

# **Good Governance and Social Responsibility**

## **Lecture 8: Agency Problems and Accountability of Corporate Managers and Shareholders**

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## Lecture Learning Objectives:

At the end of the lecture, you will be able to:

1. Recall the agency problem in corporate governance.
2. Enumerate and explain the principal-agent specific issues.
3. Enumerate and elaborate on the identified agency problems in corporate governance.
4. Ascertain the significant differences among the types of takeovers.
5. Show the important roles the external bodies serve to improve corporate governance.

**"The way I calculate it, while I gained \$139 million (in options) I created about \$37 billion of wealth for shareholders."**

**- Dennis Kozlowski (rationalizing his pay)**

## INTRODUCTION

The debate over corporate social responsibility is often vague or unrealistic or both. The participants speak in terms of how corporations ought to be run without specifying the legal changes that will produce these results. When **social responsibility advocates** recommend legal fixes, they typically focus on their aspirations for how these changes will function without fully analyzing how the proposals will actually operate in the context of real-world constraints on governing large firms.

The relevant legal issues for corporate social responsibility concern whether and to what extent legal rules should mandate or restrict mechanisms of corporate governance in order to ensure that corporate managers act in society's interests rather than those solely of the shareholders. It is helpful to begin the analysis by delineating what the relevant questions do not concern.

**First**, although social responsibility is often referred to as a "**corporate**" **concept**, it has no coherent meaning detached from the specific mechanisms by which corporations are governed.

**Second**, the legal issue is not whether the corporation or any of the individuals who manage it should care about society. There may be strong ethical or moral arguments for socially responsible governance. The question addressed here is whether the law should mandate such governance, given lawmakers' inherent limitations, the potential costs of legal rules, and disagreements about appropriate social objectives.

**Third**, there is no question whether the parties to the firm may contract to take society's interests into account. The question is the extent to which the law should mandate contracts intended to produce more socially responsible governance or prohibit contracts that constrain socially responsible management.

**Fourth**, the specific question regarding corporate social responsibility is not whether the managers should maximize profits, but rather in whose interests they should manage. Managers can promote shareholders' interests without maximizing profits to the extent the shareholders have some objective other than profit maximization.

The argument for laws intended to ensure more socially responsible management is that corporate managers who are forced to respond to shareholders' interests may not maximize social welfare.

**Social responsibility theorists** argue that markets alone cannot adequately discipline corporate conduct, and that regulation of corporate conduct does not redress all social harm because these harms are difficult to detect, regulation is difficult to design, and sanctions may be ineffective. **Shareholders** care only about profits in the narrow accounting sense rather than social welfare and take no moral responsibility for social harm. Advocates of more socially responsible governance accordingly argue for empowering or compelling managers to run their companies with a view to society's interests as well as those of shareholders. **Directors** are "mediating hierarchs" who do, and should, respond to the interests of the various parties to the corporate contract, including creditors, suppliers, and workers. One response to this argument is that society's interests are not as inconsistent with those of shareholders as social responsibility theorists assume. Markets can reflect political and social tastes and socially-relevant information. It follows that managers who closely attend to shareholders' interests have incentives to maximize social wealth.

Another response concerns the costs of legally compelling socially responsible governance—that is, of reducing managers' accountability to shareholders. **Berle and Means** argued seventy years ago that the central problem with corporate governance is that corporate managers are essentially free from effective shareholder discipline.

Enron and other notorious corporate scandals demonstrate that this agency's cost problem has not disappeared. Substantially restructuring corporate governance to reduce managers' accountability to shareholders could exacerbate these problems. Adopting recommendations by some commentators to make managers accountable to non-shareholders could have similar consequences because empowering stakeholders leaves managers effectively accountable to nobody.

If corporate managers should not be made significantly less accountable to shareholders, the remaining corporate social responsibility issue is whether firms ought to be able to make them more accountable to shareholders. The initial question is whether such a move is feasible. The governance of large corporations is based on the general principle of "**director primacy**" which reposes basic management power in corporate directors. The conventional mechanisms for controlling this power—shareholder voting, fiduciary duties, and the market for corporate control—all have significant gaps that inhere in the difficulty of controlling managers' discretion in publicly held firms.

One type of accountability mechanism that might be considered is to weaken managers' grip on the firm's cash through partnership-like devices that mandate distributions and permit dissatisfied owners to cash out. These mechanisms have not been used as tools of public corporation governance at least partly because the effect of tax makes distributions to owners unattractive. Other factors also may play a role, including large firms' need for financing flexibility in the light of changing business needs, which in turn may require that managers decide distributions. In other words, greater managerial accountability to shareholders might be infeasible because it would increase operating costs more than it would reduce agency costs. If so, it is unnecessary even to reach the issue of whether these mechanisms are otherwise socially desirable.

