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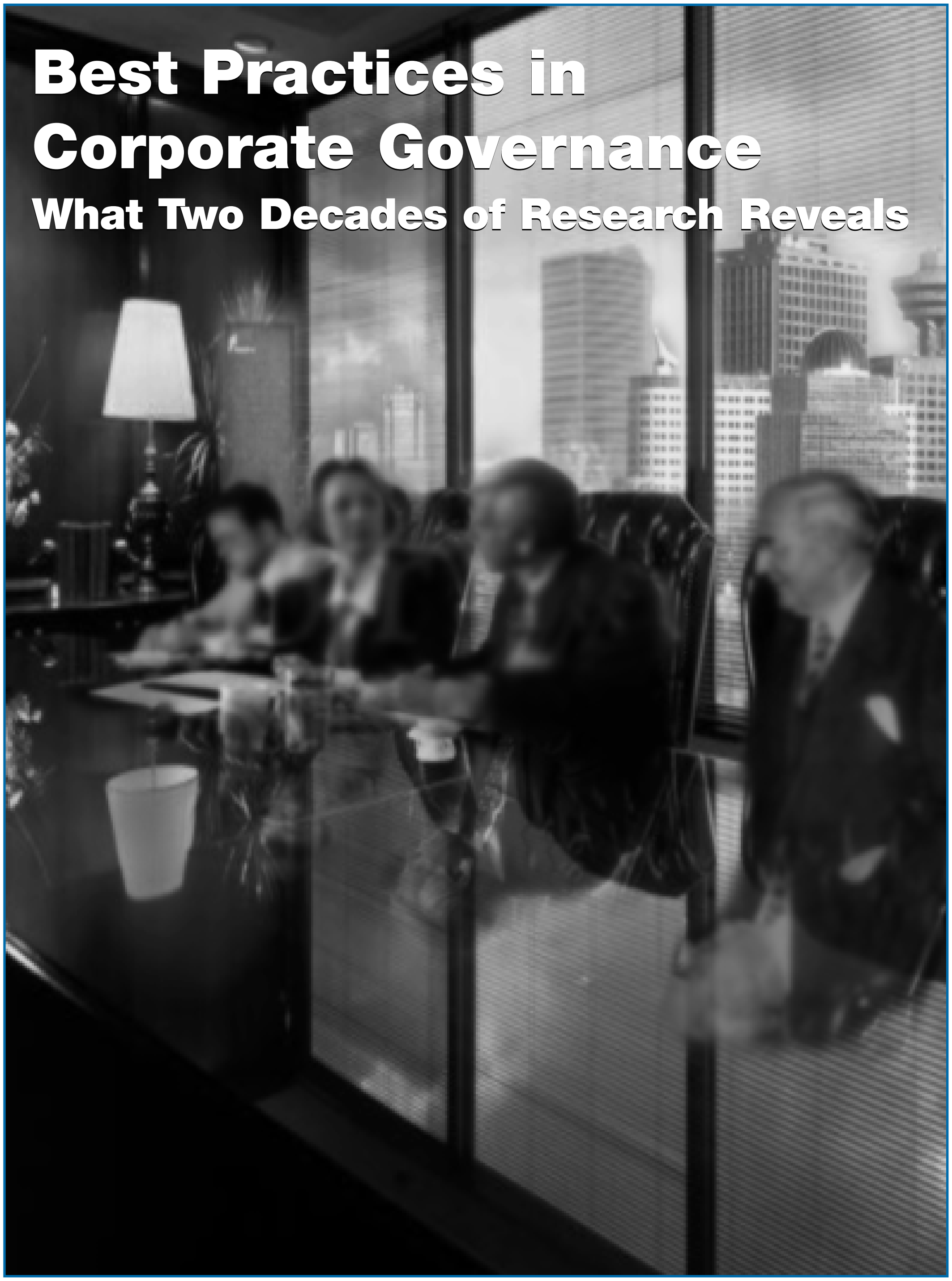
Best Practices in Corporate Governance

What Two Decades of Research Reveals



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Executive Summary

The quality of corporate governance can be an important driver of shareholder value and companies with strong governance systems have outperformed peers in a wide range of settings.

The composition and structure of corporate boards has been instrumental in determining companies' ability to cope and react to declines in operating performance, in CEO succession, in the pursuit of acquisition opportunities, and in responding to takeover bids.

The independence of the audit, compensation, and nominating committees significantly affects the quality of governance.

Executive ownership in the form of common stock and/or stock options enhances decision-making and increases shareholder value in most instances.

Stock options have increasingly become a part of director compensation, and this trend has had a positive effect on value.

