

# **Good Governance and Social Responsibility**

## **Lecture 11: Institutional Investors, Governance Organizations and Legal Initiatives**

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## Lecture Learning Objectives:

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

1. Define institutional investor.
2. Enumerate and explain the different types of institutional investors.
3. Define cross-listing.
4. Enumerate and explain the motives of cross-listing.
5. Explain the role of institutional investors in corporate governance.
6. Name some of the global corporate governance organizations.
7. Address the basic questions concerning investment promotion and facilitation.
8. Cite the reasons for the enactment of the Sarbanes-Oxley Act of 2002 and state its key features.
9. Discuss the challenges confronting institutional investors.

“Being a CEO still means sitting across the table from big institutional investors and showing your leadership and having them believe in you.”

-Christie Hefner

## Introduction

**Corporate governance** is a process that aims to allocate corporate resources in a manner that maximizes value for all **stakeholders**-shareholders, investors, employees, customers, suppliers, environment, and the community at large and holds those at the helms to account by evaluating their decisions on transparency, inclusivity, equity, and responsibility. The **World Bank** defines **governance** as the exercise of political authority and the use of institutional resources to manage society’s problems and affairs.

**Corporate governance** is the set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered, or controlled. **Corporate governance** also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed.

In contemporary business corporations, the **main external stakeholder groups** are the shareholders, debt holders, trade creditors, suppliers, customers, and communities affected by the corporation’s activities. **Internal stakeholders** are the board of directors, executives, and other employees.

**Corporations** are created as legal persons by the laws and regulations of a particular jurisdiction. These may vary in many respects between countries, but a corporation’s legal person status is fundamental to all jurisdictions and is conferred by the statute. This allows the entity to hold property in its own right without reference to any

particular real person. It also results in the perpetual existence that characterizes the modern corporation. The statutory granting of corporate existence may arise from general purpose legislation (which is the general case) or from a statute to create a specific corporation, which was the only method prior to the 19<sup>th</sup> century.

In addition to the statutory laws of the relevant jurisdiction, corporations are subject to common law in some countries, and various laws and regulations affecting business practices. In most jurisdictions, corporations also have a constitution that provides individual rules that govern the corporations and authorize or constrain their decision-makers. This constitution is identified by a variety of terms, in some jurisdictions, it is known as the **Corporate Charter**, but in the Philippines, it is the **Articles of Incorporation**.

### **Institutional Investors**

**Institutional investors** can be described as organizations that buy and sell securities in large volume of share quantities or amounts that made them qualify sometimes for preferential treatment and lower commission cuts. **Examples of institutional investors in the Philippines are the Social Security System (SSS), Government Service Insurance System (GSIS) and the Armed Forces Savings and Loan Association Incorporated (AFSLAI).**

These **institutional investors** may also include operating corporations which decide to invest excess funds or those funds above their liquidity requirements. **Typical investors** included in this classification are as follows: banks, insurance companies, retirement or pension funds, hedge funds, investment advisors and mutual funds. Their role in the economy is to act as highly specialized investors whose competencies are focused on taking care of investments on behalf of others. The good thing about institutional investors is that they manage aggregated sums of money and have these funds invested in different investment prospects which are appropriate, ideal, and favorable to each of the contributors under given circumstances.

These investors are entitled to vote on their shareholdings. With the right, **institutional investors** can play an active role in corporate governance. And, with their significant holdings and war chest at their disposal, their power to make a “to buy” or “to sell” order of the shares the institutional investor and how it conducts its business.

### **Types of Institutional Investors**

#### **Hedge Fund**

A **hedge fund** is an investment account open to a narrow range of investors that take on a wider range of investment and trading activities in addition to traditional long-term investment funds. Every hedge fund has its own investment approach that determines the category of investments and the methods of investment it embarks on.

**Hedge funds**, as a class, invest in a wide range of investments including equity and debt securities, and commodities.

