

GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE: JOINT VENTURE GOVERNANCE GUIDELINES

JOINT VENTURE GOVERNANCE

Shareowners have a direct interest in the returns, risks, and governance of all wholly and partly-owned assets that make up public companies. To date, the focus of CalPERS efforts on governance, and that of regulators and investors, has been on wholly-owned business units, subsidiaries, and affiliates of public companies. CalPERS believes that ensuring the effective governance of material equity joint ventures – a key asset class with well-documented and unique performance challenges where there has been historically less transparency than for similar-sized wholly owned businesses – is also an essential part of effective corporate governance.

To enhance investor confidence and to raise performance, CalPERS believes that companies need to raise the level of transparency, accountability, and discipline in the governance of their material joint ventures. As a minimum, any joint venture accounting for 10 percent or more of a publicly-traded parent company's total assets, invested capital, costs or revenues – or that is expected to account for 10 percent of the profit and loss of the corporation – should be viewed as material, as should smaller joint ventures that are strategically important, or that carry disproportionate risks. We believe that companies may wish to adopt a more inclusive standard for materiality, and, for instance, draw the line at joint ventures at or above \$500 million in annual revenues or invested capital.

For this class of joint ventures, CalPERS believes that the Company Board – i.e., the Board of parent companies that have ownership interests in joint ventures – should ensure the adoption of certain practices related to these joint ventures:

1. CORPORATE-LEVEL JOINT VENTURE GOVERNANCE PRACTICES

For any publicly-held company with one or more material joint ventures, that parent company should:

- 1.1 Require that the Audit Committee of the Company Board annually review the governance integrity and compliance policies of the company's material joint ventures ¹

¹ Such a review would likely include: i) corporate audit processes, ii) financial reporting, iii) training and compliance programs, and iv) (potentially) Sarbanes Oxley compliance issues for large joint ventures. Note: this Audit Committee review is not intended as a broad-based strategic performance review of individual ventures, but a fact-based conversation about the corporate-level policies and implementation status of various controls related to joint ventures.

- 1.2 Designate a Corporate Board member to be responsible for ensuring that the Company's corporate-level strategic business review process includes the Company's material joint ventures, and this review process holds joint ventures to similar performance standards to one another and to similar-sized business units²
- 1.3 Adopt and make available to the public a set of Joint Venture Governance Guidelines for the Company's material joint ventures (such as those in Appendix I, co-authored by CalPERS and Water Street Partners) which define a set of minimum expectations for overseeing such ventures
- 1.4 Designate a Corporate Board member to be responsible for ensuring, on an annual basis, that the Company's material joint ventures are subject to a review of their adherence to these Joint Venture Governance Guidelines, and that the results of the review are discussed and approved by the Corporate Board³

2. PUBLIC DISCLOSURE AND TRANSPARENCY

For any material joint venture that has at least one public company shareholder, that parent company should disclose to its public investors:⁴

- 2.1 The name, business scope and objectives, and current financial impact of each material joint venture of the Company
- 2.2 A list of the Lead Director of the Joint Venture Board of Directors of each material joint venture
- 2.3 Whether each material joint venture is complying with the guidelines outlined in Appendix I; to the extent that the venture is not meeting any of these governance standards, provide an explanation for why such governance standards are not being met⁵

2 It is the experience of the authors that joint ventures – even billion-dollar joint ventures – are routinely left outside the regular corporate-level review process, and are therefore not subject to the same “challenge process” or “restructuring conversations” as wholly-owned business units, which, in turn, drives financial underperformance.

3 This Board member may be the Chair of the Audit Committee (and thus link the JV Governance Guidelines into the broader JV compliance and financial integrity review process as described in 1.1), or the same individual as named in 1.2 above.

4 This applies irrespective of the parent company's equity ownership interest in the venture, or whether the parent company consolidates to joint ventures on its financial statements

5 Such a “comply and explain” approach - i.e., require that public companies disclose whether they are complying with a set of minimums and, if not, why – has been used in a number of corporate governance situations. For instance, in adopting the Cadbury Code (UK corporate governance guidelines similar to CalPERS' guidelines in the US), the London Stock Exchange asked that listed companies reveal in their annual reports whether they were complying with it – and if not, why. We believe that this is a powerful alternative to a “corporate requirement” in JV situations, creating better governance behaviors while also allowing for flexibility across different ventures operating under different circumstances.