Shareholder activists have frequently challenged anti-takeover provisions, but these provisions do not necessarily reduce shareholder value.

Introduction

The increasing investor, regulatory, and public concern about corporate governance makes this an opportune time for companies to assess the quality and structure of their governance systems. The NYSE has recently adopted, and Nasdaq and organizations such as Institutional Shareholder Services (ISS) have proposed a range of recommendations that most companies will have to consider. In this report, we survey a broad range of research that has been conducted over the past two decades on a variety of corporate governance topics and summarize the key findings. We have made frequent contributions to this literature as authors, and our summary is based on our view of the most important and influential studies in this area. The sheer volume of the literature dictates that we must focus on a few key areas and emphasize the principal findings in each.

Our summary focuses on the following broad areas:

- What is the appropriate mix of inside, independent, and nonindependent outside directors on the board?
- Who are the independent directors?
- What is the appropriate composition of board committees?
- What kinds of directors should companies seek to attract and how should they be compensated?
- What kinds of compensation policies for executives and directors create the most value for shareholders?
- What is the impact of various anti-takeover provisions?

The existing research examines many, but not all, of the proposals being considered. Most of the studies that we summarize are based on analyses of large numbers of public companies over several years. Therefore, the results of any specific study will not be directly applicable to all types of companies in all situations. Nonetheless, we believe that these studies highlight common themes, which should serve as a useful resource as boards evaluate and consider ideas for designing governance structures that enhance long-term shareholder value.

What Does the Research Tell Us?

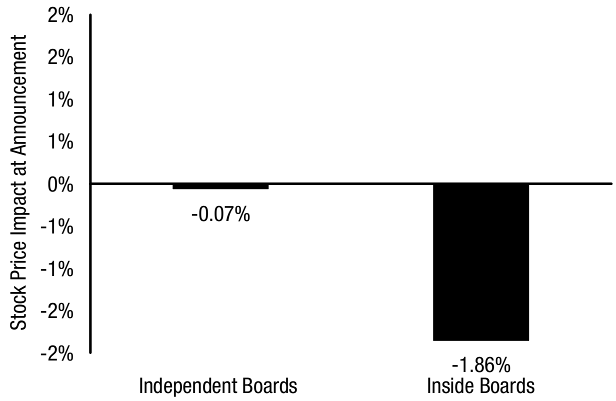
Our overview is based on our view of some of the key findings, drawn from the finance, economics, accounting, and strategic management literature. It is not intended to serve as a comprehensive review of every published study. Rather, we have chosen to highlight the common elements from key studies and those published in leading academic journals. Our summary is organized in a question and answer format.

Should the Board Be Composed of a Majority of Independent Directors?

Few questions in academic work generate as much consensus as this one. The literature is filled with studies that show that in situations requiring a specific board decision, the outcome is more likely to be beneficial to shareholders when the board consists of a majority of independent outside directors (that is, when the board is "outside dominated"):

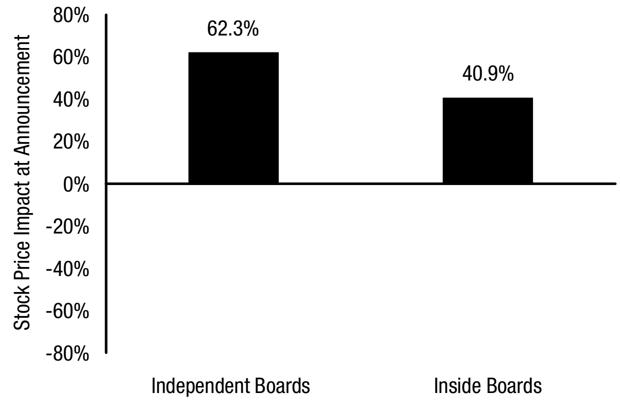
- Because the supervision of management is a primary responsibility of boards, studies have focused on the responsiveness of boards in replacing CEOs after poor company performance. Outside-dominated boards are more likely to replace poorly performing CEOs (Weisbach 1988).
- When company performance deteriorates significantly, outside boards are more likely to opt for a clean slate and hire the replacement CEO from outside the firm than promote an internal candidate (Borokhovich, et al. 1996 and Huson, et al., 2000).
- Companies tend to make better acquisitions when the board is outside dominated (Byrd, et al. 1992). The discipline of vetting acquisition proposals by independent directors results in actual bids that are viewed more favorably by equity investors (see Figure 1).
- Boards dominated by outsiders tend to bargain more intensively when their companies become targets of takeover bids, resulting in larger stock price gains for the target shareholders (Cotter, et al. 1997) (see Figure 2).

Figure 1. Announcement Day Returns for Acquiring Companies



Source: Byrd and Hickman (1992).

