

Check for delivery

**Corporate Governance:
Time to Get Serious**

An Address

by

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to

The Canadian Club of Toronto
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Thank you for that generous introduction. Good afternoon, ladies and gentlemen. It is an honor to address the members and guests of the Canadian Club.

As you have gathered from the introduction, corporate governance is a very important topic for Teachers ... as it should be for each of you as an investor.

Unfortunately, those who are supposed to represent us ... the directors of corporations ... often do not share our enthusiasm.

Yet every director and chief executive in office today is surely familiar with the Dey Report and its recent echo the Saucier Report.

Both reports addressed basic improvements in structure and form by, for example, calling for smaller boards ... more independent directors ... separation of Chair and CEO ... and so on.

These two reports ... and many others published around the world ... have had an impact ... but not a big enough one....

Some companies have responded positively. Others have not ... and clearly have no early plans to change after all the debate in the past seven years.

I think it is fair to conclude that not all members of the Canadian business community endorse first-class corporate governance.

Today, less than 40 percent of the companies listed on the Toronto Stock Exchange even bother to report their compliance or non-compliance with the exchange's voluntary governance guidelines.

The governance section of many annual reports and proxy circulars has become boilerplate. And why not? There is no enforcement for non-compliance ... and no sell-side analysts take note of these things.

However, there is much that institutional investors can do to re-focus attention on the importance of governance. That's what I will talk about today.

What institutional investors can do. What companies can do. And what governments can do.

Good corporate governance matters. Let me cite some of the ways ... starting with the impact on financial performance.

Last year, Paul Gompers and two other researchers in the U.S. set out to build a governance index based on data collected from fifteen hundred firms. They built the index on 24 different governance provisions.

And they made an astonishing discovery.

Between 1990 and 1998 ... companies in the top governance decile had an 8.5 percent higher annual return than companies in the bottom decile.

This is clear evidence that good governance pays off.

Now let's look at the behavior of directors.

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A 1999 study in the U.S. publication *Business Lawyer* found a significant correlation between the amount of stock owned by outside directors and performance.

How did that correlation manifest itself?

The higher the dollar value of equity owned by outside directors ... the greater the likelihood that the CEO of a poorly performing company would be fired.

The alignment of director and shareholder interests doesn't get much better than that.

Yes ... as these and other studies show ... corporate governance matters ... not only to corporate performance but also to the behavior of directors.

Well-governed ... and, by extension, well-managed ... companies are among the best investments any of us can make.

Unfortunately, there are too many examples to the contrary. Let's look at three to illustrate the difficulty of applying best governance practices.

Consider first Nortel and JDS Uniphase – two companies that incurred the greatest financial losses in Canadian history.

In the 1990s, they went on buying binges ... acquiring future revenue at ever-rising prices with the new and highly inflated currency of the day – their own shares.

The number of shares outstanding at both companies exploded between 1998 and 2001 ... by 50 percent at Nortel to 3.2 billion shares ... and by more than 100 percent at JDS Uniphase to 1.3 billion shares.

During the same time period ... Nortel reported 14 percent sales growth over those four years. But on a per share basis that was a decline of 26 percent. In the same period ... JDS Uniphase reported a 586 percent increase in sales. But on a per share basis it was only 81 percent over four years.

So what did the buying binge do for long-term investors? It diluted their holdings and depressed the value of their shares.

What did the directors of these corporations know that we didn't? As it turned out, not much.

Perhaps they were mesmerized by the management magic of their CEOs. Pro forma numbers took on greater – and certainly more exciting -- meaning than the numbers required by generally accepted accounting principles.

Eventually, the financial pro forma game caught the attention of the Securities & Exchange Commission. In December of last year it issued a formal warning that public companies could be sued for not fully explaining how they calculate pro forma or adjusted earnings.

It would appear that the directors of many corporations were bewitched by stock options that made them instant multi-millionaires.

In addition to that ... stock options only serve to align the personal interests of directors with those of the CEO ... and those are not necessarily the same interests as the shareholders.

Ontario Teachers' is opposed to excessive stock options for directors and executives. They rob shareholders ... and thus the teachers of your children and grandchildren ... of full and fair value on their investments.

