

OVERSIGHT OF THE ACCOUNTING INDUSTRY

Turning to the supervision of the accounting industry, we again applaud the efforts of this committee, SEC Chairman Pitt and President Bush for identifying the need to strengthen the oversight of auditors and accountants.

The Public Oversight Board has done a fine job since its creation in 1977, but our capital markets and corporate finance structure have changed dramatically in the last 25 years. It is now time to update the accounting industry's oversight to reflect these changes.

In principle, CalPERS believes that a public accounting regulator must represent the interests of end-users—that is, investors and those whom investors rely upon (for example, Wall Street analysts). This representation is best assured through the composition of the entity's governing body. The new entity must also have the power to effectively investigate, adjudicate and discipline the industry, and it must have a stable funding source that is independent of both the corporate community and the accounting industry. We also believe that, while the SEC should oversee this new entity and will clearly need to adopt regulations to assist it in its work, the creation of the new entity, its charter and scope of authority, at a minimum, must be established by Congress.

OTHER CORPORATE GOVERNANCE ISSUES

CalPERS also believes that, in addition to the principles of corporate governance that we adopted in 1998 (attached to my written testimony), additional issues have arisen in these initial post-Enron, post-Global Crossing days. These include:

- Strengthening the competency of a corporation's audit committee. This requires providing market guidance as to what it means to be "financially literate;" requiring that more than simply one committee member possess these skills; and requiring minimum training standards for all members of audit committees.
- Strengthening the independence of outside directors by requiring greater disclosure of potential conflicts of interest;

- Scrutinizing the roles of investment banks, Wall Street analysts, rating agencies, lending institutions, liability insurance carriers, outside attorneys and other consultants; and
- Reforming accounting standards so that they more accurately reflect the current complexities of financial structures (including addressing Special Purpose Entities or Vehicles), and are capable of changing to adapt to rapid market developments.

Allow me to expand on this last point for a moment.

We think these revisions can and should be made by the Financial Accounting Standards Board (FASB). CalPERS believes that FASB serves a vital role in our system of financial reporting. However, because of a myriad of budgetary and political reasons, it is slow to produce new, comprehensive rules. I recently heard that it's been working on developing a rule for SPEs for nearly 20 years. No offense, but even Congress acts quicker than that.

We think FASB should also have a stable, independent funding source so that it may have the resources necessary to more effectively and efficiently address such matters. In addition, we believe the SEC should hold FASB's feet to the fire on producing needed rules in a more timely manner.

Finally, CalPERS was pleased to support HR 1088, the Investor and Capital Markets Fee Relief Act, because of both the SEC fee reduction and pay parity aspects. In fact, CalPERS CEO Jim Burton testified in support of its sister bill in the Senate last year. However, thus far only the fee reduction component has been implemented and we would like to express our strong desire that pay parity for the SEC staff be fully funded by Congress this year.

CONCLUSION

In conclusion, CalPERS is pleased that the members of this committee are taking such a thoughtful and constructive approach to addressing the financial reporting issues stemming from the Enron collapse. We believe Congress must play an important role in helping to restore investor confidence by improving auditor independence, enhancing accounting oversight, providing regulators with the power and resources to effectively regulate these industries and encouraging interested market participants to assist them where practical.

Thank you again for the opportunity to testify today and I would be pleased to answer any questions you may have.

THE CALIFORNIA PUBLIC EMPLOYEES'
RETIREMENT SYSTEM

CORPORATE GOVERNANCE CORE PRINCIPLES & GUIDELINES

April 13, 1998

The United States

"Everywhere shareholders are re-examining their relationships with company bosses – what is known as their system of 'corporate governance.' Every country has its own, distinct brand of corporate governance, reflecting its legal, regulatory and tax regimes… The problem of how to make bosses accountable has been around ever since the public limited company was invented in the 19th century, for the first time separating the owners of firms from the managers who run them…."

"Corporate Governance: Watching the Boss," THE ECONOMIST 3 (Jan. 29, 1994).

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I. INTRODUCTION

CalPERS' Corporate Governance[1] Program is a product of the evolution that only experience and maturity can bring. In its infancy in 1984-87, corporate governance at CalPERS was solely reactionary: reacting to the anti-takeover actions of corporate managers that struck a dissonant chord with one's sense – as the **owners**[2] of the corporate entity – of accountability and fair play. The late 1980s and early 1990s represent a period in which CalPERS learned a great deal about the "rules of the game" – how to influence corporate managers, what issues are likely to elicit fellow shareowner support, and where the traditional modes of shareowner/corporation communication were at odds with current reality.

