# Caldwell Securities Ltd.

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## When it comes to Enron, we are still missing the point.

The numerous inquiries, investigations and exposés will provide us with all - indeed, more than all - we need to know regarding the "how" of the Enron debacle. "How" the guardians at Enron failed is clear - they ignored their primary responsibility to shareholders and the investing public.

The real question is "why." The answer is not hard to find, but the ramifications reach into all corners of U.S. public enterprise.

The genesis of many corporate failures and longer-term underperformance likely lies in the absolutely insane levels of management compensation based on stock options, which by definition is related to shorter-term share price performance. How smart does one have to be in order to be earning in the hundreds of millions of dollars managing a major corporation? Let me assure boards of directors that many very successful large corporations get by with chief executive officers making single-digit millions.

The problem with massive compensation schemes based upon share price performance is one of focus. You don't build great companies with a quarter-by-quarter desire to beat the "whisper estimates." Any competent manager will confirm this, along with the probability that long-term growth will be hampered. Given that CEOs with massive stock options are paying more than passing attention to their company's share price, inordinate concern arises about the optics of financial statements and the impact or timing of negative news releases. In short, when CEOs have massive amounts of their personal net worth riding on their company's share price, managements often begin to run the organizations for themselves, rather than for the longer-term benefit of investors. Truth, however so slightly, becomes a casualty in this process. And once the CEO is compensated at wildly inflated levels, the problem starts to spread.

Financial officers now come under pressure to put their best financial foot forward. Pesky little items that could affect stock market perceptions are buried in small print notes at the back of the statements or simply made to go away. The pressure here is intense yet subtle, and the resultant little white lies are often never found. Problems arise only when many of them start to add up.

Boards of directors are also clearly failing the system. The fact that many are friends of management and are now granted significant stock options along with other major perks, puts them in the same position as the CEO and the management group. The price of the company's shares during the option time frame now becomes of inordinate interest to this group as well. News releases are often spun to put the best corporate face forward.

Once compromised as to their focus and commitment as shareholder guardians, directors tend to "go along" with managements. Auditors, too, come in for their share of the blame. Although much is being revealed about Arthur Andersen's conflicts and actions, it should be noted that auditors have not, in recent memory, ever provided timely information in a form that would protect public shareholders from disaster. The wording of many notes provides only vague indications that there might be "something" that warrants investigation. Only sophisticated analysis and penetrating questions can glean hints of potential disasters.

Investment analysts have also failed to guard the shareholder. Both retail and institutional investors have become focused on reducing the commissions they pay to brokers and investment advisers. This false economy has, in great measure, resulted in the investment analysis function being usurped by corporate finance departments. Corporate finance clients get the service, the benefit of the doubt and the opportunity to present their cases. They are often the real clients in this process, not Mr. or Mrs. Smith or even the large institutional investors.

Bankers used to provide some degree of check on the system. Now, however, commercial bankers are also investment bankers. Again, the motivation to "go along" is significant, since no major bank would wish to lose major underwriting or corporate finance fees. It is far easier and far more profitable to sell an equity issue to underpin problem loans.

In short, the guardians, CEOs, chief financial officers, directors, auditors, investment analysts and bankers have ever so slowly changed their focus, and they simply are not performing with the commitment and gusto required to protect wider shareholder interests. A return to their fiduciary responsibilities cannot be legislated.

To truly address the wider issues involved here, we have to go back to the beginning. The net result of our guardians not living up to their responsibilities is a lack of credibility in the information provided to investors. The damage to markets and our economy is just beginning to be felt. Confidence and credibility are central to the functioning of our capitalist system.

At the CEO level, greed can be destructive to both the corporation and the overall environment in which it functions. The master of all should be the servant of all.

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