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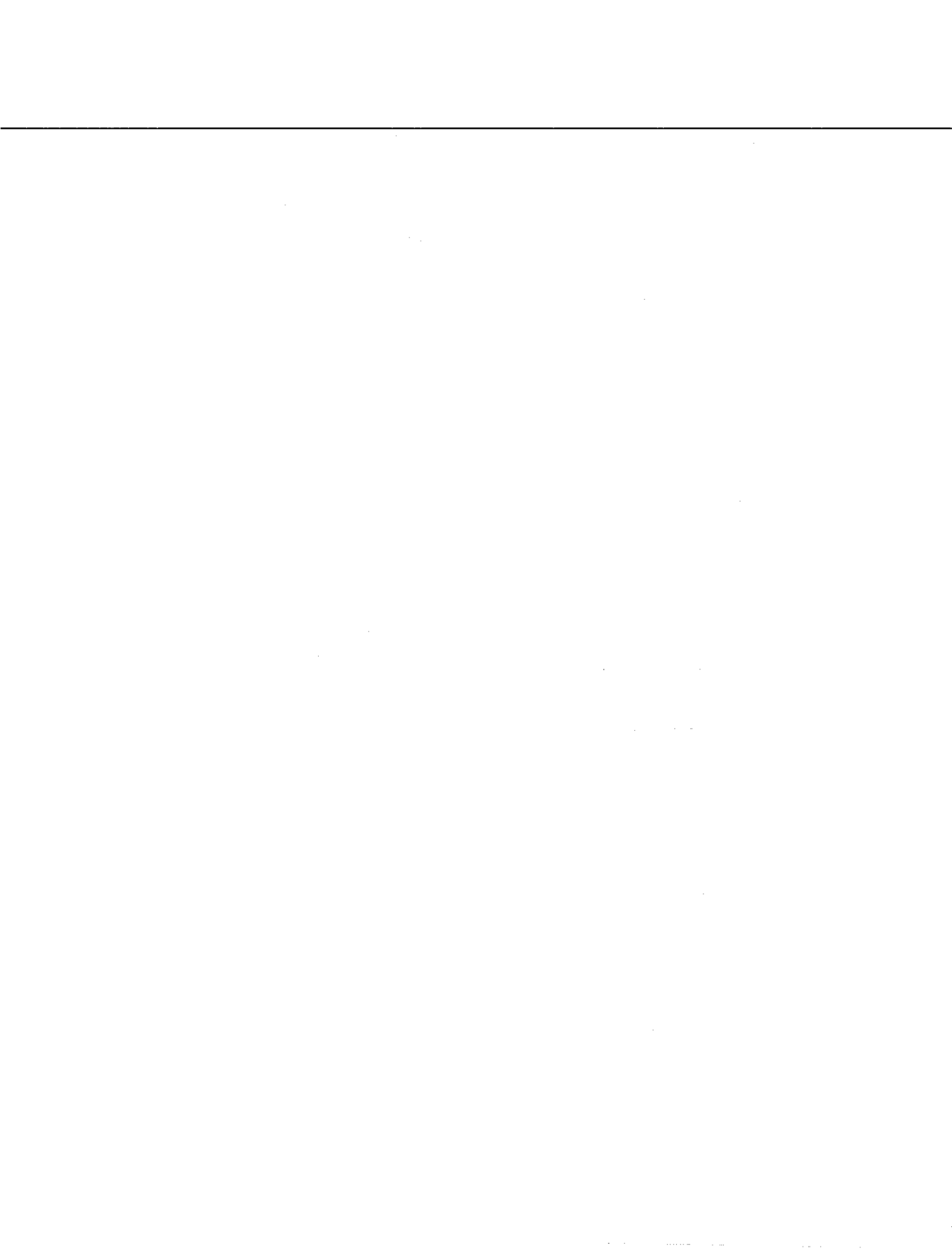
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We are an even greater opponent of the current accounting for stock options. As you all know, the value of stock options is not deducted on the income statement ... although it represents a future drain on profits for existing shareholders.

This is an area where the CICA is failing Canadian investors. Merely following the American practices is not good enough.