An **agency problem** occurs when the interests of stockholders, the board of directors, and/or the management of the company are not perfectly aligned or when these entities conflict. In **publicly held companies**, there are a variety of individuals with an interest in the performance of the company. The **managers and executives** who run the company on a day-to-day basis, the **shareholders** who own stock, and the **board of directors** who oversee the company's business development all may have different aims or ideas of how the business can be run.

**Executives** of a corporation, for example, may be interested in achieving good long-term growth of the company. Since their performance is measured by how the company does in both the short term and the long run, the decisions they make are based on the goals of generating profit both now and in the future. This may mean they wish to engage in capital expenditures now to secure a possible benefit or gain in the future.

## **AGENCY PROBLEM IN CORPORATE GOVERNANCE**

**Agency theory** suggests that the firm can be viewed as a loosely defined contract between **resource providers** and the **resource controllers**. It is a relationship that came into being occasioned by the existence of one or more individual's called **principals**, employing one or more other individuals, called agents, to carry out some service and then entrust decision-making rights to the **agents**. In a corporate context, the **key agency relationships** are those between stockholders and BODS, Executives, and managers. Recent laws in response to corporate financial accounting scandals in the U.S. and other countries however redefined these relationships in a more specific way. There now exists a cascading nature of principal agent relations. For instance, **shareholders** are the principal of the board of directors, **board of directors** on the other hand are principal of the executives, managers, and auditors.

## **PRINCIPAL-AGENT SPECIFIC ISSUES**

### **Diversification vs. Dividends**

Use of free cash flows which are by description, resources of the principal generated after investment in all projects, managers prefer this fund to be invested in additional product diversification while shareholders prefer the funds to be declared as

dividends so long as it is backed by income. **Control on how the available funds will be used or invested** is another example of an agency problem.

### **Managerial Opportunism**

There are examples or instances wherein shareholders return will not be maximized to the fullest because of unrelated diversification and growth which leads to increased compensation for managers not to mention that it reduces the employment risk of top managers. This explains why we see some subsidiary companies that are still alive even when they are becoming more of a liability than an asset to the holding company because some officers and managers want them to be there; "it is hard to let go of these management fees." Without the watchful eyes of the advisers, we cannot expect that all of these facets can be seen by the shareholders or even by the majority shareholder himself.

### **Power Supremacy vs. Technical Expertise**

Some of the corporate investors, especially institutional investors, are just putting their money with the expectation of dividends at a certain time. It is not that these shareholders don't know how to run their own corporations; it is just that they have excess funds, and they want to have productive placements of these funds. The nature of their intention made them rely only on the expertise of the agents. What is left to the shareholders is supreme power over the corporation, which is rarely being talked about and sometimes not an issue from the operating point of view. It is a clear picture of agents doing the real things and principals waiting for the ultimate result.

### **Trust**

Another specific agency issue is **trust**. **Shareholders** have more trust than doubts to the agents and they are entrusting everything as far as operation including the charting of the corporation's future to its directors and officers. It is the kind of comfort that agents are taking pleasure from that would sometimes make them lose their balance. This failure in balance is one of the essential components of managerial opportunism, the prevailing agency problem.

## **IDENTIFIED AGENCY PROBLEMS**

### **Adverse Selection**

Another identified problem in principal-agent relationship is the **insufficiency of information** that is normally obtainable to the principal and to the agents; this is the core concept of adverse selection. **Agents** (executives and managers to be in relation to the board of directors) present their working paper in résumés; they discuss their qualifications in interviews, **principals** screen the agents to be, most of the screening process is actually anchored on the information provided by the agents. Based on such information, the principals decide whether such agents are accepted or not for positions. In some cases, such **résumés** are later found to contain inaccurate information, or versions made in interviews are later documented as not the same as what is desired in real performance.

**Insufficiency of information** may also be done by the principals through misrepresentation of information or providing incomplete or half-cooked information. Principals in interviewing prospective accountants, for example, may affirm that high ethical standards are to be maintained in processing as well as in reporting financial information to shareholders. Based on this representation, agents believe it as something so consistent with their training and beliefs. Unfortunately, some of them will find out later that what has been said is not really happening. Corporate agents in accepting positions as accounting or finance managers are sometimes just being informed that the company figures must reflect a specified level of profit at the end of the fiscal year, regardless of what the actual accounting records reflect. The words of the principal during the initial interview are not supported with actual events or the principal in this case is becoming inconsistent by trying to influence the financial figures.

### **Agency Costs**

Resources to be sacrificed to keep an eye on things that are perceived or need to be closely controlled from the perception of the principal are significant costs in a principal-agent relationship. Since the principal is delegating power and responsibility, cautious principals will carry out some type of monitoring activities to have reassurance that decisions are most favorable from the point of view of the principal. These activities include reports, observation visits, supervision and third-party assurance like compliance audit and external financial statement audit. None of the mentioned activities are cost-free.

When the above efforts of the shareholder to alter the managerial behavior are not present, there will normally be some loss of shareholder wealth due to inappropriate managerial actions. On the other hand, **agency costs** would be excessive if shareholders would attempt to ensure that every managerial action is in accordance with shareholder interests. Therefore, the most favorable amount of agency costs to be borne by shareholders is determined in a cost-benefit context; **agency costs** should be increased as long as each incremental peso spent results in at least a peso increase in shareholder wealth.