Beginning in 1993, CalPERS turned its focus toward companies considered, by virtually every measure, to be "poor" financial performers. By centering its attention and resources in this way, CalPERS could demonstrate to those who questioned the value of corporate governance very specific and tangible economic results.[3]

What have we learned during these past dozen years? We have learned that (a) company managers want to perform well, in both an absolute sense and as compared to their peers; (b) company managers want to adopt long-term strategies and visions, but often do not feel that their shareowners are patient enough; and (c) <u>all</u> companies – whether governed under a structure of full accountability or not – will inevitably experience both ascents and descents along the path of profitability. We have also learned, and firmly embrace the belief that good corporate governance – that is, *accountable governance* – means the difference between wallowing for long (and perhaps fatal) periods in the depths of the performance cycle, and responding quickly to correct the corporate course. As one commentator noted:

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[1] "Corporate Governance," at CalPERS, means the "relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) shareowners, (2) management (led by the chief executive officer), and (3) the board of directors." (Robert A.G. Monks and Nell Minow, CORPORATE GOVERNANCE 1 (1995).)

[2] Throughout this document, CalPERS has chosen to adopt the term "shareowner" rather than "shareholder." This is to reflect our view that equity ownership carries with it active responsibilities and is not merely passively "holding" shares.

[3] See Steven L. Nesbitt, "Long-Term Rewards From Shareholder Activism: A Study of the 'CalPERS Effect'," J. OF APP. CORP. FIN. 75 (Winter 1994) [concluding that CalPERS' program generates approximately $150 million, per year, in added returns].

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

Ira M. Millstein, New York Times, April 6, 1997, Money & Business Section, at p. 10.

Now, with the benefit of its experience, CalPERS is embarking on its next evolutionary step. With the Corporate Governance Core Principles and Guidelines that follow, CalPERS speaks not only to today's underperformers, but also to tomorrow's.

II. PURPOSE

The document that follows is separated into two components: **Core Principles** and **Governance Guidelines**. CalPERS believes the criteria contained in **both** the Principles and the Guidelines are important **considerations** for all companies within the U.S. market. However, CalPERS does not expect nor seek that each company will adopt or embrace every aspect of either the Principles or Guidelines. CalPERS recognizes that some of these may not be appropriate for every company, due to differing developmental stages, ownership structure, competitive environment, or a myriad of other distinctions. CalPERS also recognizes that other approaches may equally – or perhaps even better – achieve the desired goal of a fully accountable governance structure. CalPERS has adopted these Principles and Guidelines to advance the corporate governance dialogue by presenting the views of one shareowner, but not to attempt to permanently enshrine those views. As one shareowner, CalPERS believes that the **Core Principles** represent the **foundation** for accountability between a corporation's management and its owners. The **Guidelines** represent, in CalPERS' view, additional features that may further advance this relationship of accountability.

III. CORE PRINCIPLES

A. Board Independence & Leadership

Independence is the cornerstone of accountability. It is now widely recognized throughout the U.S. that independent boards are essential to a sound governance structure.[4] Therefore, CalPERS suggests:

1.	**A *substantial majority* of the board consists of directors who are independent.[5]**
2.	**Independent directors meet periodically (at least once a year) alone, without the CEO or other non-independent directors.[6]**

But the independence of a majority of the board is not enough. The ***leadership*** of the board must embrace independence, and it must ultimately change the way in which directors interact with management.

> *"In the past, the CEO was clearly more powerful than the board. In the future, both will share influence. In a sense, directors and the CEO will act as peers. Significant change must occur in the future if boards are to be effective monitors and stimulators of strategic change. Directors and their CEOs must develop a new kind of relationship, which is more complex than has existed in the past. . . ."*

Jay W. Lorsch, "The Board as A Change Agent," THE CORPORATE BOARD 1 (July/Aug, 1996).