As far as membership, **hedge funds** are available only to sophisticated or wealthy investors who meet certain criteria. These selective membership attributes give this investor incentives. The foremost of this is that **hedge funds** are exempt from many regulations that rule ordinary investment funds. The exemption typically includes limitations on short selling, the application of derivatives and leverage, fee structures, and on the liquidity of concentration in the fund. Lighter guidelines and the existence of performance fees are the distinguishing characteristics of hedge funds.

## **Investment Banking**

An **investment bank** refers to a financial institution that helps out corporations and governments in raising capital by underwriting and acting as the agent in the issuance of both equity and debt securities. An **investment bank** also assists companies involved in business combinations like mergers, acquisitions, and other diversification efforts. **Investment banks** also provide auxiliary services such as market making and the trading of derivatives, fixed income instruments like bonds and other bills, foreign exchange transactions, commodity, and equity securities. The distinguishing feature of an **investment bank** is that it does not accept deposits unlike commercial banks and retail banks.

## **Investment Trust**

**Investment trust** refers to Investors' money being pooled together from the sale of a fixed number of shares a trust issue in its first offering. The board will normally hand over responsibility to a professional fund manager to invest this money in the stocks and shares of a wide range of companies. This is a typical investment endeavor where the entity's money is invested in several placements more than most people could realistically invest in themselves. The **investment trust** often has no employees, only a board of directors comprising only non-executive directors. In recent years, this has started to change, especially with the emergence of both private equity groups and commercial property trusts both of which every so often use investment trusts as a holding company, this strategy is normally used to increase the sources of funds, and consequently enlarge the pipeline of money for wider investment coverage.

## **Mutual Fund**

**Mutual fund** is another institutional investor that is a professionally managed type of collective investment scheme that pools money from many investors and invests typically in investment securities which includes, stocks, bonds, short-term money market instruments, other mutual funds, and securities, including commodities such as precious metals.

This fund is managed by a fund manager that buys and sells instruments and commodities from the fund's investments in accordance with the fund's investment objective. These funds will be overseen by a board of directors or trustees, the body taking charge with ensuring that the fund is managed appropriately by its investment adviser and other service organizations and dealers, all for the best interests of the fund's investors.

## **Pension Fund**

A **pension fund** is a collection of assets forming a separate legal entity that came into being from the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. **Pension funds** are important shareholders of listed and private companies because pension fund is considered as one of the biggest investors in the stock market, any movement of a certain pension fund from one investment to another can definitely be felt by the entire listed community.

## **CROSS LISTING**

**Cross listing** refers to listing of equity shares of a company in more than one stock exchange in different countries. The term can also be used to refer to the listing of a company on more than one stock exchange in the same country: for **example**, in the U.S., there are companies that are listed in both the NASDAQ and in the New York Stock Exchange. Here in the Philippines, we only have one (fused from the original Manila Stock Exchange and Makati Stock Exchange) stock exchange which is the **Philippine Stock Exchange Inc. (PSE)**. U.S. companies may choose to cross-list their shares on different Asian or European stock exchanges as a strategy to address U.S. dollar positioning against major and dominant global currencies.

### **MOTIVES FOR CROSS-LISTING**

By cross-listing and selling its shares on a foreign stock exchange, a firm typically tries to accomplish one or more of the **following objectives**:

#### **To Improve Liquidity**

By cross listing a company can improve the liquidity of its existing shares at the same time, find and support a liquid secondary market for new equity issues in foreign markets. Firms from countries with small illiquid capital markets often outgrow those markets and are forced to raise new equity abroad. In order to maximize liquidity, the firm ideally should cross-list and issue equity in more liquid markets in other countries or regions. The idea still remains, the more source for investors' money, the better for the company.

#### **To Increase Its Share Price**

Another subtle reason for cross-listing is trying to increase the company's share price by defeating mispricing in a segmented and illiquid home capital market. In a more

liquid market or region where share is cross-listed, not only that the company has fresh source of funds but also the company's share marketability is enhanced.