Many investors believed the directors at companies like Nortel and JDS Uniphase knew something substantive to support acquisitions at extraordinary prices ... and they invested accordingly.

All this helped to drive stock prices to frenetic levels.

And so we can ask:

- Where did the directors get their information to believe such a fantasy? Hopefully not from financial analysts who, despite the denials in congress last week, behaved shamefully in promoting technology companies with no idea of their long-term earning prospects.
- What motivated these directors to go along with management's wild-eyed views of the future?
- What responsibility did they have to warn their shareholders that the growth forecasts were unsustainable -- and the bubble would burst?

Let's not forget on this last point that ... even in a free market ... the board represents the shareholders. They should and must act in shareholder interests.

There is a lesson in all this. Last year, Fortune magazine published a study of the earnings per share of 150 big companies. The study analyzed their performance over three 20-year periods. It found that less than 5 percent of the companies grew earnings per share by more than 15 percent annually in any 20-year period.

Surely any CEO forecasting growth well above that level ... year after year ... should set off alarm bells in the boardroom.

It is critical that the directors challenge management on downside risk.

Perhaps the most disgraceful example of board negligence is the recent collapse of Enron.

Before it fell apart, the CEO was quoted as saying that "there is a very reasonable chance that we will become the biggest corporation in the world."

Instead, Enron became the biggest corporate collapse in the world.

And a large part of the blame has to rest with the directors. They failed on every count.

- Allowing management to grow the company too fast.
- Fostering a culture of greed that infected the entire organization, from top to bottom.
- Permitting sloppy risk management ... and misleading accounting.
- Approving the creation of a series of partnerships that moved debt off the balance sheet to enrich management at the expense of the shareholders.

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- Therefore helping to conceal the company's true financial position ...including massive undisclosed losses over the last five years.

This is a classic case of the directors being wowed by a self-possessed visionary ... who today cannot remember anything ... not even how **he** made all those millions of dollars.

This is in sharp contrast to the personality that management expert Jim Collins found makes the most successful CEO of a company that performs well over the long term.

In his book *From Good to Great*, Mr. Collins graded leaders on five levels. He described a Level 5 Leader as someone who embodies personal humility and professional will. Who is quiet ... unassuming ... unflappable. "When bad things are happening, they will become clearheaded and focused."

(pause)

So ... with this vivid background ... what **can** we do to improve the substance of corporate governance?

We don't need more rules on board structure and composition. What we need are new attitudes.

A good place to begin is a report on Institutional Investing in the U-K issued in March 2001. Known as the Myners Report, it found that fund managers are reluctant to intervene in companies where they own substantial shareholdings ... even where this would be in their clients' financial interests.

To quote the report: "If fund managers are truly to fulfill their duty of seeking to maximize value for their shareholders, then there will be times when intervention is the right action to take ... to do their best for the client."

This supports a 1994 U.S. Department of Labor bulletin that urged fiduciaries to vote proxies on issues that may affect the value of a pension plan's investment.

Or as the Myners report put it ... managers should intervene in investee companies as one of the means of adding value for their clients.

Yet according to Fairvest Proxy Monitoring Corp. ... less than 65 percent of Canadian shares are voted.

In the case of fiduciaries ... this is a gross abdication of duty.

A second thing that institutional investors can do is encourage boards to exercise real power.

This means looking at the role, character and resources of directors quite differently.

We cannot expect directors to do a first-rate job unless they can commit the time to board matters ... have access to independent advice on major issues ... own shares in the companies they govern ... and are part of a board culture that encourages frank discussion.

Governance committees must aggressively recruit independent directors.

This is more difficult at some companies than you might think ... considering one-third of Canadian public companies still do not have a governance committee.

For those that do, they need to deepen and broaden their talent pool beyond Canada. Best business practices and governance expectations are exactly the

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same here as they are in the United States. And Europe is moving steadily toward the North American governance model.

Governance committees should contact major institutional investors, such as pension funds and mutual funds, many of which maintain lists of prospective directors.

They should also consider contacting headhunters who specialize in this area.

Either approach puts the process at arm's length from management and will discover strong candidates.