### **Conflict of Interest**

Agency theory pulls an essential problem in organizations and that is conflict of interest. A corporation's managers can or may have personal objectives that compete with the owners' objective of maximization of shareholder wealth. Because the shareholders authorize executives and managers to manage the firm's resources, a potential conflict of interest exists between the two groups.

In the majority of large publicly traded corporations, **agency conflicts** are almost certainly considerable, because the firm's managers generally own only a small percentage of the common share. Therefore, shareholder wealth maximization could be subordinated to an assortment of other managerial objectives. For instance, managers may have the **primary objective** of maximizing the size of the firm. In creating a large, swiftly growing firm, executives increase their own status, create more opportunities for lower- and middle-level managers, improve the status of salaries, and enhance their job

security because an unfriendly takeover is less likely. As a result, current management may push for diversification at the cost of the shareholders who can easily diversify their individual portfolios simply by buying shares in other companies, agents in this case are creating leverage out of shareholders' (principal's) resources.

**Managers** can be encouraged to take action in the in shareholders' best interests through incentives, constraints, punishments and other control mechanisms. These methods are effective only if shareholders can closely monitor all of the actions being undertaken by the managers. However, if close monitoring is infeasible, this might lead to a **moral danger problem**. It is a problem where agents take unobserved actions against the principals' interests because it is impracticable for shareholders (principals) to monitor all managerial actions performed at the different levels in the organization. To reduce the moral danger problem, shareholders (principals) must incur agency costs to monitor the agent's activity.

### **Legal Requirements vs. Opportunistic Behavior**

The culture of opportunism as manifested by excessively paid executives and managers combined with the financial accounting scandals in US companies presented a very strong reflection of the ineffectiveness of principal-agent relationships and the massive deficiency of the current agency theoretical efforts and practices. As a consequence of the surge of scandals in the decade prior to 2002, the U.S. Congress enacted the Sarbanes-Oxley Act of 2002, which imposed new regulations on public companies and their auditors. Such rules are understood to be effective in making sure that executives fulfil their obligations in doing things expected from them, protection of the principal or the investing public is just one of them.

This law not only strengthens the protection of the investors (shareholders) but also affects the hierarchy of principal-agent relationships: **shareholders** are principals of public companies, and their **immediate agents** are boards of directors. **Boards of directors** are principals; their **agents** are the executives selected to carry out policies and the independent auditors they engage to audit the financial statements of the company. The principal-agent relationships continue to lower levels of organizations.

### **Self-Interested Behavior**

Agency theory suggests that, in imperfect labor and capital markets, executives and managers will seek to make the most out of their own value at the expense of corporate shareholders. **Agents** have the capability to operate in their own self-interest rather than in the best interests of the firm because executives and managers know better than shareholders whether they are capable of meeting the shareholders' objectives or not. Another issue which tempts self-interested behavior is the **absence of clear and compelling evidence** that it is the agents that is at fault or responsible and consequently to be blamed or be crowned on the final outcomes of the organization positive or negative. This reality can lead to maverick behaviors of some BOD or executives which if not checked by the principals, may spin out of control and the next thing the shareholder may know is that the agents got more than the shareholders rightfully deserved.

Proof of self-interested executive and managerial behavior includes the consumption of some corporate resources in the form of stratospheric privileges, unrelated diversification. Apparent effort of trying to avoid optimal risk positions, whereby risk-reluctant managers bypass profitable opportunities in which the firm's shareholders would wish they invest in; BODS and executives sometimes prefer to be secured in a status quo instead.

This can lead to a conclusion by outside investors that the firm will make decisions contrary to their best interests. For that reason, investors will be unwilling to pay the real market price of the firm's securities; instead, investors will only pay the firm securities at a discount.

## **Remedies Within Shareholders**

### **Proxy Voting**

Under the law, a shareholder has no right to cast votes by proxy in shareholders' meetings without special authority given by the supposed voting shareholder. The solution is by **proxy voting** which refers to an exercise of voting on behalf of shareholders through the use of a special authority given by the shareholder/principal. In this process, the one who would cast votes would either by another shareholder or a fund manager. For practical reasons, **proxy voting** is normally used in corporations by voting shareholders, for it permits shareholders who have confidence in the judgment of another shareholder or investment and fund managers to vote for them. It also provides the required quorum of votes to undertake important corporate undertakings.

In corporate settings, proxy voting's use is normally limited to voting at the annual meeting for directors, for the sanctioning of acts of the directors, for the increase or decrease of capital, and for other crucial amendments in the policies of the organization. These proposed amendments and changes are summarized in the memorandum circular sent to shareholders before the annual shareholders' meeting. The **stock-transfer book** will be closed at a certain number of days before the annual shareholders' meeting to give time for the corporate secretary to prepare a list of stockholders and the number of shares held by each shareholder. Then, voting will be based on shareholdings of each shareholder shown in the stock book. Shareholders with proxy arrangements are listed and all proxies are then checked against this list.

