

CORPORATE GOVERNANCE PRINCIPLES

I) INTRODUCTION

The fundamental objective that guided the Los Angeles County Employees Retirement Association (LACERA) when drafting Core Principles of good corporate governance was to safeguard and promote the economic interests of its active and retired members. LACERA's Board of Investments recognized that good governance must "maintain an appropriate balance between the rights of shareholders... and the need of board and management to direct and manage the corporation's affairs free from non-strategic short-term influence."¹

This document identifies LACERA's Board of Investments' Core Principles in corporate governance. Core Principles include Board Independence, Board Management and Evaluation, and Shareholder Rights. It is also intended to communicate the importance of **fiduciary duty**, **integrity**, **accountability**, and **transparency** to Corporate America.

Corporate **fiduciary duty** is an obligation to act in the best interests of the company and its shareholders. Lack of independence by corporate directors may periodically impede their ability to act in the shareholders' best interest. Therefore, it is important that a substantial majority of directors be independent to help promote shareholder interests over company management.

Integrity and trust are the cornerstones of America's capital markets and essential for economic stability. Building a corporate culture based on integrity is of paramount importance at all times. Consequently, directors must establish a "tone at the top" for an organization. For example, establishing an ethics committee and encouraging prompt investigation of non-compliant events ensures that a "foundation based on integrity" is promoted throughout the corporation.

Accountability is the obligation of the Board of Directors and Senior Management to be responsible for their actions. Accountability helps to ensure that a company's operations and reporting mechanisms are managed in the best interests of its shareholders. The passage of The Sarbanes-Oxley Act of 2002 helped to enforce corporate accountability by establishing the Public Company Accounting Oversight Board (PCAOB) "to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

Transparency is a basic shareholder right and critical for an institutional investors understanding of an organization's financial activities. Transparency is essential in the following two areas: first, a complete and clear disclosure of an organization's business and financial activity. Second, complete and clear disclosure of executive compensation including fringe benefits. All investors have a basic right to thorough disclosure of a firm's financial activities and how senior managers are being compensated for their services.

¹ TIAA-CREF Policy Statement on Corporate Governance.

Finally, LACERA's Board of Investments believes strong corporate governance practices should help maximize shareholder value. Therefore, the Board of Investments adopts these Principles in the spirit of the LACERA's mission statement: "To produce, protect, and provide the promised benefits" to the employees of Los Angeles County.

II) BOARD INDEPENDENCE

An effective corporate governance structure recognizes that "management is held accountable to the Board and the Board is held accountable to shareholders."² The ability to challenge management decisions and objectively evaluate the performance of corporate management may be compromised if a director is not truly independent. Therefore, **a substantial majority** of a corporation's directors should be independent.

Director Definitions³

Inside Director

- Employee of the company or its affiliates (subsidiary, sibling company, or parent company).
- Non employee officer⁴ of the company if among the five most highly compensated individuals.
- Section 16 officer⁵
- Interim CEO.
- Beneficial ownership⁶ of more than 50 percent of the company's voting power (this may be aggregated if voting power is distributed among more than one member of a defined group; e.g., members of a family beneficially own less than 50 percent individually, but combined own more than 50 percent).

Affiliated Outside Director

- Board attestation that an outside director is not independent.
- Former CEO of the company or its affiliate.
- Former interim CEO if the service was longer than 18 months. If the service was between twelve and eighteen months, then an assessment of the interim CEO's employment agreement will be made.

² RiskMetrics Group Proxy Voting Manual: page 3.3

³ Source: RiskMetrics Group: Corporate Governance Policy 2005 Updates.

⁴ According to RiskMetrics Group, an example of a non employee officer is when the Chairman of the Board is not an employee of the company.

⁵ Officers subject to Section 16 of the Securities and Exchange Act of 1934 include the chief executive, operating, financial, legal, technology, and accounting officers of a company (including the president, treasurer, secretary, controller, or any vice president in charge of a principal business unit, division or policy function).

⁶ RiskMetrics Group definition of beneficial ownership: A shareholder that exercises direct voting rights and accrues economic value from holding those shares.

- Former executive of the company, an affiliate or an acquired firm within the past five years.
- Executive of a former parent or predecessor firm at the time the company was sold or split off from the parent/predecessor within the last five years.
- Executive, former executive, general or limited partner of a joint venture or partnership with the company.
- Relative of a current employee of company or its affiliates (relative follows the SEC definition of “immediate family members” which covers: spouses, parents, children, step-parents, step-children, siblings, in-laws, and any person sharing the household of any director, nominee for director, executive officer, or significant shareholder of the company).
- Relative of a current Section 16 officer of the company or its affiliates.
- Relative of former Section 16 officer of the company or its affiliates within the last five years.
- Currently provides (or a relative provides) professional services directly to the company, to an affiliate of the company or an individual officer of the company or one of its affiliates in excess of \$10,000 per year.
- Employed by (or a relative employed by) a significant customer or supplier (if the company makes or receives annual payments exceeding the greater of \$200,000 or five percent of the recipient’s (the party receiving the financial proceeds from the transaction) gross revenues.
- Has (or relative has) any transactional relationship with the company or its affiliates, excluding investments in the company through a private placement.
- Any material financial tie or other related party transactional relationship to the company.
- Has a contractual/guaranteed board seat and is party to a voting agreement to vote in line with management on proposals being brought to shareholders.
- Has (or relative has) an interlocking relationship as defined by SEC involving members of the board of directors or its Compensation and Stock Option Committee.
- Founder of company but not currently an employee.
- Is (or relative is) a trustee, director, or employee or a charitable or non-profit organization that receives grants or endowments from the company or its affiliates.