Figure 2. Takeover Period Returns for Target Companies[a]



[a] Calculated as the market-adjusted stock return from inception to completion of bid.
Source: Cotter, Shivdasani, and Zenner (1997).

Although outside-dominated boards help companies make better specific decisions, the existing research has not found any direct link between board composition and metrics of financial performance or shareholder value. Studies in this area typically show that for companies with outside boards, valuation multiples[1] and metrics such as return on assets (ROA) and operating performance margins are comparable to those of companies with insider dominated boards (Hermalin, et al. 1991, Mehran 1995, Bhagat, et al. 1999). Researchers have advanced two explanations for this lack of relation between board independence and firm performance:

- Board composition is itself affected by financial performance. Companies typically react to deteriorating performance by adding outside directors to the board. Research shows that independent director appointments tend to be associated with share price appreciation (Rosenstein, et al. 1990).
- The advantages of an active outside board are most visible when a specific issue such as an acquisition proposal or the replacement of the CEO needs to be voted on. The operating performance, which is tied most closely to the quality of the day-to-day management of the company, is less affected by board composition.

Who Qualifies as an Independent Director?

Studies have identified that the impact of outside directors on corporate governance depends critically on whether they are independent or share some affiliation with management. Virtually every study on the topic finds that the board needs to have a majority of independent outsiders to enhance shareholder value. The types of affiliations that have been identified as creating the potential for conflicts of interest include:

- Past employment with the company as an executive. Studies have not, however, examined whether the five-year cooling off period for an executive under the

[1] Most of the studies reviewed here have examined the price-to-book multiple or the Q ratio, which represents the ratio of firm market value to replacement cost of assets, as valuation multiples. When studying large samples of companies across numerous industries, studies have found that these metrics produce more reliable inferences than the price/earnings ratio because of the cyclical nature of earnings in many industries and the numerous nonoperating charges that can affect an individual company's earnings in any given year.

adopted NYSE guidelines, overcomes potential conflicts when former executives serve on the board.

- ➤ Any consulting or contractual arrangement with the company from which a director may derive a pecuniary benefit. Directors who are executives of suppliers, customers, etc. would therefore not be considered independent.
- ➤ Relatives of the top management team.
- ➤ Commercial bankers, investment bankers, and lawyers even if no business ties currently exist, because of the potential for conflict of interest and the possibility that business ties may be sought.
- ➤ Outside directors with interlocked directorships with the top management team (e.g. CEOs that reciprocally serve on each others boards).
- ➤ Studies, however, do find that representatives of large shareholders on the board can have a positive impact on corporate governance.

Should the CEO be the Only Insider?

Although the evidence in support of having a board dominated by a majority of independent directors is overwhelming, studies typically do not find much evidence that percentages of independent directors greater than 50% add incremental value. This is perhaps not surprising, because most board decisions are determined by the majority rule. In certain situations, it can also be beneficial to have nonindependent directors on the board:

- ➤ Surveys of independent directors reveal that one of the biggest challenges is having the CEO as the primary conduit of information presented to the board (Lorsch, et al. 1989). By having one or two non-CEO executives on the board, it is likely that a more comprehensive view of the company is presented to the outside board members. Particularly in today's environment, the CFO might be a logical candidate for the board.
- ➤ Having the top one or two internal candidates on the board gives outside directors a better view of the capabilities of insiders as potential successors and, in turn, helps evaluate whether a replacement, if needed, should be internal or external (Hermalin, et al. 1988).
- ➤ The presence of outside directors with financial expertise, such as investment and commercial bankers, can add value in certain situations. For small and medium-sized companies with limited access to in-house financial expertise, appointments of investment bankers and commercial bankers lead to a positive stock price reaction, suggesting that affiliated directors can add value in some circumstances (Lee, et al. 1999).

Should the Chairman be Separate from the CEO?

The question of whether the chairman and CEO positions should be separated has been controversial. The advantages and the drawbacks of separating the chairman and CEO positions have been studied extensively:

- ➤ Combining the positions of chairman and CEO confers greater power to the CEO. Brickley, et al. (1997) find that in most companies, CEOs gain the title of chairman after having outperformed their peers. They argue that the chairman title serves as a reward to a new CEO who has demonstrated superior performance and represents an implicit vote of confidence by outside directors. In their view, requiring companies to separate the positions of CEO and chairman would deprive boards of an important tool to motivate and reward new CEOs.

- However, bestowing the CEO and chairman duties in one individual makes it harder for a board to replace a poorly performing CEO, which can reduce the flexibility of a board to address large declines in performance (Goyal, et al. 2002).
- Among large industrial companies, those with non-CEO chairmen traded at higher price-to-book multiples (Yermack 1996).
- In a study of banks, those with CEO-chairman separation had higher ROAs and cost efficiency ratios than banks where the titles were held by the same individual (Pi, et al. 1993).