In proxy voting system, in the absence of the principal from the annual meeting of a business corporation, the proxy, being given the authority, has the right to vote in all instances, but the proxy is not having the right to debate or otherwise participate in the proceedings since this is outside of the authority given to him. The right to argue participate in the proceedings is reserved only if you are a voting shareholder of the corporation.

### **Benefits of Proxy Voting**

The following are the **areas where proxy system accrues benefit** to the principal/shareholder more especially if the proxy is a fund manager:

- **Routine Decisions**

Investment and fund managers serving as proxies will generally vote for uncontested director or trustee nominees, other minor things like changes in company name and other procedural matters related to annual meetings. These are examples of things that are not practically sensible for all the stockholders to be present and vote on the above concern.

- **Governance**

Proxies especially fund manager will generally vote for charter and amendments of by-laws, on matters related to compliance with applicable laws and regulations affecting the organization.

- **Issues on Anti-takeover**

Proxies and fund managers normally will vote for proposals that necessitate shareholders' confirmation of anti-takeover measures and proxy system provides a swift and effective way of piling up these poison pills. Considering that proxy's right is specific, once poison pills are there, it can never be redeemed by the company through the use of proxy unless another separate authority to do so is given by the principal. Proxies in this situation will be serving working horses on anti-takeover concerns.

**Proxy system** is not without negative implications. **Proxy voting** is said to lack deliberative features due to the limited authority and instructions given by their principal/shareholder. Thus, proxies cannot modify their decision on the deliberation process; a process where strengths and weaknesses of the arguments as well as counter arguments are theoretically tested.

### **Derivative Suit**

A **derivative suit** is a lawsuit filed by a shareholder on behalf of the corporation against a third party. More often, the **third party** referred to here is an insider of the corporation, directors, and other senior officers of the company. A **shareholder derivative suit** has this unique feature in the sense that under the corporation law, the management which is composed of directors, officers and other senior managers are mandated to be partly responsible in bringing and defending the corporation against the suit. In the case of derivative suit, it is the stockholder who will initiate the suit in cases where management has failed to do so.

### **Specific Feature**

While, under the **Corporation Code of the Philippines** shareholders are the owners of a corporation but for practical reasons, they are not empowered to manage the day-to-day operations and other routine concerns of the corporation. Instead, shareholders appoint directors, and the directors in turn appoint executives and high-ranking managers. A **derivative suit** allows a shareholder to bring an action in the name of the corporation against the parties that may cause or are allegedly causing harm to the

corporation. When the directors, officers, managers, or employees of the corporation are not keen on filing an action, a shareholder may first petition them to do so. If such petition is unsuccessful, the shareholder may do it himself to bring an action on behalf of the corporation. Any reward monetary or otherwise of a successful action will be awarded to the corporation and not to the individual shareholders that initiated such action.

### **Process**

In initiating this action, a shareholder must satisfy various requisites to prove that he has a strong and valid status before being permitted to proceed with the action. The shareholders may be required to meet some qualifications. One of these qualifications might be the minimum value of his holdings in the corporation and the minimum duration of his being a shareholder. In addition, the shareholder who is about to initiate the action may be required to post a bond or other fees to compensate whenever his action is unsuccessful.

### **Takeover**

**Corporate takeover** is the "general term" referring to transfer of control of a firm from one group of shareholders to another group of shareholders. Change in the controlling interest of a corporation, either through a friendly acquisition or an unfriendly, hostile, bid. A **hostile takeover** (with the aim of replacing current existing management) is usually attempted through a public tender offer."

### **Types of Takeovers**

#### **- Friendly Takeover**

Before a bidder company makes an offer for another company, it usually informs first the board of directors of the company to be taken over. When the board thinks that accepting the offer serves the shareholders interest better, it then recommends the said offer be accepted by the shareholders.

In closely held or privately held companies, since the shareholders and the board of directors is usually the same people or closely connected with one another, private takeovers are normally friendly. If the shareholders are in agreement to sell the company, then the board is usually of the same mind or sufficiently under the command of the equity shareholders to cooperate with the acquiring company.

#### **- Hostile Takeover**

A hostile takeover permits the "acquirer to be" company to bypass the target company's management if it is uncooperative and unwilling to agree to a merger or takeover. A takeover is regarded as "hostile" if the target company's board casts off the offer but the "acquirer to be" is persistent to pursue it. It can also be considered hostile if an offer was made without informing the target company's board ahead of time.

A hostile takeover can be done in **several ways**, the following are some of these:

1. By making a **tender offer** whereby the acquiring company makes a public offer the price of which is way higher than the current market price making it hard for the existing shareholders to resist.
2. By engaging in a **proxy fight** whereby the acquiring company persuades enough shareholders, usually a simple majority is sufficient, to replace the management with a new one. This new management will be installed purposively to approve the takeover.
3. Another is **by quietly purchasing enough stock in the open market**, known as a "**creeping**." The purpose of this is to gather enough holdings that can somehow influence the decisions within the corporation. A 20% shareholding is already significant enough for one voice to be heard and influence management.