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[4] The National Association of Corporate Directors' (NACD's) Blue Ribbon Commission on Director Professionalism released its report in November 1996. (Hereafter "NACD Report".) The NACD Report calls for a "substantial majority" of a board's directors to be independent. This report also suggests that independence "may be compromised by" reciprocal directorships ("director interlocks"); existing significant consulting or employment relationships between the director and the company; existing substantial commercial relationships between the director's organization and the board's company; and new business relationships that develop through board membership. (NACD Report, at p. 9-10.) The Business Roundtable's Statement on Corporate Governance (September 1997, hereafter "BRT Statement") is in general accord that a "substantial majority" of directors should be "outside (non-management)." (BRT Statement, at p. 10.) The BRT, however, believes that financial relationships between directors and the company should be evaluated on a case-by-case basis "rather than through the application of rigid criteria." (BRT Statement, at p. 11.)

[5] The definition of "independence" is discussed in part IV, Governance Guidelines, below.

[6] BRT Statement, at p. 17.

To instill independent ***leadership***, CalPERS suggests:

3. When the chair of the board also serves as the company's chief executive officer, the board designates – formally or informally – an independent director who acts in a *lead capacity*[7] to coordinate the other independent directors.

4. Certain board committees consist *entirely* of independent directors. These include the committees who perform the following functions:

Audit
Director Nomination
Board Evaluation & Governance
CEO Evaluation and Management Compensation[8]
Compliance and Ethics[9]

Lastly, independence also requires a lack of conflict between the director's personal, financial, or professional interests, and the interests of shareowners.

> *"A director's greatest virtue is the independence which allows him or her to challenge management decisions and evaluate corporate performance from a completely free and objective perspective. A director should not be beholden to management in any way. If an outside director performs paid consulting work, he becomes a player in the management decisions which he oversees as a representative of the shareholder…."*

Robert H. Rock, Chairman NACD, DIRECTORS & BOARDS 5 (Summer 1996).

[7] The potential duties of a "lead independent director" are illustrated in Appendix A. See also NACD Report, at p. 4 ["Boards should consider formally designating a non-executive chairman or other independent board leader. If they do not make such a designation, they should designate, regardless of title, independent members to lead the board in its most critical functions . . . ."]. "The BRT 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 rotational basis if and whether the need arose." (BRT Statement, at p. 13.) A recommended definition of "independent director" is provided in Appendix B-1. Appendix B-2 contains a matrix of some of the differing definitions of this term that currently exist.

[8] See NACD Report, at p. 5.

[9] See Harvey L. Pitt, Karl A. Groskaufmanis, and Vasiliki B. Tsaganos, "Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct," CLIENT LETTER FROM FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, Feb. 21, 1997, at p. 5.

Accordingly, CalPERS recommends that:

5. No director may also serve as a consultant or service provider to the company. [10]

6. *Director compensation* is a combination of *cash and stock* in the company. The stock component is a significant portion of the total compensation.[11]

B. Board Processes & Evaluation

No board can truly perform its overriding functions of establishing a company's strategic direction and then monitoring management's success without a system of evaluating itself.

CalPERS views this self-evaluation to have several elements, including:

1. The board has adopted a written statement of its own *governance principles*[12], and regularly re-evaluates them.

2. With each director nomination recommendation, the board considers the *mix of director characteristics, experiences, diverse perspectives and skills* that is most appropriate for the company.[13]

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[10] "A firm's board of directors owes its fiduciary responsibilities to the common stockholders of the firm. If the directors also serve as consultants to the firm's management, then their willingness to confront management when they think they have done something wrong is limited -- for to confront management is to risk the loss of those management consulting fees. Even if directors are not swayed by the prospect of losing their consulting fees, academic studies indicate that investors appear to view the prospect that they might as sufficient reason to discount the firm's shares." (John D. Martin and Robert Parrino, "Using Directors as Consultants," DIRECTORS & BOARDS 32, 35 (Summer 1996).)

[11] See NACD Report at p. 5, referring to 1995 Report of the NACD Blue Ribbon Commission on Director Compensation. See also GM BOARD OF DIRECTORS CORPORATE GOVERNANCE GUIDELINES ON SIGNIFICANT CORPORATE GOVERNANCE ISSUES (Adopted January 1994; Revised August 1995; hereafter "GM Guidelines"); Guideline No. 13.

[12] General Motors is perhaps the most well known company to have formally adopted governance principles. However, as of May 1995, nearly 70% of the largest 300 U.S. companies had also adopted written governance principles.

[13] CalPERS does not believe that each director must possess all of the core competencies. Rather, following the conclusion of the NACD Report, we believe that *each* director should contribute some knowledge, experience or skill in at least *one* domain that is critical to the company. (See NACD Report, at p. 8-9.) In addition, CalPERS believes that consideration of the appropriate director skill mix should also include consideration of obtaining a diversity of experiences and perspectives within the board. (See BRT Statement, at p. 7.)