How Should Board Committees be Structured?

The composition of three principal committees has been studied in the literature: the audit, nominating, and compensation committees.

- Although studies do not find any direct link between company performance and audit committee independence, earnings releases tend to be more informative to equity investors when the audit committee is independent (Klein 2002). This result suggests that, on average, equity investors place greater reliance on earnings releases when the audit committee comprises a majority of independent directors.
- CEO involvement in the director nomination process has been shown to have a significant impact on the types of directors that are appointed to boards. When CEOs participate directly in the selection of new board appointees, either by serving on the nominating committee, or when no independent nominating committee exists, companies tend to appoint fewer independent outside directors and more affiliated outside directors with potential conflicts of interests (Shivdasani, et al. 1999).
- The stock market reaction to appointments of independent outside directors is more positive when the director selection process is viewed to be relatively independent of CEO involvement (Shivdasani, et al. 1999).
- When the CEO sits on the nominating committee, the audit committee is less likely to have a majority of independent directors (Klein 2002).
- CEOs are more likely to receive excessive cash compensation when they sit on the nominating committee (Klein 2002).
- Research for the period prior to 1992–1993[2] shows that a greater proportion of a CEO's compensation is equity-based when retired or current executives dominate the compensation committee (Anderson, et al. 2002). When CEOs serve on their own compensation committee, there is no evidence of excessive

[2] Changes in tax regulation in 1992–1993 stipulated that executive compensation in excess of $1 million would not be tax deductible unless the compensation committee was composed of two or more outside directors.

compensation (Anderson, et al. 2002). Thus, the research has not found that CEO presence on the compensation committee leads to weaker governance, but this may simply reflect the fact that very few CEOs actually serve on the compensation committee.

How Often Should the Board Meet?

Board meetings serve as key forums where executives and directors share information on company performance, plans, and policies. Frequent meetings allow for better communication between management and directors. However, frequent meetings might also distract the firm's managers from their day-to-day operational responsibilities and may deter the board participation of some of the most desirable directors with other time-consuming responsibilities. Is there an optimal board meeting frequency?

- Boards increase meeting frequency after poor performance. On average, meeting frequency does not lead to poor performance but is a reaction to deteriorating performance (Vafeas 1999).
- The recovery from poor performance is faster if board meeting frequency is increased (Vafeas 1999).

This research suggests that boards should balance the costs and benefits of board meeting frequency and should be willing to increase meeting frequency whenever the situation requires significant board input and supervision.

How Large Should the Board Be?

The size of the board has been shown to have a material impact on the quality of corporate governance. Several anecdotal accounts support the idea that large boards can be dysfunctional[3] and this view has been confirmed in two broad statistical studies (Yermack 1996; Eisenberg 1998).

- Valuation multiples, such as the price to book ratio, are highest for companies with small boards. Among the largest 500 companies ranked by Forbes, those companies with the highest multiples had boards that included eight or fewer people, while companies with a board membership of more than 14 displayed the lowest multiples.
- In addition to lower multiples, companies with large boards experienced lower ROAs and operating efficiency metrics.
- Companies with large boards have been slower to replace CEOs in the face of large declines in performance.
- Significant changes in the size of the board[4] have a material valuation impact. Companies that announced decreases in board size had an average market-adjusted stock return of 2.9% at the announcement, while those that increased board size saw the stock price decrease by 2.8% adjusted for market movements.

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[3] For example, an outside director of American Express who organized the removal of the CEO in 1993 cited the unwieldy 19-person board as an obstacle to change (Monks and Minow, 1995).

[4] In Yermack (1996), the set of companies with "significant changes" includes six companies that decreased board size by four to seven directors and four companies that increased board size by four to six directors.

This evidence suggests that some boards may be larger than optimal and that it may be worthwhile for some companies to reevaluate their optimal board size. The rationale for any board reduction should be carefully communicated to investors because news of the departure of a well-respected director may be received negatively.

How Many Boards Should Directors Sit On?

Despite the popular view in the media that serving on multiple boards lowers the ability of independent directors to perform their duties, most academic studies on the topic do not confirm this view. Instead, the findings collectively suggest that directors with multiple board seats are generally likely to be individuals with strong reputations whose services are in demand by many boards.