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“Businesses used to grow in one of two ways: from grassroots up or by acquisition. In both cases, the manager had control. Today businesses grow through alliances, all kinds of dangerous liaisons and joint ventures, which, by the way, very few people understand.”

– Peter Drucker ⁶

Good governance matters to joint ventures – and joint ventures matter to many public companies and, therefore, their public shareowners.

Today there are more than 1000 joint ventures (JVs) with more than \$1 billion in annual revenues or invested capital. The 8 largest publicly listed oil and gas companies and 6 metals and mining majors have more than \$500 billion in assets in major joint ventures. More broadly, many public companies hold a dozen or more material JVs in their portfolios, and depend on JVs for 10-20 percent of total corporate revenues, assets, or income, using joint ventures as a key tool to access technology and innovation, gain scale and reduce costs, share risk, and build new businesses. In such industries as conventional petroleum, alternative energy, chemicals, basic materials, and aerospace, joint ventures account for upwards of 30-50 percent of many company’s economic activity. Likewise, joint ventures are widely used in China, India, Russia, Korea, Latin America, and the Middle East.

More than 10 years ago, CalPERS established a set of governance principles for public companies at the corporate level with the underlying tenet that fully accountable corporate governance structures produce, over the long term, the best returns to shareowners.

We believe a similar level of scrutiny and focus should be extended to the largest joint ventures of public companies, and that shareowners will benefit by the application of more consistent standards of governance. These JV Governance Guidelines, co-authored by CalPERS and Water Street Partners⁷, are an effort to promote such attention and, in time, drive improved performance and reduced risk within a large but relatively less-transparent asset class.

INTRODUCTION: THE JV GOVERNANCE CHALLENGE

Any joint venture warrants good governance.⁸ Our focus – and that of these Guidelines – is on joint ventures that are financially large or strategically significant, and entail some degree

6 The Post-Capitalist Executive: An Interview with Peter F. Drucker; Harvard Business Review; May-June 1993.

7 Water Street Partners is an advisory firm based in Washington DC founded by David Ernst and James Bamford, widely-published experts on joint venture strategy and governance who founded and led the Alliance Practice at McKinsey & Company from 1990 to 2008.

8 We define “joint venture” as a legal business entity owned by two or more separate corporate parents.

of joint managerial decision-making and operational interdependence between the shareowners and the venture.⁹

The governance of these joint ventures introduces unique challenges. These challenges are an outgrowth of the way the corporate-parent shareholders inter-relate to the venture, most notably: shared oversight and control; significant economic and business flows between the shareholders and JV for various services, inputs or outputs; differing appetites for growth, investment, and cash returns from the shareholders (i.e., corporate parents); and changes in shareholder strategies and reactions to new market conditions that put pressure on the JV.

To understand why joint ventures are different, consider how the governance of joint ventures compare to that of public companies:

Board composition and decision making:

- » Public Company Governance: Nonexecutive/independent Board members constitute a majority of the Board, and the Board is an agent for independent shareowners, who are aligned around the basic desire to maximize overall shareowner returns
- » JV Governance: In JVs, there are typically no independent Board members from outside the JV and the parent companies; Board members represent parent companies which often have differing objectives, investment and risk preferences, and receive asymmetric benefits from the venture

Resource flows from the shareholders:

- » Public Company Governance: The company does not depend on shareowners for operational inputs into the business — or, if the company does, those transactions are conducted on a true arms-length basis, and subject to legal and governance protections against conflicts of interest
- » JV Governance: Commercial relationships are not always easily conducted at arms-length market prices, and conflicts of interest cannot be completely avoided.

Management team:

- » Public Company Governance: Members of the management team do not have past or future reporting relationships or employment opportunities with the companies of Board members

⁹ To be clear, these guidelines are not aimed at certain types of joint ventures that do not demonstrate these characteristics – notably (1) joint ventures that are purely financial vehicles, such as are common in the real estate and other investment industries, or (2) joint ventures that are clearly operated by one partner and do not function as discreet organizational entities with a management team, board and assets, etc., such has been a hallmark structure of the classic upstream oil and gas joint venture.

- » **JV Governance:** The top JV executives are frequently current or former employees of one shareholder, and their future employment opportunities may be influenced by a parent-company executive who is a Board Director of the JV. In addition, especially for secondees, pension and other compensation elements may be tied to one shareholder even while serving in the venture.