There are risks involved in hostile takeovers considering that in this type of takeover, the acquirer to be or the bidder knows only what is publicly available, and what is publicly available may not be all true or given that it is all true, are all things ought to be made public are really reported? One of the dangers of a hostile takeover is that, if there is such as "**poison pill**" in a takeover issue, there can also be "**landmines**" being planted by the old management before they go and have the burden of clearing it be left to the new management. This is one of the reasons why banks and other financiers are less willing to back hostile bids because of the level of risk involved.

#### - **Reverse Takeover**

**Reverse takeover (RTO)** is a type of merger used by private companies to become publicly traded without passing through an **initial public offering (IPO)**. At first, the private company buys large portion of publicly traded company's share enough to control the publicly traded company. The private company's shareholders then use their shares in the private company to exchange for shares in the public company. At this point, shares floating will now be the private company's share and the private company has effectively become a publicly- traded one. This takeover is also known as a "**reverse merger**" or "**reverse IPO**,"

With "**reverse merger**" or "**reverse IPO**", the private company has saved itself from paying expensive fees related to an initial public offering. RTO, however, is not all good side considering that the company does not acquire any additional funds through the merger transaction, the company should have enough funding for the company to complete the transaction on its own.

#### - **Tender Offers**

A **tender offer** is a corporate finance term which means a type of takeover

proposal that is public and open invitation, usually coursed through media by a prospective acquirer to all stockholders of a publicly traded corporation ("acquired to be") which is the target corporation. The **tender offer** typically involves approaching a current shareholder and making an offer for all or part, normally the majority, of the held shares. Shareholders of the target corporation will be given an offer to tender their stocks for sale at a specified price during a specified time. In this type of takeover proposal, the bidder/acquirer communicates directly to the stockholders of the target company and the directors of the target company may not necessarily endorse the proposal.

**Tender offers** are efforts to secure outstanding shares of stock of a given company through means other than purchasing the traded shares in the open market. Intentionally to make the tender offer attractive, the purchase price is set above the current market value. To persuade the shareholders of the target company to sell their holdings, the acquirer will offer price usually includes a premium on top of the current market price of the target company's shares. For example, if a target company's shares are trading at P20.00 per share, an acquirer might offer P24.00 per share to shareholders with the clause that at least majority of the shareholders agree.

The employ of a tender offer is a familiar approach when an individual or entity is kicking off a takeover bid. **Takeover bids** may be conducted for a variety of reasons; one of which is there may be an interest in acquiring a profitable company and embedding it into a conglomerate as one of the overall corporate growth strategies. A **takeover bid** may also be a tactic to gain control of the assets of the company with motive towards methodically dismantling the operation and selling off the various assets individually for profit.

### **Financing a Takeover**

**Financing a Takeover** is an act of funding for the purpose of obtaining control over a corporation through the purchase of stock or any other means; the process of providing capital for someone to establish control of another corporation.

#### - **Debt Financing**

In principle, a company acquiring another pays a specific amount of money for the merger transaction to complete. This money can be raised in several ways. While the acquiring company has enough money to finance the transaction, some acquiring company chooses not to bleed out its cold cash for this. Usually, to finance the takeover, it will borrow from a bank or raise the funds needed through issuance of bonds. This acquisition which is financed by debt is known as leveraged buyouts and the debt will usually be booked in the balance sheet of the acquired company. The acquired company then has to pay back the debt. This technique is often used by private equity companies to lessen the impact of cash flows at the same time. Debt financing could reach as high as

80% of the purchase price leaving only 20% to be raised internally by the acquiring company.

- **Partial or Full Equity Conversion**

This is done by giving the shareholders of the target company offers that include a debt instrument in partial or in full payment of shares. This arrangement is attractive compared to a spot cash transaction from the taxation point of view considering that spot cash deals, being treated as disposal are open and exposed to taxation (capital gains tax which is 6%). This tax exposure is partly sheltered if transactions will be in the form conversion from equity to debt making the once shareholders a debt investor of the corporation.

- **Share Swap/All Share Deal**

In a takeover, sometimes the transaction can entirely be financed by a share swap or all share deal. There will be no money involved; instead, the bidder company issues its own new shares to the shareholders of the "acquired to be" company. In this case, the acquiring company will end up as the majority shareholder and have control over the company's crucial issues. The shareholders of the company being acquired, being the minority, may still have significant influence over the merged entities. Influence may include management rights in the merged companies, board and executive seats, and personnel contribution.

## **EXTERNAL FORCES AFFECTING GOVERNANCE**

### **COMPETITORS**

**Competitors** refer to corporations and other business entities, private or public, offering the same product or services that the company is offering. This affects governance considering that, in the eyes of the investors, the best run business is the most attractive for investment. **Competition** makes the corporation on guard on what to do for itself to gain competitive advantage over its competitor and at the same time, scout for things that would make your competitor at a disadvantage.