- Companies at which a large percentage of directors had multiple appointments were less likely to have been targets of unsolicited, hostile or disciplinary takeover bids (Shivdasani 1993).[5]
- Companies that were engaged in takeover negotiations for a possible sale of the company extracted higher premiums for their shareholders when more directors held multiple board appointments (Cotter, et al. 1997).
- Companies were less likely to be sued for financial statement fraud when directors served on multiple boards (Beasley 1996).
- Companies announcing appointments of outside directors with at least three other board seats experienced a positive stock price effect at the announcement of the director's appointment. (Pritchard, et al. 2002).
- Directors with three or more other board seats were more likely to serve on board committees and had higher board attendance (Pritchard, et al. 2002).
- There is no difference in the probability of securities litigation for companies with independent directors serving on more than three boards (Pritchard, et al. 2002).

Of course, practical constraints on time dictate that there is a limit to how many boards on which any individual can effectively serve, and studies have found that full-time executives with three or more board seats might be time-constrained.

- Core, et al. (1999) define directors to be "busy" if they serve on more than three boards if they hold full-time employment or if they sit on more than six boards if they are retired. They find that the presence of such directors on the board correlates with excessive CEO compensation and imply that busy directors do not contribute as much to effective corporate governance.
- When companies announce the appointment of an outside director that is a full-time executive at another firm and holds three or more other board seats, the market's reaction tends to be negative (Perry, et al. 2002).

[5] Being a target of an unsolicited, hostile bid is often viewed in the finance and economics literatures as a symptom that a company's internal governance is weak.

Should Top Executives Hold More Stock?

The bulk of the sensitivity of a CEO's wealth to company performance arises from the CEO's stock and options holdings,[6] and a large body of literature suggests that, for most companies, executive ownership increases shareholder value and helps executives make better decisions.[7]

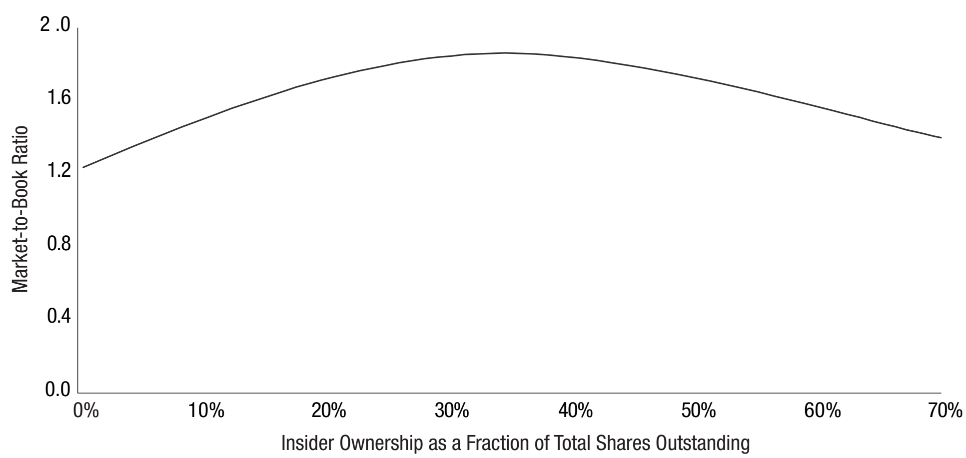
- Firm valuation multiples are higher when executives and insiders own more stock and executive stock options (Morck, et al. 1988; McConnell, et al. 1990).
- Acquisition decisions are received more positively by the market when executives have larger ownership stakes (Lewellen, et al. 1985; Loderer, et al. 1993).
- CEOs are less likely to resist tender offers for their companies when executives own more stock (Walkling, et al. 1984; Cotter, et al. 1994).

The evidence suggests that there is a positive relation between managerial ownership and firm value, and therefore that compensation committees and boards should make CEO stock ownership a key component of their compensation decision.

However, the literature also illustrates the potential drawbacks of large CEO stock holdings:

- Once CEO stock ownership (or control of voting rights) increases beyond the level where the CEO has effective control of the firm (say 25%), CEO ownership has a declining effect on value (Morck, et al. 1988; McConnell, et al. 1990). This relationship is illustrated in Figure 3.

Figure 3. Relationship Between Insider Stock Ownership and Firm Value



Source: McConnell and Servaes (1990).

- When stock ownership confers effective control to the CEO, the firm is less likely to consider changes in control (Stulz 1988), and takeover bids for the company are less likely to succeed (Cotter, et al. 1994). Furthermore, in these cases, CEO compensation may be "abnormally high" (Core 1997; Holderness, et

[6] See, for example, Jensen, et al. 1990; Hall, et al. 1998; and Perry, et al. 2001.

[7] Most of the research on employee ownership has focused on the impact of top executive ownership and not on the impact of broad employee ownership on firm value.

al. 1988), and CEO turnover occurs less rapidly after poor performance (Denis, et al. 1997).