While JVs hold some governance advantages to that of public companies¹⁰, on balance, joint venture governance is pound for pound more challenging than corporate governance, and is arguably just as important for public shareowners. CalPERS has long believed that good corporate governance represents “the grain in the balance” that “makes 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.” CalPERS and Water Street Partners believe that, in joint ventures, poor governance represents “an anvil at the end of the table” that can have enormous impact on the stability and performance of these ventures and, by extension, a meaningful impact to their public-company owner(s).

Consider some data. Despite some compelling reasons to enter into joint ventures, the historic performance of JVs has been mixed. Research has shown that roughly 50 percent of JVs fail to meet the financial and strategic goals of the corporate parents, while 46 percent of joint venture announcements have a negative impact on the parent’s share price.¹¹

Poor governance plays a role in this underperformance – and indeed is preventing many already successful JVs from delivering even better returns to their corporate parents. For instance, an ex post assessment of 49 large joint ventures showed that some 50 percent of failures were the result of poor governance and management. Likewise, some 80 percent of participants of a JV CEO and Directors Roundtable¹² stated that their JV Boards have not been a source of real strength for the JV, and some 60 percent did not have financial management

10 For example, because JV Board members almost always come from one of the parent companies, tend to be quite experienced in the relevant business area or market; and, as senior managers, are more than willing to assert their views in Board meetings when appropriate to protect shareholder interests. JV Board members also frequently are in a position to do more to help the JV management succeed, e.g. by accessing resources and skills from the parent company.

11 For more details on joint venture and alliance performance, please see Joel Bleeke and David Ernst, *Collaborating to Compete*, John Wiley & Sons, 1993; David Ernst and Tammy Halevy, “When to Think Alliance,” *McKinsey Quarterly*, Q4 2000; James Bamford and David Ernst, “Managing an Alliance Portfolio,” *McKinsey Quarterly*, Q3, 2002; and James Bamford and David Ernst, “Getting a Grip on Alliances,” *Corporate Dealmaker*, December 2004.

12 JV CEO and Directors Roundtable (sponsored by McKinsey and led by James Bamford and David Ernst) in New York on October 13, 2004 (participants ran or oversaw more than 100 major JVs across 10 industries).

systems in their JVs that were as good as those in their parent businesses.¹³ Other research showed a very high correlation between good outcome performance (e.g., financial, operational and strategic results) and good governance performance and health.¹⁴ Similarly, in more than 100 situations involving the restructuring of major joint ventures, the ventures were routinely able to capture 10-30 percent increases in annual profitability by making changes to the governance, scope, and structure of the JV.^{15 16}

Using the petroleum and basic materials industries as proxies, it is possible to estimate the amount of “value restoration” associated with improved JV good governance. For the top 8 petroleum companies and the top 6 basic and mining companies, material joint ventures today account for \$72 billion in annual earnings (on a \$503 billion asset base). Calculations by Water Street Partners indicate that, conservatively, there is \$5-13 billion in improved annual earnings available collectively to these 14 companies. At current trading multiples, this represents roughly \$50-130 billion in added market capitalization that could be created through better JV governance and enhanced performance in just these 14 companies. When we extrapolate to other companies in the petroleum and mining industries – and to other industries such as telecom, chemicals, aerospace and defense, industrial manufacturing, and high-tech – there is, at minimum, \$15-36 billion in value restoration available from the improved governance and shareholder relationship of material joint ventures.¹⁷

Despite the importance of JV governance, companies under-invest in governance design. The established body of JV governance case law and accepted good practice are underdeveloped,¹⁸

13 A McKinsey survey of 34 companies showed that 53 percent of companies do not regularly incorporate joint ventures into their standard corporate planning and review process, and that 44 percent claim that senior parent executives are not sufficiently focused on joint ventures and other major alliances. (McKinsey survey of Conference Board participants in the 2004 Strategic Alliances Conference, April 2004). Anecdotally, numerous cases where companies leave even their largest joint ventures outside the corporate challenge process. For further details, see James Bamford, David Ernst, and David Fubini, “Launching a Worldclass Joint Venture,” *Harvard Business Review*, February 2004.