### **To Increase Firm's Visibility and Acceptance**

Cross-listing increases the firm's visibility and acceptance of its customers, suppliers, creditors, and host governments. Cross-listing in the foreign markets gives the company the chance to enhance the corporate image, to expose and advertise trademarks and products, to get better local press attention, and more importantly, to become more familiar with the financial community.

### **To Support Takeover Bids**

Cross-listing can also be viewed as one of the initial steps in establishing a secondary market for shares to be used to acquire other firms in the host countries or markets. In a takeover or business acquisition scenario for that matter, companies offer their shares as partial payment, and it is significantly more attractive if those shares have a liquid secondary market in other regions. High liquidity level in the market can be noted when the firm can issue new securities without any noticeable traces of depression in terms of market price resulting from the new issuance.

### **To Support Share and Options Plan**

Create a secondary market for shares that can be used to compensate local management and employees in foreign subsidiaries. For example, if a company has foreign subsidiaries and wishes to use stock options and share purchase compensation plans for local management and employees, cross listing should reduce transaction and foreign exchange costs for the local beneficiaries.

## **ROLE OF INSTITUTIONAL INVESTORS IN GOVERNANCE**

### **MONITORING**

Close monitoring of corporate performance from institutional investors is expected considering that investments from these types of investors usually involve large amounts of money. Another reason for close monitoring is that the profiles and expectations of these investors are different from ordinary investors. From the cost-benefit standpoint, the costs of monitoring can be easily offset by the expected positive returns.

### **DRIVER OF AGENT'S PERFORMANCE**

When the share of investment by institutional investor is so huge that the balance sheet figure will significantly suffer without its investment, agents in the corporation will at all times, be in pursuit of pleasing its principal in terms of performance. Being a valued investor can, most of the time, command better performance knowing that such an amount of money can be pulled out by the investor anytime and have it invested in another field of interest by the investor or worse, be invested in a competitor-investee.

### **GOOD ACTIVIST**

Institutional investors, especially those whose investment is significant enough to earn a board seat can be the fearless fiscalizers on corporate policies. They are the

representatives who can be the voice of the investing institutions on the board. They can easily ask questions on matters affecting the corporation and of course, they have access to the records as stockholders.

### **PRINCIPAL-AGENT ROLE (DUALITY)**

When an investor has already a huge influence in the corporation, he can have the power to elect the officers for the investee corporation. One scenario is an investor earning a board seat may eventually be elected as the chief executive officer (CEO). In this case, the institutional investor is in the process performing a dual role-the role of being the **principal** (shareholder) and an **agent** at the same time (board member and/or CEO). This unique capability of institutional investors adds security and protection for their investments in the company.

### **DETERRENT TO OPPORTUNISM**

There are a lot of challenges to consider when one engages in activities for purposes of deterring opportunism. One needs something to counter the self-interested behavior of the agents. One of the best antidotes to opportunism is to have a voice on the board. In the corporate world, the level of audibility of the investor's voice may be directly proportionate to the level of investment he is representing. Institutional investor's representative to the board will serve as watchdog. The opportunistic attitudes of the other members of the board will therefore be in-check.

## **CORPORATE GOVERNANCE ORGANIZATIONS**

### **INTERNATIONAL CHAMBER OF COMMERCE (ICC)**

An organization focusing on promoting growth and prosperity, spreading business expertise and advocate for international business. This organization is considered as the voice of the world business championing the global economy as a force for economic growth, job creation and prosperity. **ICC**, the world's only truly global business organization, responds by being more assertive in expressing business views. **ICC** activities cover a broad spectrum, from arbitration and dispute resolution to making the case for open trade and the market economy system, business self-regulation, fighting corruption or combating commercial crime.

### **INTERNATIONAL CORPORATE GOVERNANCE NETWORK (ICGN)**

An investor-led organization of governance professionals, **ICGN's** mission is to inspire and promote effective standards of corporate governance to advance efficient markets and economies world-wide. **ICGN** members are largely institutional investors members who collectively represent funds under management. The breadth and expertise of ICGN members from investment, business, the professions and policymaking extend across global capital markets.