### **FINANCIERS**

A **financier** is a term given to a person or entity who manages routinely huge amounts of money. This person or entity is usually involved in the activity of lending money, project financing, large-scale investment or large-scale management of money. **Financiers** affect company's governance in the sense that being the fund provider, financiers want reputation to protect, and this may mean that the company will be around for a longer period of time.

### **REGULATORY AGENCIES**

**Regulatory agency**, in general, refers to a public authority or government agency responsible for exercising autonomous authority over some area of corporate activity in a regulatory or supervisory capacity. An **independent regulatory agency** is a

regulatory agency that is independent from other administrative law regulations; that is enforcing rules and regulations and imposing supervision or oversight for the benefit of the public at large.

**Regulatory agencies** are more often than not a part of the executive branch of the government or have statutory authority to perform their functions with oversight from the legislative branch such as Congress. Their actions are generally open to legal review. Regulatory authorities are commonly set up to enforce standards and safety, to oversee the use of public goods and to regulate commerce.

## **WATCHDOGS**

**Watchdogs** refers to independent organizations trying to police a particular industry or corporate conduct to make certain that the activities of these companies are accordance with the acceptable standards and existing laws.

## **PREDATOR COMPANIES**

**Predator companies** refer to corporations that are always on the watch and waiting for a change to take-over a certain company, be it via friendly or hostile takeover.

## **INFORMATION ENHANCERS, PROVIDERS AND GATEKEEPERS**

"Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified."

– John C. Coffee "Understanding Enron: It's about Gatekeepers, Stupid"

"The failure of this network of gatekeepers was a recurring theme in the business scandals. In too many instances, the gatekeepers in pursuit of their own financial self-interest compromised the values and standards of their professions..... In the recent round of corporate scandals, the first tier-the managers-failed, and then the gatekeepers failed as well."

- AAA&S, Report of the American  
Academy's Corporate Responsibility Steering Committee

**Gatekeepers** refer to independent third-party persons or entity whose cooperation is important because they have the capability to at least deter, if not prevent misconducts of corporations. Examples of gatekeepers are accountants, lawyers, bankers, analysts, rating agencies and examiners. The aforementioned entities and people are considered gatekeepers to financial markets by providing information on investment and business concern to investors and fund providers. In the past decade, independent accountants have been accused not only of being aware of accounting irregularities but even of aiding and indirectly supporting the violators.

Arguably the most notorious corporate scandal in modern times, "The Enron Scandal" is one good example of the gatekeepers' failure. The firm, Arthur Andersen, is even suspected of putting more emphasis on hauling its more profitable professional engagement with the company than on confirming that the company's financial records and reporting were in order. Gatekeepers' role is very important especially during this

time wherein the number of investors in financial market have increased. Some of these investors are not technically well-versed in financial things exposing them to real risk. Mitigating this risk means that they will be dependent on information provided by financial gatekeepers.

To make the responsibility legal for those who are in-charge with governance as well as to third parties (gatekeepers) and the same protect the investing public, the U.S. Government enacted the Sarbanes-Oxley Act. In all practical terms, this law was actually the by-product of a series of large corporate scandals; Enron and WorldCom are just two of them. This act regulated with muscular intent the auditing and accounting industry in two ways. One, it requires a certification from the CEO that the financial statement provided by the company is reliable. This way the company's management cannot funnel down all the blame to the auditors and other gatekeepers for undetected fraud and other irregularities. This law also increases penalties for corporate fraud and irregularities. It also outlines the cascading responsibilities from the Board to other officers and eventually to gatekeepers.

In the current Philippine setup, it is a requirement that company's financial statements which are filed with the **Bureau of Internal Revenue (BIR)** and the **Securities and Exchange Commission (SEC)** be accompanied with a **Statement of Management Responsibility (SMR)**. In this statement, the management acknowledges all the responsibilities contained in the financial statement including its compliance with the applicable laws and reporting standards.

## **INVESTMENT BANKERS**

An investment banker is an individual or entity which acts as an agent for a corporation issuing securities. Some also maintain a brokerage or dealership operation and offer advisory services to their clients on investment concerns. These entities also have a large role in assisting interested parties in mergers and acquisitions as well as in debt restructuring. Investment bankers are different from the traditional banks in that the latter does not accept deposits and provide loans to individuals or corporations.

### **Roles of Investment Banker**

In time when corporation issues and sells new securities to increase funds, the offering is called **primary issue**. The agent responsible for finding buyers for these securities for sale is called the investment banker. **Investment bankers** buy primary issues from corporations and arrange immediate disposal of these securities to the investors in public. Generally, investment banking firms perform three functions: **investigation, analysis, and research** (origination), **underwriting** (public cash offerings) and **distribution**. Most of the time, a single investor banker does all the above functions; however, some investment bankers are dedicated in certain functional areas only.

