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By Hilary Kramer

FOX NEWS

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ADVERTISEMENT "Governments are instituted among Men, deriving their just powers from the consent of the governed...But when a long train of abuses...evinces a design to reduce [their safety and happiness]...it is their right, it is their duty...to provide new Guards for their future security." — The Declaration of Independence

When Thomas Jefferson wrote this, he was referring to the unjust power that the British government imposed on the American Colonies. But ultimately, this idea of safeguards on power would manifest itself in the U.S. Constitution in what has become a cornerstone of American values -- the principle of checks and balances.

Time magazine honored this ideal of checks and balances on power when it designated its 2002 Persons of the Year as the Whistleblowers— who "helped remind us what American courage and American values are all about." Cynthia Cooper fulfilled her internal control duty to WorldCom shareholders by informing the company's audit committee of peculiar accounting practices at WorldCom. Coleen Rowley made sure that the American public knew where the FBI mishandled information that was relevant to the Sept. 11 attacks. And Sherron Watkins refused to let her discovery of an "elaborate accounting hoax" be dismissed by her superiors at Enron.

Thanks to Jefferson and the other founding fathers of our country, checks and balances have afforded us a degree of security that the government won't infringe upon our rights (conspiracy theorists notwithstanding). Of greater concern, it seems, is whether or not our corporations, financial institutions and---for that matter---stock markets will do likewise.

In fact, speaking of stock markets, the New York Stock Exchange (NYSE) has recently come under fire for the poor governance practices of its "specialists"— market-makers who determine buy-sell prices. These specialists are unique in that they represent the last group of human market-makers on trading floors. Other exchanges (most prominently, NASDAQ) have long since replaced them with electronic trading networks that objectively match buyers and sellers.

The recent revelations of "front-running" by NYSE specialists merely highlight the enormous potential for manipulation under the archaic open-outcry trading model. Front-running is the practice of buying or selling a stock in anticipation of a buy or sell order that the specialist is supposed to execute. At the NYSE, a specialist ultimately determines how many shares are issued at what price. And although they do receive commissions, specialists derive the bulk of their income from proprietary trading. The conflict of interest exists here because the specialist's pricing decisions can either preserve fair and orderly trading or it can profit the specialist's own firm. Hardly the picture of good corporate governance, when a specialist has an incentive to use the system to their benefit, a lot of freedom to maneuver and very little real oversight to regulate their behavior.

As for corporations and financial institutions, the idea of corporate governance has been around for a while now, but the 1990s in particular proved to be a time where few cared about it. The high-flying stock market rewarded investors in companies of



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all types, regardless of whether those companies demonstrated good governance practices or bad ones. And even after all the Enrons and Worldcoms, corporate scandals persist as we have recently seen with U.S. Technologies and HealthSouth Corp.

So what's the answer? The shareholders, the board of directors, and the management team must fulfill their roles and responsibilities with the goal of building long term shareholder value. In doing this, the power of checks and balances must constantly be at work -- keeping companies focused on honest profitability and growth.

Shareholder Power

The shareholder must take an active role in monitoring how their companies are both being managed and performing. In fact, a recent study by the law firm Weil, Gotshal and Manges, concluded that "superior performance is a result of activist corporate governance." The California Public Employees' Retirement System (CalPERS), as one of the largest institutional investors, with an investment portfolio valued at over \$130 billion, has been one of the leading advocates of corporate governance for over ten years now. One of the methods used by CalPERS is a grading system that assesses how well companies in its investment portfolio adhere to corporate governance principles.

CalPERS has an entire website devoted to the issue of corporate governance (<http://www.calpers-governance.org/>). It has developed an impressive Corporate Governance Program designed specifically to identify underperforming companies in its domestic equity portfolio and target them for corporate governance activism. And with great results! The companies that originally trailed the S&P 500 Index by 96 percent during the five-year period prior to CalPERS involvement ultimately outperformed the index by 14 percent in the five years following CalPERS activism. Thus a disciplined focus on improving corporate governance yielded about \$150 million a year in additional returns to the portfolio!

Reliable Board of Directors

As the shareholder's representatives, a company's board of directors is probably the most important element in determining its level of good corporate governance. As a result, the presence of a responsible and watchful board has a significant impact on the company's performance. A *Business Week* study on the best and worst corporate boards found that for three years after they initiated their survey in 1996, the stocks of the companies with the best boards outperformed those with the worst by 2-to-1. In crisis situations, the higher performance of companies with better rated boards is even more evident. The study discovered that as the economy began to slow in 2000, the companies with the best rated boards preserved substantially more of their value, returning 51.7 percent versus -12.9 percent for the companies with the worst rated boards. Some of the important criteria in evaluating the value of a company's board are its independence, the quality of its members and the compensation paid to directors.

Motivating and Aligning Management with Shareholders

Compensation isn't just an important governance issue regarding board members; it's also significant with regard to senior executives. If management is overcompensated or awarded massive stock options that reward them for even slight increases in company stock price, their incentive to serve long-term shareholder interests diminishes proportionally. Thankfully, the market punishes these corporate governance violations. Research by Wharton professors John Core, Robert Holthausen and David Larcker examined over 200 publicly traded U.S. companies and observed that a 40 percent increase in excess CEO compensation is correlated with a decrease in annual stock returns of approximately 33 percent of the sample average return for the first year and 20 percent for the first three years.

So corporate governance is more than just a symbol of American values; it holds financial value as well. Consistency decreases risk, which inspires investor confidence -- all of which decreases the cost of capital. Savvy individual investors would be well served to recognize this too. Arthur Levitt, the longest-serving chairman of the Securities and Exchange Commission and former chairman of the American Stock Exchange summarizes it well when he says, "Put simply, corporate governance is the relationship between the investor, the management team, and the board of directors of a company. Each of these groups has different rights and responsibilities. When the three groups are able to communicate openly and independently, we can say that a company is exhibiting good corporate governance."

It's interesting how this is almost analogous to the three branches of government that provide the checks and balances for the citizens of the U.S. The founding fathers really had it right -- from over two hundred years ago. In the same way that the different branches of government provide the checks and balances for their citizens, the relationships among the management team, shareholders and board of directors provide the checks and balances that keep the corporations, financial institutions and stock exchanges operating in the best interest of the owners.

Hilary Kramer serves as a business news contributor at FOX News Channel. She joined the network as a regular guest on **Cashin' In** in May 2001.

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