### **ASIAN DEVELOPMENT BANK (ADB)**

**ADB** is an international development finance institution whose mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Headquartered in Manila, and established in 1966, **ADB** is owned and financed

by its 67 members, of which 48 are from the region and 19 are from other parts of the globe. **ADB's** main partners are governments, the private sector, non-government organizations, development agencies, community-based organizations, and foundations.

Under Strategy 2020, a long-term strategic framework adopted in 2008, ADB will follow **three complementary strategic agendas**: inclusive growth, environmentally sustainable growth, and regional integration. In pursuing its vision, **ADB's** main instruments comprise loans, technical assistance, grants, advice, and knowledge. Although most lending is in the public sector-and to governments-ADB also provides direct assistance to private enterprises of developing countries through equity investments, guarantees and loans. In addition, its **triple-A** credit rating helps mobilize funds for development.

### **INTERNATIONAL FEDERATION OF ACCOUNTANTS**

**IFAC** is the global organization for the accountancy profession. It works with its 159 members and associates in 124 countries and jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants. **IFAC** members and associates, which are primarily national professional accountancy bodies, represent 2.5 million accountants employed in public practice, industry and commerce, government, and academe.

### **UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT**

Established in 1964, **UNCTAD** promotes the development-friendly integration of developing countries into the world economy. **UNCTAD** has progressively evolved into an authoritative knowledge-based institution whose work aims to help shape current policy debates and thinking on development, with a particular focus on ensuring that domestic policies and international action are mutually supportive in bringing about sustainable development.

The organization works to fulfill this mandate by carrying out **three key functions**:

1. It functions as a forum for inter-governmental deliberations, supported by discussions with experts and exchanges of experience, aimed at consensus building.
2. It undertakes research policy analysis and data collection for the debates of government representatives and experts.
3. It provides technical assistance tailored to the specific requirements of developing countries, with special attention to the needs of the least developed countries and of economies in transition. When appropriate, UNCTAD cooperates with other organizations and donor countries in the delivery of technical assistance.

In performing its functions, the secretariat works together with member Governments and interacts with organizations of the United Nations system and regional commissions, as well as with governmental institutions, non-governmental organizations, the private sector, including trade and industry associations, research institutes and universities worldwide.

## **ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)**

OECD brings together the governments of countries committed to democracy and the market economy from around the world to:

1. Support sustainable economic growth
2. Boost employment
3. Raise living standards
4. Maintain financial stability
5. Assist other countries' economic development
6. Contribute to growth in world trade

The Organization provides a setting where governments compare policy experiences, seek answers to common problems, identify good practices and coordinate domestic and international policies.

### **INVESTMENT PROMOTION AND FACILITATION**

Specific measures to promote and facilitate investments can be successful if they take place within the context of, and not substitute for, broader policies for improving the investment environment. As a country establishes a sound investment environment, investment promotion and facilitation measures can be useful instruments to attract new investors, especially in smaller, more remote markets or in those countries with a recent history of macroeconomic and political instability. Effective investment promotion also serves to highlight profitable investment opportunities, by identifying local partners and by raising the positive image of the economy.

*Has the government established an investment promotion agency (IPA)? To what extent has the structure, mission, and legal status of the IPA been informed by and benchmarked against international good practices?*

The rapid growth in the number of IPAs reflects the growing importance that governments ascribe to investment promotion. Centralizing foreign investment promotion and facilitation activities, such as information dissemination and policy advocacy, within a single agency can be more cost effective and provides an opportunity to present a coherent impression of a country's attractiveness to investors. The growth in the number of IPAs also means that a rich body of experience has been developed with respect to different approaches to investment promotion agencies and across countries at different levels of development.

Countries that have recently established IPAS, or are contemplating doing so, can use this experience to inform the design of the IPA following international good practices. This approach helps to ensure the full effectiveness of the IPA and to avoid repeating past mistakes.