#### **- Origination (Investigation, Analysis and Research)**

**Origination** covers the secondary operations of discovery, investigation, and negotiation. **Discovery** is the finding of a potential issue of securities;

investigation is the testing and analyzing of the investment credit of the potential security issuer including the inherent reliability of the issue; negotiation is the determination of the amount, the price, and the terms of the proposed issue. **Investigation** typically involves an analysis of the financial history of the corporation by accountants and other finance people, investigation of legal factors, ocular survey of its physical property by engineers and other technical professionals, and a thorough review of company's operation. Investigations and analyses are conducted to determine whether a proposed issue has satisfactory grounds to be offered to the public. In a nutshell, the primary function of investment banking is the cautious study of the soundness and reliability of the corporation with the view of bringing its securities to the investment market.

- **Underwriting (Public Cash Offerings)**

**Underwriting** is an arrangement with an investment banker whereby the investment banker agrees to buy the entire issue at a set price. It also refers to the guarantee by the investment banker that the issuer company will receive a certain minimum amount of cash for their new issued securities for sale. The investment banker buys a new security issue, pays the issuing company, and look for buyers of these securities from the public at large. The underwriter's compensation is the difference between the price at which the securities sold to the public and the price paid by the investment banker when it first bought the securities from the issuer company. **Underwriting** can be completed in two ways, first by negotiated underwriting which is the agreed and arranged negotiation between the issuing company and the investment banker. Second is competitive bidding a setup in which the issuing company awards the offering to the investment banker that bids the highest price.

In case where large and risky securities issue is involved, investment bankers pull together to form a syndicate. A **syndicate** is a temporary union of investment bankers brought together for the purpose of selling new securities. Originating house is term given to one investment banker who is chosen to manage and handle the syndicate. There are two types of underwriting syndicates, divided and undivided. In a **divided syndicate**, each member group has the legal responsibility of selling a portion of offerings allocated to them. However, in **undivided syndicate**, each member group is legally responsible for unsold securities up to the amount of its percentage of participation regardless of the number of securities that group has sold.

- **Distribution**

Marketing the security issue is another role of an investment banker. Here, the investment banker acts as a professional firm to distribute securities efficiently for the corporation. The advantage this setup could bring to the issuing company is it saves resources of the issuer considering maintaining a division relating marketing and selling of securities is expensive. As an investment banker, it is expected that the firm has already established marketing and sales network to distribute securities. And for a reputable investment banker with history of selecting

good companies and pricing securities, builds a broad client base over time which further adds to the efficiency that securities can be sold.

**Investment bankers** offer security to both the corporation issuing securities and the investors buying securities. For corporations, **the investment banker** offers an exact price guaranty on a certain date for securities to offer. The issuing corporation runs no risk and should not have any reservations of the market and need not spend on resources with which it is not technically prepared with. To the investor, the responsible investment banker offers protection against dangerous securities. Making a solid and sound issue of securities is the investment banker's business, it is here where its reputation is being harnessed, therefore it can be expected that the firm will take care of it at any cost.

## **STOCK EXCHANGES**

A **stock exchange** refers to an entity which offers trading services and facilities for stockbrokers and traders, to buy and sell shares of stock and other securities. Stock exchanges also offer services for the issue and redemption of securities as well as other financial instruments including other arrangements such as the payment of income and dividends.

The securities traded on a stock exchange include shares issued by companies, derivatives, pooled investment products and bonds. For an entity to trade a security on a certain stock exchange, this entity must be listed in that particular stock exchange first. Typically, there is a central location at least for recordkeeping and control, but trading in this modern time is becoming less and less connected to such a place physically, modern markets and businesses are now infrastructure with high technology; electronic networks to be specific, which gives them advantages in terms of pace and efficiency.

Stocks, bonds, and other securities that are initially offered to investors are by definition done in the primary market and subsequent trading of this is done in the secondary market. A stock exchange is considered as one of the most vital components of a stock market. Supply and demand in stock markets is driven by a variety of factors which, as in all free markets, influence the price of stocks. It is not necessary that issuances of stock and its subsequent issuances should be via stock exchange as parties can agree to have this so called off-exchange trading; the sale, exchange, and other stock related transaction that is not being done in local stock exchange.

### **Role of Stock Exchanges**

#### **1. Raise Capital**

The stock exchange offers companies with the facility to raise capital for expansion and other corporate developmental projects by selling shares to the investing public.

#### **2. Mobilize Savings**

Investing in stock exchange means pulling out money from deposits and

have it as part of circulation. This mobilized money adds more spin or causes multiplier-effect to the economy by promoting business activities which benefit several sectors such as trading, manufacturing, agriculture and services. The bottom line of all of this money invested in the stock market is economic growth and improved productivity levels of firms.

### **3. Facilitates Growth**

Some corporation sees acquisitions as a break to increase product lines, augment distribution channels, protect itself against market unpredictability, increase its market share, or acquire other business it believed an accessory that is necessary to achieve all of the above. The simplest way for the company to step on a takeover bid for merger or acquisition is through the stock market which is common way for a company to grow by acquisition or fusion.