3. **The board establishes *performance criteria* for itself., and periodically reviews board performance against those criteria.**[14]

4. **The independent directors establish *performance criteria and compensation incentives for the CEO*, and regularly reviews the *CEO's performance against those criteria*.[15] The independent directors have access to *advisers* on this subject, who are independent of management. Minimally, the criteria ensure that the CEO's interests are aligned with the long-term interests of shareowners, that the CEO is evaluated against comparable peer groups, and that a significant portion of the CEO's total compensation is at risk.**

C. Individual Director Characteristics

In CalPERS' view, each director should add something unique and valuable to the board as a whole. Each director should fit within the skill sets identified by the board (see B.2, above). No director, however, can fulfill his or her potential as an effective board member without a personal dedication of time and energy and an ability to bring new and different perspectives to the board.

1. **The board has adopted guidelines that address the *competing time commitments* that are faced when director candidates serve on multiple boards. These guidelines are published annually in the company's proxy statement.** [16]

IV. GOVERNANCE GUIDELINES

[14] See NACD Report, at p. 16-17. See also BRT Statement, at p. 9.

[15] See BRT Statement , at p. 5.

[16] See NACD Report, at p. 10-12 [recommending that candidates who are CEOs or senior executives of public corporations be "preferred" if they hold no more than 1-2 public company directorships; other candidates who hold full-time positions be preferred if they hold no more than 3-4 public company directorships; and all other candidates be preferred if they hold no more than 5-6 other public company directorships.] See also BRT Statement, at p. 8. However, surveys indicate that directors spend an average of 190 hours per year preparing for and attending each organization's board and committee meetings. (Jeremy Bacon, CORPORATE BOARDS AND CORPORATE GOVERNANCE, 22-24 (New York, The Conference Board, 1993.) With this level of time commitment, CalPERS believes that limitations greater than recommended by the NACD may be appropriate. "The job of being the CEO of a major corporation is one of the most challenging in the world today. Only extraordinary people are capable of performing it adequately; a small portion of these will appropriately be able to commit some energy to directorship of one other enterprise. No CEO has time for more than that." (Robert A.G. Monks, "Shareholders and Director Section", DIRECTORS & BOARDS (Spring 1995), as quoted in Autumn 1996 volume at p. 158.)

Section III (above), containing the Core Principles, represents CalPERS' view of elements of corporate governance that form the foundation of accountability between a corporation's managers and its owners. During its decade-long experience in examining governance structures, however, CalPERS has found that there are many additional features that are important considerations in the continuing evolution of "corporate governance." The importance of these issues often varies from company to company, depending upon the unique composition of each board, and the special challenges that each company faces. CalPERS offers the following Governing Guidelines as additional topics for discussion in the governance dialogue.

A. Board Independence & Leadership

1. **Corporate directors, managers and shareowners should come together to agree upon a uniform definition of "independence." Until this uniformity is achieved, each corporation should publish in their proxy statement the definition adopted or relied upon by its board.**

2. **With each director nomination recommendation, the board should consider the issue of continuing director tenure and take steps as may be appropriate to ensure that the board maintains an openness to new ideas and a willingness to critically re-examine the status quo.**

Nearly all corporate governance commentators agree that boards should be comprised of at least a majority of "independent directors" (with a growing trend toward a "substantial majority, see III.A.1 above). There is, however, no current agreement as to what constitutes "independence."[17] Despite these varying opinions, CalPERS believes an opportunity now exists for those involved in this debate to come together to craft a definition that generally meets the needs of all. Toward this end, CalPERS offers the definition attached as **Appendix B-1**.

[17] Many definitions exist, in statutes affecting certain purposes (e.g., section 16(m) of the Internal Revenue Code, section 16 of the Securities Exchange Act of 1934), in national exchange listing standards, and as endorsed by different governance participants. Appendix B-2 contains a matrix of some of the existing variations on this concept.

3. When selecting a new chief executive officer, boards should re-examine the traditional combination of the "chief executive" and "chairman" positions.