- The evidence supports granting stock to executives but also highlights the need for a strong and independent board, particularly when the CEO controls a large fraction of the voting rights. In addition, nonvoting stock may represent an effective tool for compensating CEOs when they already control a substantial fraction of the voting stock of the company.

Does Option Compensation Create Value for Shareholders?

Do companies use stock option awards effectively?

- Firms use stock option awards more when there is need for strong incentives for managers to make the appropriate investment decisions for growth, i.e. when they have significant growth opportunities and when they are research and development intensive (Yermack 1995; Core, et al. 2001).
- Firms with a cash flow shortfall or poor access to capital markets also use options more frequently (Core, et al. 2001).

These findings suggest that firms use options quite effectively. Can the use of stock options lead to abuses or to suboptimal decision-making by executives? The evidence suggests that they may, in some cases:

- Large option awards tend to be granted prior to favorable news releases and stock price appreciation, raising the possibility that in some instances, option awards might be “timed” in advance of favorable events (Yermack 1997).
- Gold mining companies hedge price risk more if stock ownership is large, but less if option ownership is large (Tufano 1996). Stockholders may prefer lower risk, while option holders may prefer more volatility because of their asymmetric payoff.
- After stock option grant initiations, companies have reduced their dividend payouts (Lambert, et al. 1989).

Option repricings are criticized because they appear to provide executives with a downside safety net that shareholders do not have. But if poor performance is not caused by poor executive decisions, repricing may be needed to provide incentives. Do repricings hurt shareholder value?

- Companies that reprice options have largely been poor performers with low equity ownership prior to the repricing (Chance, et al. 2000). After the repricing, their performance stabilizes. The evidence does not, however, conclusively suggest that repricings hurt shareholders.

How Should Directors be Compensated?

Increasingly, companies have compensated their directors with stock options. Who adopts such director incentive plans and are they beneficial for shareholders?

- Companies that use director incentive plans have low CEO stock ownership, independent boards, and greater institutional ownership (Perry 2002). This result suggests that boards adopt incentive plans to better align the directors' interests with those of shareholders.

- Boards react more quickly to poor performance by replacing the CEO when directors are compensated in stock and the board is independent (Perry 2002). This result suggests that directors who receive incentive pay may oversee management more actively.

What are the Implications of Increased Compensation Disclosure?

In 1992-1993, the SEC adopted regulations to significantly increase disclosure of CEO compensation. In particular, disclosure on stock options was moved into tables and firms were asked to value the annual options grants (prior to that, the number of options granted over a three-year period would be reported in the body of the proxy statement). There was a general expectation that this increased disclosure would reduce the use of executive stock options and possibly reduce the overall level of CEO pay.

- After increased CEO disclosure and compensation regulation increased, total compensation and the use of options actually rose dramatically (Perry, et al. 2001). This result does not mean that the disclosure actually caused the increase in option compensation. Around that same time, Congress enacted IRC 162(m) limiting deductibility of executive compensation in excess of $1 million (when it is not tied to company performance). This tax legislation may have enhanced the case for stock options (Perry, et al. 2001).[8]

This is an interesting observation given today's concern about the option-expensing choice. This evidence suggests that increased compensation disclosure will not necessarily have a negative effect on the use of stock options.

What Type of Governance Issues Do Institutional Shareholders Care About?

Institutional shareholders examine the existing evidence on various corporate governance issues and from there develop a list of corporate governance targets. They have promoted independent boards and other board composition issues, stronger ties between compensation and performance, the repeal of anti-takeover defenses, and voting rights issues (Strickland, et al. 1996; Abuaf 1998). Do these actions pay off?

- The most common proposals have been the removal of poison pills, implementation of confidential voting, shareholder voting on golden parachutes, and the establishment of an independent board with independent committees. Proposals targeting the removal of poison pills have received the most support, and investors have positively received the announcement of negotiated settlements with the United Shareholder Association (Strickland, et al. 1996).

[8] This legislation did lead to salary reductions for some firms where the CEO earned a salary of more than $1 million.

- Institutional shareholder targeting by CalPERS has had a positive effect on shareholder value in the short term (Smith 1997) but institutional targeting has not had a positive effect on long-term returns (Del Guercio, et al. 1999).
- Institutional targeting has not had a beneficial impact on operating performance (Wahal 1996).

Do Antitakeover Measures Destroy Shareholder Value?

Institutional shareholders have often been vocal in their opposition to poison pills and other antitakeover mechanisms. However, the research shows that antitakeover measures can actually be beneficial in certain situations.

