

LEITH WHEELER INVESTMENT OUTLOOK



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Corporate Governance

The Good, The Bad and the Ugly

Corporate Governance, or the lack of it, is a regular front-page story these days. Tales of horror range from phony accounting at Enron to US Securities and Exchange Commission fraud charges against Conrad Black and David Radler of Hollinger International. The SEC alleges that management diverted US\$85 million between 1994 and 2003, and that the publicly traded company was treated as their "personal piggy bank".

As shareholders, what can be done about this behaviour? Who is looking out for our interests? Are securities regulators and investment managers doing enough to ensure that the shareholders' interests are being protected?

Shareholder interests should be defended by the Board of Directors who are elected by all of the shareholders. Corporate management and the CEO report to the Board. To ensure that your interests as shareholders are protected it is essential that companies have a strong and knowledgeable Board that actively questions management. Unfortunately, not all companies have such a Board, in fact, at some companies it appears the Board reports to management, and shareholders are an afterthought.

There should be a simple solution to this problem; fire the current directors and elect a new, responsible Board. Unfortunately it is not that easy. Until this year companies did not have to publish the results of shareholder votes, so shareholders were never sure how many votes were cast in favour of the Board.

Often there is no ability to vote "against" potential directors. There are two choices on the proxy ballot, either vote "for" the directors or "withhold". To change the Board, dissenting shareholders have to nominate their own directors and call a special meeting. This is a very time consuming, expensive and difficult exercise. Since many investors just vote along with management's recommendations, the odds of changing a Board are stacked against change and in favour of the status quo. There is also no legislated requirement to allow shareholders to vote for individual directors. As a result, many companies just offer the option of a vote "for" the whole slate of directors or a "withhold" of the full slate. So, in these cases shareholders are unable to even withhold a vote for a single director who, for example, rarely attends Board meetings.

One Share, One Vote?

So called "ordinary resolutions" for Canadian corporations can be determined by a show of hands at the company's Annual General Meeting. This can entrench a Board of Directors and is obviously undemocratic. Other important issues can also be dealt with by a show of hands.

Fairvest, a company that produces excellent research on proxy issues, pointed out in their October/November 2004 Corporate Governance Review:

"Show of hands voting is anathema to the good corporate governance principle of one vote for one share. The predominance of this antiquated, ill-suited method of voting is now coming to light as companies are forced to disclose the outcome of their voting resolutions..... Take, for example, International Datacasting Corporation, where the resolution amending the Stock Option Plan was carried by a show of hands with two shareholders voting against. The end result is a shareholder

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approved stock option plan, but the only people who know whether it was approved by three of five hands or 98 of 100 hands are those that were in the room. Moreover, shouldn't it matter that some of those hands most likely held hundreds of shares, while others held hundreds of thousands of shares and yet they were all counted equally?"

Further legislation is required to protect shareholder interests. Specifically, show of hand voting should be disallowed and all voting should be by proxy ballot. Although disclosure of voting has improved, it should be mandatory that both the percentage and number of votes cast "for", "against", and "withheld" be disclosed. Additionally, the election of directors should be done on an individual basis, with a vote "for" or "against" allowed.

Many Investment Managers Are Still Wimps

Amazingly, with all the corporate wrongdoing that has occurred some money managers are still voting their proxies blindly in favour of management. The Shareholder Association for Research and Education (SHARE) surveys money managers' proxy voting records, and in their 2004 Report they note:

"For the first time, the SHARE 2004 Key Proxy Vote Survey also surveyed a shareholder resolution filed with two different companies where the management of one company supported the resolution and the other did not. The survey results show that six investment managers voted for the resolution when management supported it and against it when management did not. This raises concerns that votes are being decided based solely on management's recommendation rather than on the merits of the proposal."

At Leith Wheeler we carefully scrutinize the governance structures of companies, and in particular the people who make up the Board. Our first line of defense is to avoid companies where the Board and management don't "get it" and run the company in management's interest. For the most part we have been successful at identifying companies where this is a chronic problem. However, we do contact Board members to encourage them to effect changes when we have concerns about a company we own.

Leith Wheeler has developed voting policies to protect and advance the interests of shareholders. Here are the positions that we have taken on behalf of our clients on some of the controversial issues that have been in the news:

Option Plans: We support stock options and phantom stock awards only where there is a measurable goal to be achieved before vesting. We don't believe management should receive huge windfalls just because the price of oil or copper went up, or just because the stock market advanced. Since companies rarely have measurable goals before option vesting, we rarely vote for their approval and regularly vote against them.

Chairman and CEO: We believe that shareholders are better served when the Chairman of the Board is separate from management. We vote that way.

Auditors: We vote in favour of auditors auditing and other firms providing other management advice. Enron showed that it just doesn't work when audit firms have their bread buttered with something other than audit work.

Board Attendance: Board members should attend meetings or move on. When given the opportunity we vote against board members that attend less than 75% of meetings.

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