14 Results from McKinsey Benchmarking of JV governance (2008), authored by James Bamford, David Ernst and Lois D’Costa, and presented to the Association of Strategic Alliance Professionals in February 2008. This research evaluated the performance and rigorously calibrated a broad set of governance and talent practices of 25 major joint ventures in the oil and gas, basic materials, financial services and other industries in the US, Europe, Asia and the Middle East.

15 For further details on the value associated with restructuring large joint ventures, see David Ernst and James Bamford, “Your Alliances are Too Stable,” *Harvard Business Review*, June 2005.

16 For other significant work on joint ventures, see: Stephen I. Glover and Craig M. Wasserman (editors and co-authors), *Partnerships, Joint Ventures and Strategic Alliances*, Law Journal Press (2007); Kathryn Rudie Harrigan, *Managing for Joint Venture Success*, Lexington Books (1986); Pierre Dussauge and Bernard Garrette, *Cooperative Strategy: Competing Successfully through Strategic Alliances*, John Wiley (1999); Benjamin Gomes-Casseres *The Alliance Revolution*, Harvard University Press (1996); John Child, David Faulkner and Stephen Tallman, *Strategies for Cooperation: Managing Alliances, Networks, and Joint Ventures*, Oxford University Press (2005).

17 For details of this analysis, see Water Street Partners website, waterstreetpartners.net.

18 A few groups in the oil and gas industry have developed guidelines for auditing certain types of JVs. See, for example, *Guidelines for Joint Venture Audit Standards*, Australian Petroleum Production & Exploration Association Limited, February 2000.

with little systematic benchmarking of JV governance practices or JV performance. While certain important governance provisions do get included in most JV legal contracts (e.g., Board composition, veto rights, dispute resolution), these provisions address only a narrow set of issues, and tend to focus on establishing a rudimentary framework for governance, plus legal protections against “extreme” events (e.g., material breach, parent bankruptcy). The key legal documents of most major JVs do not come close to meeting the real needs of (i) putting in place an effective ongoing JV governance system; (ii) ensuring that each JV is appropriately monitored by the parent companies; and (iii) triggering interventions on a timely basis, based on appropriate transparency, accountability, and engaged Board members.

We believe that it is useful for corporate and JV Boards to adopt a set of JV governance guidelines – that is, a set of standards or “minimums” for JV governance – against which companies and their public shareholders can assess the governance of their largest JVs. In proposing these guidelines, our hope is to help improve the performance of these ventures that today serve as a vital – but often challenging – engine for corporate growth.

While our focus is on the material joint ventures of public companies, we believe many of these concepts are equally relevant to JVs that have private or government ownership, as well as smaller joint ventures and complex non-equity partnership structures. We encourage companies to have a discussion about where and how to apply these guidelines in their portfolio of equity joint ventures and non-equity partnerships.

DESIGN OBJECTIVES AND PRINCIPLES

The purpose of these guidelines is to improve the performance and reduce the risks associated with material joint ventures, and to do so by putting in place a set of governance practices that:

- » Raise the level of performance management discipline and accountability, which has often proven inconsistent in joint ventures
- » Improve decision making speed and the ability of joint ventures to respond rapidly to changes in the market
- » Increase transparency overall – within the venture and its board structures, within the corporate parents who own these ventures, and ultimately within the public shareowners of these parent companies
- » Promote alignment among the parent companies and put in place mechanisms to deal with the inherent tensions and conflicts that arise between joint venture parent companies

- » Create a mechanism for JV Boards to assess the health of governance on a regular basis, promoting proactive adjustments to avoid major issues that can build over time
- » Provide a set of guidelines that are complementary to existing requirements (e.g., financial disclosure, accounting, compliance, legal, etc.) to which joint ventures are already exposed

JV GOVERNANCE GUIDELINES

CalPERS and Water Street Partners recommend that the Boards of material joint ventures adopt the following guidelines, and put into place practices to support them:¹⁹

A. Board mandate and structure

1. The Joint Venture Board of Directors is the primary means for governing the joint venture, and the JV CEO reports directly and only to the JV Board. Shareholder input to the JV CEO and JV CFO should be channeled through the Board (and not communicated in an uncoordinated manner to JV management).
2. The JV Board has an explicit charter and delegation of authority framework that defines its role in relation to JV Management, JV Board Committees, and the Boards and Management of the Parent Companies. This charter and framework specifically spells out where venture management has the power to act on its own and where the parents (individually or through the JV Board) will have control, influence or close involvement.²⁰ The framework also identifies decisions that require separate approval by the Parent Company Boards or Parent Company Management – where approval by the JV Board is not sufficient. The scope of the framework should include matters to fiscal authority, operations, personnel