- Early studies show that, on average, the announcement of a poison pill adoption led to a decline in the company's stock price (Ryngaert 1988).
- Research conducted on SB 1310, Pennsylvania's antitakeover law, suggests that companies that adopted poison pills sought other measures to shore up takeover defenses. Firms with antitakeover provisions such as poison pills were more likely to seek additional protection from state antitakeover laws (Wahal, et al. 1995).
- Recent studies suggest that when the board of directors is independent, the announcement of a poison pill adoption is, on average, not viewed negatively by equity investors (Brickley, et al. 1994). The shareholder returns during takeovers are higher for takeover targets that have an independent board and a poison pill, suggesting that independent boards use poison pills to bargain for higher takeover premiums (Cotter, et al. 1997).
- Poison pills have not reduced the likelihood of being a successful takeover target and the negative stock market response to poison pill adoptions is limited primarily to those companies that adopted pills in the early 1980s (Comment, et al. 1995).
- If poison pills harm shareholders, then rescission of an existing poison pill should be good news for investors. However, the evidence shows that poison pill removals do not lead to stock price appreciation (Bizjak, et al. 1998).
- When companies mention that they reincorporate to have better takeover defenses, their stock price drops, on average. When companies reincorporate to establish limits on director liability, their stock price tends to react positively (Heron, et al. 1998).

In sum, the evidence suggests that while antitakeover provisions may help entrench managers in some cases, they can also benefit shareholders by giving independent boards increased bargaining power.

Concluding Observations

Our corporate governance recommendations and conclusions are based on independent corporate governance research. Our analysis indicates that there is empirical support for many of the implementations recently adopted by the NYSE and other corporate governance organizations. We recommend that our clients proactively engage their major shareholders in a governance dialogue and that the key governance proposals, which are supported by the evidence, be implemented in a firm-appropriate way (and of course in accordance with the laws and regulations in place at the time).

In Figure 4, we compare the various proposals to the current evidence. In particular, we believe that there is strong support for board independence, independent nominating committees, and incentive compensation for directors. The evidence does not strongly support other activist recommendations, such as the separation of the CEO and Chairman of the Board function or the repeal of poison pills (currently not on the NYSE's list). We should also highlight that many of the results are primarily driven by US corporations and that international situations, while driven by similar economic and incentive forces, need to be examined on a case-by-case and country-by-country basis. In the Anglo-Saxon model, it is assumed that the board's objective is shareholder wealth maximization. This may not be the board's official duty in some other jurisdictions. Important governance differences exist across the world, driven by different regulations, laws, and cultural forces. Finally, we also recommend that when designing a corporate governance structure, boards and shareholders alike take into account the industry, its growth opportunities, its size and need for different skills and expertise. We do not believe that one set of governance rules fits all firms and situations.

Figure 4. Comparison of Corporate Governance Principles

Principle	CalPERS Governance Principle	Empirical Support	ISS Corporate Governance Quotient Item	NYSE Rules
Board should be independent	Yes	Strong support	Yes	Yes
Board meets at least once a year without the CEO and nonindependent directors	Yes	No evidence	Yes[a]	Yes
Need for a lead director (if CEO acts as Chairman)	Yes	Mixed support	Yes	No
Some committees consist entirely of independent directors	Yes	Moderate support	Yes	Yes
No director may serve as consultant	Yes	No support	Yes/No[b]	No
Director compensation is mix of cash and options	Yes	Moderate support	Yes	No

[a] ISS examines the published board guidelines. They grant a company higher points if the guidelines mention that independent directors will also meet without the CEO.
[b] In developing its Corporate Governance Quotient (CGQ), ISS grants a higher point value if the board is independent (i.e., independent directors constitute more than 50%) and grants the company a second set of points if independent directors constitute more than 75% of the board. The presence of director-consultants, while not prohibited, will reduce the likelihood of reaching the 75% mark.
Source: CalPERS, Institutional Shareholder Services, and the New York Stock Exchange.

Appendix A. ISS Corporate Governance Quotient

Figure 5. Institutional Shareholder Services (ISS) — Corporate Governance Quotient Scorecard

Board		**Executive Director Compensation**	
1	Board composition	33	Cost of option plans
2	Nominating committee	34-35	Option repricing
3	Compensation committee	36	Shareholder approval of option plans
4	Audit committee	37	Compensation committee interlocks
5	Governance committee	38	Director compensation
6	Board structure	39	Pension plans for nonemployee directors
7	Board size		
8	Cumulative voting	**Qualitative Factors**	
9	Boards served on	40	Company performance and record of corporate governance
10	Former CEOs	41	Retirement age for directors
11	Chairman/CEO separation	42	Board performance reviews
12	Board guidelines	43	Meetings of outside directors
13	Response to shareholder proposals	44	CEO succession plan
		45	Outside advisors available to board
Charter Bylaws		46	Directors resign upon job change
14-19	Features of poison pills		
20-21	Vote requirements	**Ownership**	
22	Written consent	47	Director ownership
23	Special meetings	48	Executive stock ownership guidelines
24	Board amendments	49	Director stock ownership guidelines
25	Capital structure	50	Officer and director stock ownership
State of Incorporation		**Director Education**	
26-32	Takeover provisions applicable under state law — has company opted out?	51	Director education

Source: ISS Corporate Governance Quotient Homepage (http://www.isscgq.com/).