### **4. Distributes Profit**

**Profit** is being shared both by ordinary corporate investors who are willing to wait until declaration of dividend takes place, and to those speculative investors who are practically in the real trade of playing with the price. They are the investors who actually in the "haul **and dump**" business, they buy shares at a certain price and sell these shares when prices increase.

### **5. Improves Corporate Governance**

It is expected that companies that are listed are following a stricter standards and reportorial requirements set by the stock exchanges and the government considering the wide and varied scope of owners, and more importantly, since it involves public interest. In general, companies listed tend to improve on their management standards and efficiencies for them to please these shareholders who have different levels of demands and who are constantly conscious on the return of their investments. Contrast that with private companies (shares of which are not traded publicly) which are often owned by the incorporators themselves and/or their families and are made as a training ground for the younger generations who will soon become heirs. Sometimes these companies are closed and owned by a few investors only thus giving outsiders no chance of becoming a part-owner.

There are documented cases of failure of corporate governance in some companies listed in the stock exchanges around the world during the last decade. They are as follows: Enron Corporation in 2001 (US, Global), WorldCom in 2002 (US), American International Group (AIG) in 2008 (US, Global), Lehman Brothers in 2008 (US, Global), General Motors in 2009 (US, Global) and Satyam Computer Services in 2009 (India). These companies were involved in the most widely publicized corporate scandals, manipulations and tricks perpetrated by listed companies.

These considerable loss of balance in corporate governance by some public companies draws the conclusion that being publicly listed is no assurance

of a "watertight", fully ideal corporate conduct in all circumstances. Nevertheless, it is still a widely accepted idea that stock exchange is really a "nest of better managed companies."

Another facet that supports the contention that stock exchange can, in one way or another improve corporate governance is when a company is known for its poor ethical and managerial track records, and is not an advocate of good corporate governance, investors will definitely avoid the company's share. This will make the shares unmarketable or unattractive, this will cause a sustained decline of share price which may cause it to floor. In stock exchanges, the worse penalty for underperformance is the decline in price and it will be slapped on the shareholders without due notice. The resort available to the stockholder in this case would be dismissal of incompetent management teams. When this happens at least a strong message is sent to the new set of management; one, be concerned about matters involving governance and two, deliver the deliverables.

## **6. Creates Opportunities for Small Investors**

In contrast to other business endeavors that require large capitalizations, investing in shares is open to both large and small investors. There is a minimum amount for someone to trade in the local stock exchange depending on your broker. Once the investor has an account, then he can easily buy the shares he can afford. Also, depending on the type of account established, the investor will be provided various trading features, research, account support and other value-added services. In this context, stock exchange offers the chance for small investors to own shares of the same companies being invested in by the large investors.

## **7. Facilitates Raising Capital for the Government**

The **stock exchange** is also serving as one of the government's avenues to raise funds through issuances of bonds and other papers the latter guarantees. **Funds** raised from these issuances will then be used by the government to finance the operation of different departments of the government all the way down to the bureaus, agencies and LGUs. Debt instruments carry interests. Remember that the government only has two main sources of funds: through taxation and from borrowings.

## **8. Indicator of Economy**

**Stock exchange** is the residence of the advance thinkers of the economy and business. Prices of securities here could rise and fall depending on dictate of the market which traders are on a full-time job of reading it in advance to their advantage. In general, except when there is manipulation, increase of securities prices or prices that remain stable is a good indication that the economy in general is stable and growing. On the other hand, the stock exchange is the only facility that can provide information on a daily basis or even on real-time basis about the general behavior of the stock market.

The ugly head of economic downturn can be spotted right away in the behavior of the market, this can be gleaned from the hard figures in the stock exchange. When there is an impending economic recession, depression, or financial crisis, people don't need to read anything anymore, stock market figures provide more than enough indications. The **stock market** behaves ahead of reality so there is use for technical analysis. For the serious players, like the businessmen, economists, and stock traders, they see these tendencies or behaviors by analyzing the details derived from the stock exchange data.

### **Financial Press**

**Financial press** refers to newspapers, magazines, TV channels, broadcast programs and other media specializing in financial news and updates. Prominent examples include Bloomberg TV and The Financial Times in the US, The Asset in Asia; locally, there is Business Mirror and Business World in print, Business Nightly over ABS-CBN ANC and other program devoted to covering the goings on in the business sector on a daily basis. The **financial press** is important to the overall business sector, more specifically in the financial sector as some companies often publish information on these media. This published information in turn will become the basis for some of their investment decisions. The financial press provides an avenue where the information sources and the information seekers meet.

### **Textbook:**

Good Governance & Social Responsibility, Dr. Christopher Biore, Dr. Roberto Gonzales, Prof. Jose Lemuel Caparas, Dean Nilo Burgos and Prof. Win Ballada, ASEAN (Academicians, Students, Educators and Alliance) Inc.

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