*Is the IPA adequately funded and is its performance in terms of attracting investment regularly reviewed? What indicators have been established for monitoring the performance of the agency?*

Experience suggests that unless there is a full commitment to investment promotion agencies by the government, they are less likely to succeed in attracting new investors. They need to be adequately funded in order to attract and retain qualified and motivated staff, ideally with private sector experience. Experience also suggests that agencies with links to the center of government and with private sector representation on the board have higher visibility and credibility and hence a better record in attracting foreign investment. They are also more dynamic and adaptable to changing economic circumstances, a critical issue for countries undergoing major economic transformation.

*How has the government sought to streamline administrative procedures to quicken and to reduce the cost of establishing a new investment? In its capacity as a facilitator for investors, does the IPA take full advantage of investors?*

Long delays and costly procedures to establish a new business entity is one of the obstacles to new investment and entrepreneurial activity. Many governments have introduced reforms to quicken and simplify the process of starting a new business. One common approach to this challenge has been the establishment of a 'one-stop shop'. These allow investors to access information on the necessary steps to start or expand a business and provide services to speed up the granting of necessary permits and licenses. 'One-stop shops' also provide easy access to other information that helps to facilitate investment, both domestic and foreign, for instance, on legal and regulatory matters, on financing options, location choice, or recruitment and training. 'One-stop shops' make it easier for the government to centralize the quality provision of these services. This can deliver substantial savings in time and cost to potential and existing investors, thereby facilitating new investment.

*To what extent does the IPA promote and maintain dialogue mechanisms with investors? Does the government consult with the IPA on matters having an impact on investment?*

Investment promotion agencies can play an important role facilitating effective communication between investors and the government. As the interlocutor between the government and the foreign investor, the IPA is often the main source of feedback to government policymakers on the concerns of investors. Conversely, through its regular contact with government and the relevant government agencies, the IPA can be an effective communication channel for investors on government activities having an impact on the investment environment.

*What mechanisms has the government established for the evaluation of the costs and benefits of investment incentives, their appropriate duration, their transparency, and their impact on the economic interests of other countries?*

The use of financial and other incentives to attract foreign investors is not a substitute for pursuing policy measures that create a sound investment environment, for domestic and foreign investors alike. In the absence of a solid investment environment, competition among countries for FDI may lead to no overall increase in investment and divert public resources away from more productive uses. In some circumstances, however, incentives may complement an already attractive enabling environment for investment or serve as a partial rectification for market imperfections that cannot be addressed by direct policy reforms. Nonetheless, authorities engaging in incentive-based strategies to attract investment must periodically evaluate their relevance, appropriateness, and economic benefits against their budgetary and other costs, including long-term impacts on resource allocation. In doing so, authorities also need to consider their commitments under international agreements, since investment incentives can have effects beyond the countries that offer them, including bidding contests leading to a waste of resources. Many governments, including all OECD member countries, consider that it is inappropriate to encourage investment by lowering health, safety or environmental standards or relaxing core labor standards.

*What steps has the government taken to promote investment linkages between businesses, especially between foreign affiliates and local enterprises? What measures has the government put in place to address the specific investment obstacles faced by SMES?*

Many governments aim to attract foreign direct investment because it can bring additional benefits to its citizens through the diffusion of new technologies and human resource and management expertise. These spillovers can materialize more quickly when foreign investors and local enterprises establish close linkages and are especially helpful to harness the potential of local small and medium-sized enterprises (SMEs). These linkages can be fostered through efforts to establish a sound investment environment. For instance, open trade and investment regimes in the context of a strong competition policy provide a fertile environment for the transfer of technology. Close linkages and the broader benefits of foreign investment are also supported by government efforts to improve human resource development, through investments in education, training, and public health.

Promoting linkages between foreign and local enterprises is a particular challenge for SMES. SMEs are the largest investor community group, accounting for over 95 per cent of the business population. SMEs tend to have more difficulties gaining access to credit and in forming investment linkages with foreign affiliates. As a result, the take-up of profitable investment opportunities may be delayed, or even foregone.

