Sigma Investment Counselors

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Insiders Out! Outsiders In!

"Somebody needs to go to jail." Tom Daschle, the Senate majority leader, echoed the sentiments for many within and outside of government when he made this comment in June following numerous revelations of corporate greed and alleged fraud in the United States.

While initially the machinery of justice seemed to be snail-like, over the last couple of months, the machinery has begun to accelerate beginning with the suspected malfeasance of Dennis Kozlowski, former chief executive of Tyco International, and Mark Swartz, the company's former chief financial officer. On September 12th, these two individuals were charged with stealing more than $170 million from the company and obtaining an additional $430 million from the fraudulent sales of shares. Furthermore, Mark Belnick, Tyco's former chief corporate counsel, was accused of concealing $35 million in pay he collected for himself that was not approved by the board. All three men pleaded not guilty to the charges in a Manhattan court and were released on bail – in Mr. Kozlowski's case of $100 million. Ironically, the trail that led to these indictments began with a tip-off earlier this year from the state banking authorities in New York that led initially to Mr. Kozlowski being indicted on charges that he conspired to avoid $1 million worth of sales tax on artwork he had purchased. That now seems like small potatoes compared with the allegations made in September.

Prosecutors have also been moving closer to reeling in those responsible for wrongdoings at other companies such as Enron, Adelphia Communications, Arthur Andersen and WorldCom. With all the crooked accounting, egregious self-dealing and insider trading that has surfaced, investors are asking, where were the corporate watchdogs? What happened to the system's checks and balances? Were the corporate board members in cahoots with the unscrupulous executives or just more interested in their golf scores than their corporate governance responsibilities?

Unfortunately, it took the debacle at Enron to expose just how vulnerable companies, regardless of size, are to fraud and manipulation. Fortunately, corporations are now scrambling to implement dramatic governance reforms. The Enron wake-up call has spurred companies to grapple with many difficult questions. Should options be expensed? How much compensation is too much for the chief executive? How many independent vs. insider board members should there be? How should board members be selected? How should the audit committee be staffed and run? What about a company's charter and by-laws? Should boards be staggered? Should auditors be allowed to be consultants to the company as well as perform their audit duties?

When making investment decisions and voting proxies on behalf of our clients, we at **Sigma** closely examine all corporate governance issues. These take two main forms. One entails our guidelines for voting proxies. The other involves including an evaluation of a company's corporate governance policies as one of the metrics in assessing potentially good investments along with such traditional measures as price/earnings ratios and growth rates. In both cases, the "best interest of the shareholder" is the key tenet.

We evaluate many variables that generally fall into the following broad categories: board of directors membership, charter and bylaws, executive and director compensation, stock ownership, director eligibility, auditor issues, tender offer defenses, capital structure matters, mergers and corporate restructurings, social and environmental issues, and

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qualitative factors such as succession planning. Following are some of the major factors reviewed.

Large insider ownership is considered a big plus. Since managers are stewards of shareholder capital, what better way is there to align managers with the interests of shareholders than for them to be large owners themselves? This is not to be confused with the issuance of stock options. **Sigma** would attribute a low score to companies that issue a disproportionately large number of options to executives, board members and employees. As a rule of thumb, options representing any more than 10% of shares outstanding are considered excessive. An exception to this rule is companies or industries in the early stages of development where cash is not available to offer competitive compensation programs to attract talented people.

Some pundits, notably the U. K and Berkshire Hathaway CEO, Warren Buffet, are opposed to options in principle for directors, executives, or employees. Warren Buffet aspires to having performance be the basis for compensation. Performance, in turn, should be measured by profitability after profits are reduced by a charge for the capital employed in the relevant business or earnings retained by it. His concern with stock options is they are often irrevocable, unconditional, and can benefit managers without regard to their individual performance. While we believe Mr. Buffet's argument is valid, as long as the imputed value of options at the time of grant is included in the calculation of the total compensation and the value of that package is fair and reasonable, an option component can make sense. Obviously, we know that many of these packages have been egregious and, indeed, in some cases, obscene. But the culprit can be the cash compensation component just as often as the option program.

In our opinion, the majority of board members should be independent. There should be no financial ties between board members and the companies they serve. Independence is particularly important for members on the executive compensation, audit, nominating, and corporate governance committees. Non-management directors should meet at regularly scheduled sessions without management. Directors and managers should be personally liable for negligence or more serious violations of their fiduciary obligations. We endorse the idea that at least a portion of the compensation of directors should be paid in the form of stock rather than cash. Directors' interests need to be aligned with shareholders' just like managers'.

Companies should have and disclose corporate governance guidelines, which should include director quality standards, responsibilities, access to management, compensation, orientation and continuing education, as well as management succession, and annual performance evaluation of the board. Also, companies should have and disclose a code of business conduct and ethics for directors, officers, and employees and disclose any unethical incidences.

In addition, we prefer that auditors not do any consulting or non-audit work for the companies they audit. We disapprove of staggered boards for which a few directors are elected each year. By having the whole slate of directors up for election each year, dissident shareholders can more easily rid companies of directors not acting in shareholders' best interests. Further, companies should not have takeover defenses so stringent that a takeover is virtually impossible.

While proxy votes related to mergers and acquisitions are considered on a case-by-case basis taking into account the anticipated financial and operating benefits and offering price, we are increasingly mindful of the very high percentage of mergers and acquisitions that have been ill conceived or overpriced. Recently, such companies as Comerica, Cisco and AOL/Time Warner have had to take very large impairment charges indicating significant overpayment of recent acquisitions. Companies that have a history of successfully acquiring and absorbing acquisitions, particularly if they are small relative to the size of rest of their business, are given the benefit of the doubt. Clearly, we prefer companies that require shareholder approval before an acquisition or merger can be completed.

There are many other corporate governance issues; we have commented only on those of greatest concern.

While all of the best corporate governance practices will never prevent all fraud, corporate governance in the United States is being challenged for good reason. At its best, America's private enterprise system provides the highest living standards in the world, the opportunity for creativity and innovation, and attractive employment opportunities. It would be most unfortunate for the nation's future if such powerful benefits are undermined by continuing malfeasance and egregious activities at so many companies. The challenge to American business is to respond promptly and constructively to the severe challenges to corporate governance that face them. At stake is nothing less than public and investor confidence in our private enterprise system.

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*Subsequent to the completion of writing this **Sigma Summaries**, we learned that General Electric announced a set of new corporate governance policies consistent with many of those advocated in the summary. We did not know that Ann or anyone at **Sigma** had that much influence.* ☺ *In all sincerity, this is just what is needed in all of corporate America.*