There has been much debate concerning the wisdom, and feasibility, of an "independent chair" structure in American corporate culture. Although this structure is more common in European corporations[18], it remains the exception in the United States. CalPERS believes, however, that *true* board independence may ultimately – within the next decade – require a serious re-examination of this historic combination of powers.[19]

CalPERS also believes that much of the current debate in the U.S. is the result of uncertainty, and a lack of a clear definition of the role of an independent chair. Many commentators are concerned that such a position would undermine the CEO, confuse accountability, and disrupt daily company operations. CalPERS agrees that an independent chair should not effectively equate to a "co-CEO" role; rather, CalPERS sees the role as – although vital – quite narrow. To promote further dialogue of this issue, CalPERS offers in **Appendix C** a possible "Independent Chair Duty Statement."

[18] In a recent study of the impact within the United Kingdom market of separating, or combining, the roles of CEO and chair, the author found a "significant positive market reaction . . . followed the separation of the responsibilities of chairman and CEO." Also, companies that announced a separation subsequently performed better than their counterparts based on several accounting measures. Conversely, companies that announced combination of the positions resulted in "the largest negative market response the day after the announcement." (J. Dahya et al., "The Case for Separating the Roles of Chairman and CEO: An Analysis of Stock Market and Accounting Data," 4 CORP. GOVERNANCE 71, 76 (1996).)

[19] "The function of the chairman is to run board meetings and oversee the process of hiring, firing, evaluating, and compensating the CEO . . . . Without the direction of an independent leader, it is much more difficult for the board to perform its critical function." (Michael C. Jensen, "Presidential Address: The Modern Revolution, Exit and the Failure of Internal Control Systems," 48 J. OF FIN. 831, 866 (1993).) "Wearing both hats is like grading your own paper." (Anne Hansen, deputy director of the Council of Institutional Investors, as quoted in "A Walk on the Corporate Side," TRUSTEE 9, 10 (Nov/Dec. 1996).) See also, Constance E. Bagley and Richard H. Koppes, "Leader of the Pack: A Proposal for Disclosure of Board Leadership Structure," 34 SAN DIEGO L. REV. 149, 157-158.

B. Board Processes & Evaluation

In addition to the processes described in the Core Principles, above, CalPERS recommends that boards consider the following:

1. The board should have in place an *effective CEO succession plan*, and receive periodic reports from management on the development of other members of senior management.

2. All directors should have *access to senior management*. However, the CEO, chair, or independent lead director may be designated as liaison between management and directors to ensure that the role between board oversight and management operations is respected.[20]

3. The board should periodically review its own size, and determine the size that is most effective toward future operations.[21]

C. Individual Director Characteristics

Many of the Core Principles and Guidelines in this document would not be necessary if corporate boards had an effective means of evaluating ***individual director performance***. It is this seeming inability to promptly replace directors who are not fully contributing toward overall board success that has led shareowners to question many concepts that would, under a true delegation of management responsibility to boards, otherwise be unnecessary. With this in mind, CalPERS recommends that:

1. Each board should establish *performance criteria*, not only for itself (acting as a collective body) but also *individual behavioral expectations* for its directors. Minimally, these criteria should address the level of director: attendance, preparedness, participation, and candor.[22]

2. To be re-nominated, directors must satisfactorily perform based on the established criteria. Re-nomination on any other basis should neither be expected nor guaranteed.

[20] See GM Guidelines, No. 12. See also BRT Statement, at p. 18.

[21] See NACD Report, at p. 4, 5.

[22] See NACD Report, at p. 16-17.

3. Generally, a company's retiring CEO should not continue to serve as a director on the board.[23]

4. The board should establish and make available to shareowners the skill sets which it seeks from director candidates. Minimally, these *core competencies* should address: accounting or finance, international markets, business or management experience, industry knowledge, customer-base experience or perspective, crisis response, or leadership or strategic planning.

D. Shareowner Rights

Shareowner rights – or those structural devices that define the formal relationship between shareowners and the directors to whom they delegate corporate control – are not typically featured in the governance principles adopted by corporate boards. CalPERS generally believes that, if the Principles and Guidelines described above are internalized and become part of the way in which American corporations operate, then shareowners should trust that independent boards will make the decisions that promote long-term shareowner interests – whether those decisions concern shareowner rights or other issues. But, we are not yet at that point. Therefore, to help build tomorrow's corporate governance structure, CalPERS offers today's corporate boards the following views on issues affecting shareowner rights:

1. A majority of shareowners should be able to amend the company's bylaws by shareowner proposal.

2. A majority of shareowners should be able to call special meetings.

3. A majority of shareowners should be able to act by written consent.

4. Every company should prohibit greenmail.

5. No board should enact nor amend a poison pill except with shareowner approval.

6. Every director should be elected annually.

7. Proxies should be kept confidential from the company, except at the express request of shareowners.

8. Broker non-votes should be counted for quorum purposes only.

[23] "What about losing the accumulated experience of the retiring CEO? That is easily solved. If the new CEO wants to tap the perceived wisdom and experience of the retired CEO, a telephone call or a quiet meeting does not require a board seat." (Former Citicorp Chairman Walter Wriston, "Resist the Desire to Stay On," DIRECTORS & BOARDS (Spring 1993) 35.)

9. Any shareowner proposal that is approved by a majority of proxies cast should either be implement by the board, or the next annual proxy statement should contain a detailed explanation of the board's reasons for not implementing.

10. Shareowners should have effective access to the director nomination process.

V. CONCLUSION

In adopting these Core Principles and Governance Guidelines, CalPERS' goal is to stimulate healthy debate. To the extent this document evokes disagreements, may these disagreements be used to promote greater clarity of thought. With continued experience and communication between corporate managers and owners, the issue of accountability can become – if not resolved – more clear.

> *"As conflict – difference – is here in the world, as we cannot avoid it, we should, I think, use it. Instead of condemning it, we should set it to work for us… So in business, we have to know when to … try to capitalize [on conflict], when to see what we can make it do…. [In that light] it is possible to conceive of conflict as not necessarily a wasteful outbreak of incompatibilities but a normal process by which socially valuable differences register themselves for the enrichment of all concerned…. Conflict at the moment of the appearing and focusing of difference may be a sign of health, a prophecy of progress."*

THE PRICE WATERHOUSE CHANGE INTEGRATION TEAM, THE PARADOX PRINCIPLES 275 (quoting Mary Parker Follett) (1996).

APPENDIX A

LEAD INDEPENDENT DIRECTOR
POSITION DUTY STATEMENT

- The chief executive officer is the senior executive of the Company. The CEO is responsible for:

    - ♦ providing management of the day-to-day operations of the Company;

    - ♦ recommending policy and strategic direction of the Company, for ultimate approval by the Board of Directors; and

    - ♦ acting as the spokesperson of the Company.

- In contrast, the Lead Independent Director is responsible for coordinating the activities of the independent directors. In addition to the duties of all Board members as set forth in the Company's [Governance Guidelines], the specific responsibilities of the Lead Independent Director are as follows:

    - ♦ advise the Chair as to an appropriate schedule of Board meetings, seeking to ensure that the independent directors can perform their duties responsibly while not interfering with the flow of Company operations;

    - ♦ provide the Chair with input as to the preparation of the agendas for the Board and Committee meetings;

    - ♦ advise the Chair as to the quality, quantity and timeliness of the flow of information from Company management that is necessary for the independent directors to effectively and responsibly perform their duties; although Company management is responsible for the preparation of materials for the Board, the Lead Independent Director may specifically request the inclusion of certain material;

    - ♦ recommend to the Chair the retention of consultants who report directly to the Board;

    - ♦ interview, along with the chair of the [nominating committee], all Board candidates, and make recommendations to the [nominating committee] and the Board;

- assist the Board and Company officers in assuring compliance with and implementation of the Company's [Governance Guidelines]; principally responsible for recommending revisions to the [Governance Guidelines];

- coordinate, develop the agenda for and moderate executive sessions of the Board's independent directors; act as principal liaison between the independent directors and the Chair on sensitive issues;

- evaluate, along with the members of the [compensation committee/full board], the CEO's performance; meet with the CEO to discuss the Board's evaluation; and

- recommend to the Chair the membership of the various Board Committees, as well as selection of the Committee chairs.

APPENDIX B-1

DEFINITION OF INDEPENDENT DIRECTOR

“Independent director” means a director who:

- has not been employed by the Company in an executive capacity within the last five years;
- is not, and is not affiliated with a company that is, an adviser or consultant to the Company or a member of the Company’s senior management;
- is not affiliated with a significant customer or supplier of the Company;
- has no personal services contract(s) with the Company, or a member of the Company’s senior management;
- is not affiliated with a not-for-profit entity that receives significant contributions from the Company;
- within the last five years, has not had any business relationship with the Company (other than service as a director) for which the Company has been required to make disclosure under Regulation S-K of the Securities and Exchange Commission;
- is not employed by a public company at which an executive officer of the Company serves as a director;
- has not had any of the relationships described above with any affiliate of the Company; and
- is not a member of the immediate family of any person described above.