ISS examines 51 issues to develop its CGQ. However, these issues do not necessarily carry the same number of points. For example, the fact that poison pill features relate to questions 14–19 does not necessarily mean that poison pill issues carry more weight than, for example, question 1 on board composition.

Appendix B. NYSE New and Former Corporate Governance Rules

Figure 6. NYSE New and Former Corporate Governance Rules

NYSE Committee Recommendation — Recently Adopted	Prior Rules
Independent directors must comprise a majority of a board.	Listed company must have an audit committee composed of at least three independent directors.
Non-management directors must meet without management in regular executive sessions.	No such requirement.
Listed companies must have an audit committee, a nominating committee, and a compensation committee, each comprised solely of independent directors.	Listed companies must have an audit committee comprised solely of independent directors. No requirement for establishment or composition of nominating or compensation committees.
The chair of the audit committee must have accounting or financial management experience.	All committee members must be financially literate and at least one must have accounting or financial management expertise.
Audit committee must have sole responsibility for hiring and firing the company's auditors, and for filing any significant non-audit work by the auditors.	Audit committee charter must provide that selection and firing of the independent auditor is subject to the "ultimate" authority of the audit committee and the board of directors.
For a director to be deemed "independent," the board must affirmatively determine the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).	Existing definition precludes any relationship with the company that may interfere with the exercise of director's independence from management and the company.
Independence also requires a five-year "cooling-off" period for former employees of the listed company, or of its independent auditor; for former employees of any company whose compensation committee includes an officer of the listed company; and for immediate family members of the above.	Cooling-off period is three years; does not specifically apply to former employees of the auditor or any company whose compensation committee includes an officer of the listed company. Board of directors can make an exception for one former officer, provided the reason is explained in the next proxy statement.
Director's fees must be the sole compensation an audit committee member receives from the listed company; further, an audit committee member associated with a major shareholder (one owning 20% or more of the listed company's equity) may not vote in audit committee proceedings.	No current requirement.
Listed companies must adopt a code of business conduct and ethics, and must promptly disclose any waivers of the code for directors or executive officers.	No current requirements.
Shareholders must be given the opportunity to vote on all equity-based compensation plans. Brokers may only vote customer shares on proposals for such plans pursuant to customer instructions.	Shareholder approval required of equity-compensation plans in which officers or directors may participate, but broad-based plans and one-time employment inducements are exempt. Broker can vote customer shares except when given instructions from the customer, or when the action is contested.
Listed companies must publish codes of business conduct and ethics and key committee charters. Waivers of such codes for directors or executive officers must be promptly disclosed.	No current requirements.
Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from NYSE rules.	No current requirements.
Each listed-company's CEO must certify annually that the company has established and complied with procedures for verifying the accuracy and completeness of information provided to investors and that he or she has no reasonable cause to believe that the information is not accurate and complete. The CEO must further certify that he or she has reviewed with the board those procedures and the company's compliance with them.	No current requirements.
CEOs must also certify annually that they are not aware of any company violations of NYSE rules.	No current requirements.
Upon finding a violation of an Exchange rule, the NYSE may issue a public reprimand letter to any listed company and ultimately suspend or de-list an offending company.	No current provision for a public reprimand.
The NYSE urges every listed company to establish an orientation program for new board members.	No such recommendation has been made previously.
In conjunction with leading authorities in corporate governance, the NYSE will develop a Directors Institute.	NYSE has generally supported educational initiatives, but this will be the first formalized program designed for directors.

Source: The New York Stock Exchange.

Appendix C. CalPERS Corporate Governance Guidelines[9]

Core Principles of Board Independence and Leadership

1. A substantial majority of the board consists of directors who are independent.
2. Independent directors meet periodically (at least once a year) alone, without the CEO or other nonindependent directors.
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 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 and governance
   - CEO evaluation and management compensation
   - Compliance and ethics
5. No director may also serve as a consultant or service provider to the company.
6. Director compensation is a combination of cash and stock in the company. The stock component is a significant portion of the total compensation.

[9] Source: CalPERS Corporate Governance Web Site (www.calpers-governance.org).

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