¹⁹ These guidelines are aimed at financially large or strategically significant joint ventures that entail some degree of joint managerial decision-making and operational interdependence between the shareholders and the venture. As such, they are not aimed at joint ventures that are, for instance, purely financial vehicles, such as are common in the real estate and other investment industries, or joint ventures that are clearly operated by one partner and do not function as a discreet organizational entities with a management team, board and assets, etc.. Likewise, these guidelines relate to the governance of joint ventures – and not to other important aspects of these business structures, including ownership and financial arrangements, legal issues, including dispute resolution and exit provisions, and human resource and staffing policies.

²⁰ Areas where the Board could comment on its level of ongoing involvement include: second-level staffing decisions and performance reviews, product pricing decisions, negotiation of commercial and service agreements between the venture and one of the parents, and development of new growth opportunities. This level of clarity will almost certainly go beyond what is written in the joint venture legal agreement, which typically only spell out matters that require super-majority or unanimous approval, or where one shareholder has veto rights (e.g., hiring of a new CEO or CFO, approval of capital investments above \$20M, settlements of litigation against the company, dissolution of the business). While there is some early evidence that less operational involvement by the shareholders / Board is linked to stronger outcome performance, the above governance guideline only aims for the Board to clarify its posture toward the venture, rather than recommend what that posture should be.

decisions, and strategy (such as changes to the venture's product, pricing or market positioning). The Board periodically reassesses this delegation of authority framework, and takes measures to adjust approval levels based on JV performance and business conditions.

3. The JV Board is responsible for performing the roles of a traditional Corporate Board, including: (i) setting strategy and direction; (ii) approving major capital investments; (iii) ensuring strong performance management and managing financial risk; (iv) protecting shareholder and public interests, including legal, safety, ethics and environmental considerations; and (v) overseeing CEO and top-management hiring, evaluation, compensation and succession planning. In addition, the JV Board is responsible for JV-specific roles, including:
 - 3a. Securing needed resources and organizational commitments from the corporate parents, on a timely basis. This includes facilitating staff rotations as needed between the JV and parent companies
 - 3b. Overseeing the negotiation of major commercial agreements between JV and parent, and shielding the JV CEO and management team from negotiating with parent stakeholders on issues where parent interests are misaligned
 - 3c. Periodically assessing the need for major change in the venture strategy, scope, ownership/financial structure and operating model within the strategic confines defined by the parent company – much as a corporation would challenge the strategy, structure, and, if needed, continued corporate ownership of a business unit
4. The Board has established and maintains an active Audit Committee, which meets more than once a year, and is responsible for reporting and oversight of compliance, financial statement integrity, and overall risk management.²¹ At least one Board member has significant financial expertise and is the chair of the Audit Committee.
5. The Board has established and maintains an active Compensation Committee,²² which meets regularly and is responsible for: (i) approving the compensation

21 One US company that is a highly-experienced user of joint ventures has taken this practice one step further: As a way to promote good financial disciplines and controls, it requires its major JVs to comply with Sarbanes Oxley, and for the JV CEO and JV CFO to provide a written "Sarbanes Oxley Attestation" on a quarterly basis to the company. This attestation is not a legally binding document, but is a powerful signifier of shareholder expectations and driver of individual accountability among the JV management team. The approach is notable because it is above what is required from a legal standpoint: Sarbanes Oxley, as a piece of regulation, applies only to publicly-traded US companies, and therefore is not something that joint venture companies must per se comply with.

22 This committee may operate under different names, such as Human Resource, People or Talent Committee.

and incentive framework for the venture's top management team, including developing an annual Performance Contract for the JV CEO; (ii) nominating, evaluating, and determining compensation for the CEO; (iii) overseeing succession planning for the JV CEO and other members of venture top management; and (iv) assisting the JV CEO in ensuring access to skills and people, as needed, from the parent companies.