Independent Outside Director

- No material connection to company other than board seat (Material is defined as a standard of relationship (financial, personal or otherwise) that a reasonable person might conclude could potentially influence one’s objectivity in the boardroom in a manner that would have a meaningful impact on an individual’s ability to satisfy requisite fiduciary standards on behalf of shareholders).

Separation of CEO and Chairman

“The responsibilities of leading the board and management are distinct. The CEO is the highest ranking member of the management team,”⁷ and the Board of Directors is responsible for management oversight. A dual role played by the CEO and Chairman may create conflict. To mitigate the risk of a dominant CEO controlling the Board, the CEO and Chairman positions should be separated.

If an independent director (as defined above) does not hold the Chairman position, the Board should assign an independent lead director.

Director Compensation

Pay packages of outside directors should be placed on proxy ballots and then be approved by a majority vote of shareholders. Proxy statements should include a table showing exactly what outside directors are paid, including how much is received for each type of compensation and the total pay figure.⁸

“Directors can be compensated in either cash or stock, but the majority of compensation should be in stock.”⁹ Stock compensation should help align directors’ interests with shareholders. To focus the directors attention on the firm’s long-term value, directors should be required to hold a significant portion of the stock for as long as they remain on the Board.

Key Committee Structures

The following committees should only include independent directors:

- Audit
- Director Nominating
- Board Evaluation and Governance
- CEO Evaluation and Management Compensation
- Compliance and Ethics

The Board, rather than the Chief Executive Officer, should appoint committee chairs and members.

⁷ The Conference Board Commission on Public Trust and Private Enterprise: page 7.

⁸ Council of Institutional Investors: The Councilor Newsletter: Improving the Way Senior Executives are Paid: page 6

⁹ Council of Institutional Investors, Corporate Governance Policies: page 4.

III) BOARD MANAGEMENT AND EVALUATION

Board Meetings and Operations

Board members assume a significant amount of responsibility when accepting a director position. Core responsibilities include understanding the corporation's long-term business strategy, understanding the risks that define and drive the company's business and overseeing management. Therefore, to help Board members effectively carry out these duties, the following information and/or options should be available to them:

- Directors should be provided information in advance of meetings.
- Directors should have full access to senior management and information concerning the corporation's operations.
- Directors should be able to place items on the Board agendas.
- Directors should be familiar with a firm's operations independent of the CEO or senior management.
- Directors should have access to outside experts if necessary.
- Independent directors should meet at least annually, without management or the other non-independent directors participating.
- Directors should establish a succession plan for the CEO and senior management.
- Directors should develop a plan for evaluating the CEO's performance and evaluate the CEO at least annually.

Board Evaluations

"Board effectiveness and credibility depend in part on a regular self-evaluation process."¹⁰ The Board should adopt a written statement of its own governance principles and a process for regular re-evaluation. Independent directors should control the evaluation process, which should be tailored to meet the needs of the individual company and Board.

The evaluation process should include the following factors:

- Review the Boards' own size, and determine that the size is most effective toward future operations.
- Align with established evaluation processes and goals.
- Design to ensure candor, confidentiality, and trust.

¹⁰ Comparison of Board Guidelines and Best Practices—United States: page 27.

- Delineate Board and management powers.
- Create effective interaction between and among directors.
- Assess directors education and development.
- Disclose process to shareholders and the public.

IV) SHAREHOLDER RIGHTS

Basic shareholder rights include the clear and complete disclosure of a company's financial activities. Financial statements provide investors with key financial data that may spur interest in a company as an investment opportunity. Without thorough financial disclosure for all corporations, the foundation for the economic system will erode.

Part one of this section relates to executive compensation and disclosure issues. Part two of this section recognizes shareholders rights specifically relating to voting proxies. Part three addresses shareholder/director communications. Focusing on these issues will help to continue promoting integrity and transparency in the process.

Executive Compensation

Philosophically, LACERA believes that corporate executives should be fairly compensated for their efforts. Corporate executives contend their compensation should be based primarily on risks incurred. LACERA, however, believes that executive compensation should not be based on perceived risks because it is the stockholders, more than anyone else, who ultimately bear these risks. Moreover, executives should not expect to be compensated like top-tier entrepreneurs because generally, unlike entrepreneurs, they do not have much personal wealth at risk.

Rather, the vast majority of capital at risk belongs to the corporation's shareholders.