APPENDIX B-2

VARIATIONS ON A THEME – "INDEPENDENT DIRECTOR"

Source	Citation	Applicability	Standard	Definition
Investment Company Act of 1940	15 USC sec. 80a-10(a); 15 USC sec. 80a-2(a)(18)	Registered investment company boards	No more than 60% of the directors may be "interested persons"	"Interested person" means: • affiliated to the company • a member of the immediate family of one who is affiliated to the company • affiliated (directly or through familial relationships) with an investment advisor or principal underwriter to the company • legal counsel to the company within the prior two fiscal years (including all partners and employees of such counsel) • all brokers and dealers, including persons affiliated to brokers or dealers • any person so deemed by order of the SEC, by virtue of having had, within the prior two years, a material or professional relationship with the company or its CEO, or with any investment company having the same investment adviser or principal underwriter, or with the CEO of such investment company
Securities Exchange Act of 1934	17 CFR sec. 240.16b-3 (interpreting 15 USC sec. 78p, concerning certain insider transactions)	Companies whose securities are registered for sale under the 1934 Act	A grant, award or other acquisition of a security, from a company to an officer or director, is exempt from the Act's insider trading restrictions if, among other alternatives, the transaction is approved by the company's board or by a committee of the board composed solely of two or more "non-employee directors"	"Non-employee director" means: • is not currently employed by the company (or a parent or subsidiary of the company) • does not receive compensation, directly or indirectly, from the company or a parent or subsidiary, in an amount which is significant enough to be disclosed under Regulation S-K, excluding directors' fees • has no interest in any significant transactions or business relationships with the company, such that they would have to be disclosed under Regulation S-K

Source	Citation	Applicability	Standard	Definition
Internal Revenue Code	26 CFR sec. 1.162-27 (interpreting 26 USC sec. 162, concerning the deductibility of certain executive pay)	Publicly held corporations	Generally, executive compensation over $1 million is not deductible. Among the many exceptions to this rule is compensation that is "performance based" and is determined by a compensation committee that is comprised solely of two or more "outside directors"	"Outside director" means: • is not currently employed by the company • is not a former employee who received compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year • has not been an officer of the company • does not receive compensation (defined to be more than *de minimus*, which is also a specifically defined term) for goods or services performed, excluding directors fees
FDIC	12 CFR pt. 363 Appendix A	Insured depository institutions	All audit committee members must be "independent of management of the institution"	"Independent of management" is generally a determination each institution may make. This term absolutely excludes a director who: • is, or has been within the preceding year, an officer or employee of the institution or its affiliates • owns or controls, or has owned or controlled within the preceding year, assets representing 10% or more of any outstanding class of the institution's voting securities. Beyond this, the institution should consider whether the director: • has been, prior to the preceding year, an officer or employee of the institution or its affiliates • serves as a consultant, advisor, promoter, underwriter, legal counsel or trustee of or to the institution or its affiliates • is a relative of an officer or other employee of the institution or its affiliates • hold or controls, or has held or controlled, a direct or indirect financial interest in the institution or its affiliates • has outstanding extensions of credit from the institution or its affiliates.

Source	Citation	Applicability	Standard	Definition
American Law Institute	ALI, *Principles of Corporate Governance* sec. 3A-01	Recommended for large publicly held corporations (2,000 or more record holders and $100 million or more in total assets)	A majority of the directors should be "free of any significant relationship" with the company or its senior executives	"Significant relationship" means: • is, or was within the preceding two years, employed by the company • a member of the immediate family of such a current or former employee • received from the company during either of the two preceding years over $200,000 • owns an equity interest (with the power to vote) in a business that received compensation from the company, such that the director's equity share was over $200,000 • is the principal manager of a business that received from, or paid to the company, during either of the two preceding years, 5% of the business' consolidated gross revenues, or $200,000, whichever is more • is professionally affiliated with the corporation's primary outside legal firm Notwithstanding the above, a director may still be considered not to have a "significant relationship," if "on the basis of countervailing or other special circumstances, it could not reasonably be believed that the judgment of a person in the director's position would be affected by his relationship."
National Association of Corporate Directors	NACD's Blue Ribbon Commission on Director Professionalism (1996), at p. 9-10	n/a	A substantial majority of directors should be independent	"Although potentially valuable benefits may accrue from business relationships, these benefits can impair the director's independence. It is important to make the distinction between directors and service providers. . . If the director's primary value to the company is as a consultant or advisor, the individual should be brought on as such and paid as such, not brought on as a director and paid as a consultant.." • Boards should define and disclose to shareholders a definition of "independent director."