6. The JV Board conducts an annual audit of the joint venture's governance performance, which would include compliance with these governance guidelines and a view of the overall health of the governance system.²³ Related to this:
 - 6a. The JV Board has designated at least one Board member (likely a Lead Director, as described in section B.4) to lead such a review and discussion
 - 6b. The review involves a level of rigor and seriousness similar to other major reviews, and includes a set of criteria against which the shareholders agree to evaluate the venture, a summary of performance, and a discussion of opportunities to improve how the shareholders relate to each other and the venture

B. Board composition and individual roles

1. Absent compelling, unusual circumstances, the JV Board should range from 4 to 10 members. If outside that range, the number of members should be justified.
2. The JV Board has established – and at least annually updates – a set of skills it seeks from Director candidates. Minimally, these skills, across the Board, should include general management experience, finance expertise, experience in the JV industry and with the geographic markets in which the JV operates, and prior experience with other JVs. In selecting members of the Board, the parent companies explicitly account for the desired mix of skills and personal dynamics within the Board overall.
3. Each shareholder has appointed to the JV Board at least one representative who is a senior executive of the parent company, and who is able to truly represent the interests of the parent company and command internal resources to support the venture. The following test is to be used to determine if such authority level exists: that Board member has the proven authority to: (i) sign-off on the JV's annual budget and operating plan, within limits consistent with the parent

²³ Assessments of governance health would likely relate to decision making speed and effectiveness, the delivery of resources and people between the shareholders and parents, the level of transparency and rigor in the reporting and challenge processes, and other factors that the Board deems important to a well-working joint venture governance system.

company strategy, budget, and operating plan; (ii) approve the JV's material supply or service contracts; and (iii) approve the JV CEO's annual performance contract and, when needed, the selection of a new CEO of the joint venture.

4. Each parent has designated a Lead Director. The Lead Director is a senior executive of the parent company who:
 - 4a. Spends at least 20 days per year in an active non-executive capacity overseeing and supporting the venture ²⁴
 - 4b. Performs the following roles: (i) coordinates other Directors from his or her parent company – i.e., ensure opinions heard, consistent voice presented to JV and partner; (ii) accesses resources from inside the parent company in support of the JV; (iii) works with the other Lead Director(s) and JV CEO between Board meetings to resolve issues that do not require full Board approval; (iv) shields the JV from excessive parent company information requests and bureaucracy (e.g., duplicative reporting requirements, slow capex approval processes); and (v) supports the parent executive team and parent board in ensuring that the JV is meeting governance, compliance, risk management and transparency requirements; and, ideally, (vi) explains the JV's strategy, performance, risks and prospects at corporate-level reviews in the parent company.
5. Each Lead Director has an element of his or her annual performance review and short-term variable compensation tied to the performance of the joint venture, and his or her performance as the Lead Director. In no circumstances does the JV account for less than 10 percent of his or her total performance review and short-term variable compensation calculation.
6. The JV Board has designated a Chairperson (who may be the Lead Director from one parent company) to be additionally responsible for: (i) managing the overall Board agenda (including syndication prior to Board meetings of key issues and decisions); and (ii) overseeing the quality, quantity and timeliness of the flow of information to the Board from venture management; and, (iii) unless assigned to another Board member or committee, ensuring the integrity of the governance system, including being responsible for an annual assessment and discussion

²⁴ Our research indicates that such 20-days-per-year Director commitment is in the upper quartile of large joint ventures today; however, we do not believe that this represents exceptional or unrealistic commitment. For comparison purposes, in Corporate Boards, directors spend an average of 24 days (190 hours) per year preparing for and attending Company Board and Board Committee meetings. [Source: Jeremy Bacon, *Corporate Boards and Corporate Governance*, 22-24 (New York, The Conference Board, 1993).

about governance performance, underlying health, and potential changes to the governance, scope or structure venture to improve its performance.

7. No member of the Joint Venture Management Team is a member of the JV Board.²⁵
8. The JV Board ensures that it has a strong independent perspective, preferably by the inclusion of an Independent Director, with stature in the industry.²⁶ An Independent Director would not be expected to hold a swing vote in Board decisions, and may be a non-voting member of the Board. To additionally promote independence, the Board should: (i) endorse the principle that Board members and full-time venture staff (including secondees) are first and foremost to promote the interests of the venture as a whole (rather than the singular interests of one shareholder), and (ii) periodically invite independent outsiders (e.g., industry experts, customers) to Board meetings to share their perspectives and challenge the Board.²⁷ To function effectively, an Independent Director needs to have a professional stature and personality that allows him or her to raise issues to and influence the shareholders.