Executive compensation should also be considered in the context of how a firm compensates its employees relative to their peers in the industry. If the firm pays their employees "bottom quartile" wages, it is difficult to justify paying their executives "top quartile" salaries.

The compensation committee, comprised exclusively of independent directors, is responsible for establishing CEO and senior management compensation packages. An independent compensation committee is important to avoid compensation abuses. The committee should be required to hire its own compensation consultant.⁷ Promoting transparency is critical when establishing compensation packages for senior level managers.

Core Principles in this area include:

- Senior managers' total compensation package should be disclosed to shareholders. This includes full disclosure of all fringe benefits and retirement benefits and the fair value of those benefits.

⁷ California State Teachers Retirement System (CalSTRS): The Perfect Stock Option Plan: page 12

- Compensation consultants retained for assisting directors work exclusively for the compensation committee. Ideally, the consultant should not have other relationships with the firm and should be required to attend all compensation committee meetings.⁸
- Benchmarking for compensation purposes should be avoided because not all executives can be in the top quartile of pay scales.
- Performance-based compensation plans should be indexed against appropriate peers.
- Boards should award senior managers only one form of equity-based compensation.
- Compensation based on earnings should only include operating earnings. Earnings generated by the pension plan should not be included for compensation purposes.
- Companies should expense the aggregate fair market value of all stock options, stock awards, and other share-based compensation paid to employees, in their annual financial statements.
- Companies should be required to disclose in their proxy statements:⁹
 1. Five-year graph of a CEO's total pay along side the company's total return to investors.
 2. Five-year graph showing the relationship between the annual bonus of the CEO and the company's diluted earnings per share.
 3. Five-year graph showing the ratio of the CEO's total pay to that of an average worker in the company.
 4. Table showing various termination of employment payments to the CEO, including death, disability, normal retirement, discharge for cause, discharge for other than cause, and voluntary resignation.
 5. Names of compensation consultant employed by the compensation committee and by corporate management. Also,

⁸ California State Teachers Retirement System (CalSTRS): The Perfect Stock Option Plan: page 12

⁹ Council of Institutional Investors: The Councilor Newsletter: Improving the Way Senior Executives are Paid: pages 3-5.

the names of the comparable companies the consultant uses to compile pay data.

6. Percentile ranking of the CEO's total pay package against those of various comparable companies surveyed by compensation consultant, and percentile ranking of the company's five-year total return against the same comparable companies.
- Recognizing that stock option plans are long-term incentives: 1) vesting periods for stock options should be at least five years from the grant date, 2) executives planning to retire from the company within three years should be prohibited from receiving stock options, and 3) post retirement exercise periods should be limited to no more than three years.¹⁰
 - Severance agreements for mergers should be modified to require that the only way anyone receives compensation is if, subsequent to the merger, the executive is fired.¹¹

Proxy Issues

- Proxy votes should be kept confidential.
- Broker votes should be counted for quorum purposes only.
- Every company should prohibit greenmail.
- Each share of common stock, regardless of class, should have one vote. Corporations should not have classes of common stock with disparate voting rights. Authorized unissued common shares that have voting rights to be set by the Board should not be issued without shareholder approval.
- Each director should be elected annually.
- Any shareholder proposal that is approved by a majority of proxy votes cast should either be implemented by the Board, or LACERA will withhold votes for director nominees after one year of Board inaction.
- All stock option plans should be approved by shareholders.
- Options should not be re-priced without shareholder approval.

¹⁰ California State Teachers Retirement System: The Perfect Stock Option Plan: page 9.

¹¹ Council of Institutional Investors: The Councilor Newsletter: Improving the Way Senior Executives are Paid: pages 3-5.

Shareholder/Director Communication

“All companies should establish a mechanism by which shareholders with non-trivial concerns could communicate directly with the independent directors. At a minimum, there should be an open meeting in connection with the company’s annual meeting (before or after) in which shareholders could ask questions and communicate their concerns to the independent directors.”¹²

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Revisions adopted by the Board of Investments on August 13, 2003
Revisions adopted by the Board of Investments on June 11, 2003
Original adopted by the Board of Investments on March 12, 2003

DOCUMENTS REFERENCED

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2. Council of Institutional Investors: Corporate Governance Policies.
3. The Conference Board’s Commission on Public Trust and Private Enterprise: Part 1: Executive Compensation.
4. The Conference Board’s Commission on Public Trust and Private Enterprise: Part 2: Corporate Governance and Part 3: Audit and Accounting: January 9, 2003.
5. California Public Employees’ Retirement System: U.S. Corporate Governance Core Principles and Guidelines: April 13, 1998.
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7. RiskMetrics Group U.S. Proxy Voting Manual, January 15, 2009 Edition.
8. Council of Institutional Investors: The Councilor Newsletter: Improving the Way Senior Executives are Paid: Graef “Bud” Crystal: March 2003.
9. California State Teachers Retirement System: The Perfect Stock Option Plan: Graef “Bud” Crystal: February 2003.

¹² Council of Institutional Investors, Corporate Governance Policies: page 4.