Source	Citation	Applicability	Standard	Definition
				• Boards should require that director candidates disclose all existing business relationships between them or their employer and the board's company. • Boards should then evaluate the extent to which, if any, a candidate's other activities may impinge on his or her independence as a board member, and determine when relationships are such that a candidate can no longer be considered independent."
Business Roundtable	Business Roundtable's Statement on Corporate Governance (Sept., 1997), at p. 11-12	n/a	A substantial majority of directors should be independent	"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 . . . with the corporation or any business or personal relationship . . . with management. . . Depending on their significance to the director and to the corporation, such relationships may affect a director's actual or perceived independence. The [BRT] believes that, where such relationships exist, boards should be mindful of them and make a judgment about a director's independence based on . . . individual circumstances rather than through the mechanical application of rigid criteria. . . . For certain functions, such as membership on an audit or compensation committee, more specific standards of independence should be used."
National Association of Securities Dealers	NASD By-Laws, Subdivision D, Schedule D, Part II	Corporations quoted on NASDAQ	Boards must maintain a minimum of two independent directors; audit committees must be comprised of a majority of independent directors	"Independent director" means a person other than an officer or employee of the company or its subsidiaries, or any other individual having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Source	Citation	Applicability	Standard	Definition
New York Stock Exchange	NYSE Listed Company Manual, sec. 303.00	US companies listed on the exchange	Audit Committees must be maintained and comprised entirely of independent directors	"Independent director" means a person who is independent of management and free from any relationship that, in the opinion of the board, would interfere with the exercise of independent judgment as an audit committee member. However, no officer or employee of the company or its subsidiaries is qualified as an "independent director."
Council of Institutional Investors	CII Core Policies, at p. 1, 7-10	n/a	At least a majority (proposed to be increased to 2/3) of the directors should be independent	A director is deemed independent if his or her only non-trivial professional, familial, or financial connection to the corporation or its CEO is his or her directorship. (Explanatory notes provide additional general guidance.)

APPENDIX C

INDEPENDENT CHAIR
POSITION DUTY STATEMENT

- The chief executive officer is the senior executive of the Company. The CEO is responsible for:

  - ♦ providing management of the day-to-day operations of the Company;

  - ♦ recommending policy and strategic direction of the Company, for ultimate approval by the Board of Directors; and

  - ♦ acting as the spokesperson of the Company.

- In contrast, the Independent Chair is responsible for coordinating the activities of the Board of Directors. In addition to the duties of all Board members as set forth in the Company's [Governance Guidelines], the specific responsibilities of the Independent Chair are as follows:

  - ♦ conduct all meetings of the Board and the meetings of shareowners;

  - ♦ serve as an ex-officio member of each of the committees of the Board of which the Independent Chair is not a member;

  - ♦ schedule Board meetings in a manner that enables the Board and its Committees to perform their duties responsibly while not interfering with the flow of Company operations;

  - ♦ prepare, in consultation with the CEO and other directors and Committee chairs, the agendas for the Board and Committee meetings;

  - ♦ define the quality, quantity and timeliness of the flow of information between Company management and the Board; although Company management is responsible for the preparation of materials for the Board, the Independent Chair may specifically request the inclusion of certain material;

  - ♦ approve, in consultation with other directors, the retention of consultants who report directly to the Board;

- interview, along with the chair of the [nominating committee], all Board candidates, and make recommendations to the [nominating committee] and the Board;

- assist the Board and Company officers in assuring compliance with and implementation of the Company's [Governance Guidelines]; principally responsible for recommending revisions to the [Governance Guidelines];

- develop the agenda for and moderate executive sessions of the Board's independent directors; act as principal liaison between the independent directors and the CEO on sensitive issues;

- evaluate, along with the members of the [compensation committee/full board], the CEO's performance; meet with the CEO to discuss the Board's evaluation; and

- recommend to the full Board the membership of the various Board Committees, as well as selection of the Committee chairs.