C. Board processes and evaluation

1. Working with executives in the parent companies if need be, the JV Board establishes and periodically updates a set of guiding principles defining the parents' shared philosophy toward the venture.²⁸ These principles include statements regarding the desired level of independence from the parents, whether the venture is to be run as a business or an operating asset,²⁹ and the evolution path and, if possible, planned end-game of the venture.

²⁵ It is expected that the JV CEO, JV CFO, and other members of the JV management team may be present at JV Board meetings, and may make specific presentations to the Board on the business, operational and financial affairs of the joint venture company.

²⁶ We define an "Independent Director" as a Board Member not currently an employee of any of the parent companies, and who does not receive compensation for goods and services performed, excluding director fees, for any parent. Despite very limited usage in joint ventures today, we believe that Independent Directors have the potential to be an extremely powerful lever to improve governance performance – creating an independent perspective that is often missing from joint ventures.

²⁷ Another – and more aggressive – approach to fostering independence (and a strong performance culture) within the JV is to bring in an outside investor (e.g., venture capital or private equity firm) as a 5-10 percent owner of the JV.

²⁸ As an illustration, one joint venture adopted a set of ten guiding principles that included the following statements: "No Slots – best people for available jobs", "JV Board Members must promote the interests of the JV as a whole – not merely advance their own parent's interests," and "Equal Communication – information available to one parent is available to all parents."

²⁹ By "operating asset" we mean an entity whose purpose is to perform specific operating activities at worldclass levels but is not judged based on its ability to grow into new areas or to drive bottom-line profits. This distinction from a "business" is especially important in the energy, basic materials, and semiconductor industries, where we have seen numerous production joint ventures encounter significant inefficiencies because the management team or one shareholder believed that the venture was to operate as a business, while one or more shareholders believed that the venture was a narrow-purpose production asset.

2. The Board has established performance criteria for itself as a collective body, and periodically reviews its performance against these criteria.
3. The Board has established performance criteria for its individual Board members, including individual behavioral expectations. Minimally, these criteria address the level of Board member attendance, preparedness, participation, and candor. To be re-nominated, directors must satisfactorily perform based on the established criteria; re-nomination on any other basis is neither expected nor guaranteed.
4. Each director has an attendance rate of at least 75 percent at Board meetings and 75 percent of Board Committee meetings of which they are members, and the Board has established a minimum standard to that effect.

D. Management incentives and reporting relationships

1. The JV CEO reports solely to the JV Board, which alone reviews his or her performance and determines his or her compensation.^{30 31}
2. The JV Board has collectively endorsed an annual “performance contract” for the JV CEO, which includes a balanced set of key performance indicators.
3. The JV CEO compensation package is structured to promote the interests of the joint venture as a whole, and not asymmetrically advance the interests of a subset of parent companies. The details of this compensation package (including determinants and actual payout) are disclosed to all members of the Board even if the JV CEO is a loaned /seconded employee from one parent company.

30 One allowable exception to this guideline would be joint ventures that are clearly operated by one partner, depend on that partner to supply significant numbers of loaned employees to perform the work of the joint venture, and are essentially run as business units of that parent company.

31 This practice, which WaterStreet Partners strongly endorse, is a matter of some controversy. An argument is sometimes made that when a JV CEO is a seconded – or loaned – employee from one shareholder, that it is impractical to expect that the JV CEO will have no objectives or interests outside the scope of the joint venture, and it is unrealistic to believe that the JV CEO truly reports solely to the JV Board. This argument is based on a view individuals seconded in as JV CEOs tend to be high-potential individuals who have career goals greater than the specific JV they are running, and that acting solely based on the joint venture’s interests – rather than protecting their long-term employer’s vested interests when in conflict with the joint venture’s interests – turn out to be “career-limiting moves.” Our view is that while this may be the unfortunate reality in some cases, it should not be an excuse for a poor practice that drives added misalignment into the system and likely leads over the long-run to suboptimal returns for all shareholders as a group

4. The JV CEO, working in consultation with the Compensation Committee, has the freedom to offset any compensation disadvantages associated with the joint venture structure (e.g., lack of stock options, reduced career headroom relative to larger global companies, added career risk) with other forms of remuneration.^{32 33}