Directors should be paid in line with a senior consultant so that being a director of three or four companies is an attractive career ... with fair compensation for the responsibilities and liabilities assumed.

As for compensation in shares ... our position is straightforward. We prefer that directors receive stock grants in lieu of some or all of their cash compensation ... and that stock options be avoided.

Boards should hold in-camera sessions without management present as a matter of routine so that directors can sound off without embarrassment.

We also think it would be beneficial for the board of every major company to meet with its top ten or so shareholders at least once a year to get a frank reading on their concerns.

This, we promise, would be a different experience from the annual shareholders' meeting. At those events, we tend to be very Canadian – that is, polite.

But a private meeting is something else. Pension funds and mutual funds have the financial and human resources to monitor and research corporate activities. They have the expertise to discuss issues candidly with the directors.

But it is just as important to ensure that individual investors have the opportunity to better understand the companies in which they invest.

We believe securities regulators should require plain English and succinct reporting of financial results and other important information.

In my days in the U.S. insurance industry, our contracts had to meet a readability test.

It can be done.

Warren Buffet's Berkshire Hathaway issues a nine-page information circular that anyone can read and understand. He even answers questions from shareholders for 4 or 5 hours.

But over at Nortel the information circular requires 55 pages. Now, I wonder why. Legal mumbo-jumbo may have its purpose – and it is never good (?).

This is an issue that all directors ... along with the CICA, the OSC and institutional investors ... should insist on. Transparency should mean clarity.

In the interests of transparency ... companies should be required to publish the results of all shareholder votes at annual and special shareholder meetings.

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(Pause)



I hope what I have discussed today does not come across as dogmatic. We don't have all the answers and recognize the need to be adaptable to a particular company's history and circumstances.

What I wanted to illustrate is the scope and flexibility of introducing better governance practices.

The era of structural and cosmetic change is behind us. It's time to get serious about corporate governance and bring about change that matters.

Simply put, institutional investors have to act forcefully in the best interests of Canadians on whose behalf they invest.

Let me close with a summary of suggestions for institutional investors, corporations and governments.

First, all fiduciaries should vote the shares they hold – and report on how they voted to those for whom they invest. This applies as much to mutual funds, banks and insurance companies as it does to pension funds.

Second, corporations should be required to report the results of each shareholder vote within one day of the annual general meeting ... if not the same day.

Third, governance committees should seek the active involvement of their institutional investors in recruiting independent directors.

Fourth, all directors should invest their own money in the shares of companies they govern. Nothing aligns the director and shareholder interests quite like having real money on the line.

Fifth, the board should have regular sessions in the absence of management.

Sixth, Canadian regulators should work with the CICA to promote the best accounting standards ... as opposed to the least offensive.

Regulators should find independent individuals who are more than securities or financial specialists to oversee compliance.

It is heartening to see an OSC panel reject a penalty for insider trading negotiated by staff.

We need more common sense outrage and less clubby negotiation behind closed doors.

Seventh, all press releases should be based on GAAP earnings – and the releases should be approved by both the auditor and audit committee.

Eighth, annual reports, quarterly reports and proxy circulars should be written in clear language that makes sense to ordinary investors. Claims of sophistication and complexity are not an acceptable defence for obfuscation.

Ninth, auditors should not be allowed to earn other fees of any kind from the companies they audit.

Tenth, laws should be changed to make share ownership and options tax neutral.

And finally, the cost of options should be clearly charged on the P&L and disclosed in the financial statements and should be deducted from income.

We are writing to every TSE company asking them to do this voluntarily. We are also asking other large pension funds to join us in this campaign.

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In addition, we are also in the process of developing a scorecard for the governance of each corporation we own.

These are my suggestions to further advance governance practices. Good corporate governance matters to all of us.

But let's not kid ourselves. Investor confidence has been badly shaken by incompetent corporate governance. It's time for investors to shake back.

Every shareholder should question the performance and ethical commitment of corporate leaders as well the best governance efforts of regulators, institutional investors, accountants and corporate lawyers.

If shareholders do not exert their right to force change, the capital market system we take for granted will be in jeopardy.

And what is most surprising ... it doesn't take much money or effort to implement change.

All it takes is a determined attitude.

Thank you.