E. Financial and compliance policies

1. The parents have explicitly established – and collectively endorsed and updated – specific financial hurdle rates for additional investments, dividend repatriation policies, and other key financial policies of the joint venture. (Note: Defining these hurdle rates is typically the job of the parent companies, and therefore JV Board members, depending on their role in the parent company, may or may not have the authority to do this on their own.)
2. The Board subjects the JV to a “challenge process” of equal intensity to similar-sized 100%-owned business units in the corporate parents, and does not allow the JV to be subject to a lower performance bar.³⁴ However, the JV is not subject to “double jeopardy” – i.e., full and separate reporting to both corporate parents where the JV must comply with different data and format requirements.^{35 36}
3. The joint venture service and supply agreements with the shareholders are disclosed and made available to all JV Board members, are actively monitored

32 In one financial services industry JV, members of the JV management team (direct reports to the CEO) were paid annual base salaries of 25 percent higher than similar positions inside the parent companies of the venture, and annual bonuses on par with parent company employees. The rationale for higher base and annual bonus pay relative to the owner banks was that the JV employees, who did not have stock options, had significantly lower opportunities for long-term wealth creation. Similarly, in a multi-billion dollar downstream oil industry venture, the JV pegged employee base pay at the 50th industry percentile benchmark, and the performance-based short-term bonus at the 75th industry percentile benchmark as a way to compensate for some inherent long-term incentive disadvantages of its JV structure.

33 This problem generally does not exist in joint ventures that are either (i) partially floated on public stock exchanges, or (ii) where the JV employees have phantom equity options based on JV performance.

34 A number of different approaches can be used to ensure that the JV Board has access to the performance and other information that it needs. In one industrial JV, the parent created a small “affiliate analysis unit” of 4-6 finance staff whose sole job was to make sure that the Board members of three major JVs got the data and analysis they needed (beyond what the JV CEO was providing). In another case, a US-Japanese joint venture made a very deliberate decision to staff the JV itself with very strong finance talent and build the financial systems within the JV to create these insights.

35 There are many different ways to do this. For example, in one 70-30 JV, the approach taken to avoid double jeopardy was for the JV to report to the senior parent management team of the 70% owner in a way that was similar to any business unit, with the key difference being that the Board members from the 30% partner participated in these meetings, challenging the JV from its perspective. In a multi-billion dollar oil industry JV with 50-50 ownership, the JV Board established an independent review process, including a separate and very strong finance and audit committee, as well as aggressive use of outside auditors to benchmark venture performance.

36 This form of double jeopardy occurs when a JV is forced to comply with both / multiple parents’ planning and review processes for the operating plan, budget, and/or capex approval. We believe that in well-governed JVs, the JV Board will coordinate and align these information requests from the parents.

and governed, and ideally, unless there are compelling business reasons otherwise, are set up on an arms-length basis with externally-sourceable specifications, with market-based pricing, and with the JV having the option to source externally.

4. In the event that a Parent Company provides significant and strategically sensitive services to the venture (e.g., potential for leakage of intellectual property, or compromise of customer data or relationships), that parent company provides “compliance training” to those individuals within its own organization who are involved in providing those services to the venture. This training includes what information can – and cannot – be shared, how to prioritize work for the venture relative to internal requests, treatment of cost allocations, and reporting of potential incidence, etc. The Parent Company also reinforces these compliance policies through regular communications regarding the importance of complying with these guidelines and variations.
5. The JV Board takes active and regular steps to ensure compliance with all applicable safety, environmental, anti-corruption (e.g., FCPA), and other regulatory and social requirements of responsible corporate citizenship. A recommended medium for disclosing economic, environmental, and social risks and impacts is the Global Reporting Initiative Sustainability Reporting Guidelines. In particular, the joint venture adopts practices to ensure that the JV does not commit or support human rights violations in countries in which the venture operates.

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Today, there are few if any JVs that follow all of the above governance guidelines, and indeed relatively few companies that have adopted any explicit governance guidelines for JVs. Nonetheless, we believe that each of these guidelines is relevant to all material joint ventures of public companies, and that each has the potential to improve venture performance and reduce risk. A decade ago, a growing chorus of commentators began to forcefully make the case that good governance was a key contributor to corporate performance. As one wrote:

*“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.”*³⁷

37 Ira M. Millstein, New York Times, April 6, 1997.

We assert that good governance matters at least as much in joint ventures – and that there is a significant performance opportunity for public companies. The first step toward capturing the performance upside is for corporate and JV Boards to adopt a set of guidelines to serve as a measuring-stick.