*Has the government made use of international and regional initiatives aimed at building investment promotion expertise, such as those offered by the World Bank and other intergovernmental organizations? Has the IPA joined regional and international networks?*

Many international organizations work with IPAs, facilitating the exchange of best practices on investment promotion strategies and assisting in building policy capacity. For instance, the World Association of Investment Promotion Agencies (WAIPA) assists IPAs in advising their governments on the formulation of investment promotion strategies; the Foreign Investment Advisory Service, within the World Bank Group provides investment climate diagnostic studies at the request of host governments, consisting of recommendations for a combination of policy, regulatory and procedural reform, institutional frameworks for investment promotion and methods for monitoring effectiveness; and UNCTAD's Advisory Services on Investment and Training (ASIT) is experienced in instruction programmes for IPA staff to improve capacity.

*To what extent has the government taken advantage of information exchange networks for promoting investment?*

One of the roles of IPAS is to facilitate the recognition of potential investment opportunities by promoting partnerships between domestic and foreign enterprises. A number of initiatives exist to help governments and IPAS in their linkage promotion efforts. For example, the UNIDO Subcontracting and Partnership Exchanges (SPXS) act as technical information, promotion and matchmaking centers for industrial subcontracting. The SPX Network currently provides detailed, standardized, updated and certified data on approximately 20,000 manufacturing companies worldwide, thereby favoring the establishment of partnerships between contractors, suppliers and subcontractors. To date, more than 60 SPXs have been set up with UNIDO's assistance in more than 30 countries.

## **SARBANES-OXLEY ACT OF 2002 SUMMARY**

### **METRICS-BASED CORPORATE GOVERNANCE**

The Sarbanes-Oxley Act seeks to lay the ground for a culture of proactive management of risks going beyond the reactive approach that has been common so far. Typically, companies were often caught off-guard as unexpected events struck. In order to avoid the embarrassment of unmet expectations, companies took recourse to creative accounting to patch up their financial statements. The chief executives had a ready excuse that their responsibilities were limited to providing strategic direction to their companies. Similarly, the directors of boards of companies pleaded that their powers are limited in the presence of an omnipotent CEO and the paucity of access to information.

The Sarbanes-Oxley Act ensures that the senior executives have greater responsibility as well as the means to meet them. Thus, the directors of boards of companies will have direct access to company information and their committees will have independent oversight over important matters such as executive compensation, selection of auditors and governance policy. In turn, the directors will have greater exposure to liability for negligence in the management of companies. Similarly, the chief executives will now be responsible for not only the strategic direction of the company but also its operational effectiveness. Their hands will be strengthened by additional support they will

receive from the board of directors for strategic planning. In addition, they will also receive much more detailed information about their companies than was possible in the past.

The Sarbanes-Oxley Act provides for checks and balances that were not available in the past. Whistleblowers will now have greater protection from the law as well as the opportunity to report fraud in their companies. Similarly, the auditors of companies have to report to the independent audit committees.

Above all, the Sarbanes-Oxley Act seeks to make companies more transparent and vigilant by requiring the reporting of all their operational risks as well as the internal controls put in place to monitor them. Any material change in the monitoring of risks has to be reported to the shareholders in real time.

Overall, the Sarbanes-Oxley Act seeks to focus the attention of companies on fortifying their companies by anticipating risks, all across the enterprise, and to take preemptive action to guard against the damage that they could wreak. The bedrock of this model of governance would be the business intelligence infrastructure that will help companies to receive information. This information will be more widely shared among the executives, shareholders, and the board of directors. All the stakeholders in the company will have both the opportunity and the resources to put all their minds together to effectively manage their companies.

## **BOARD OF DIRECTORS**

Increasingly, directors on boards of companies are expected to play much more active roles in the interest of shareholders. The New York Stock Exchange, consistent with Increasingly, directors on boards of companies are expected to play much more the provisions of the Sarbanes-Oxley Act, expects that non-management directors should hold regular sessions without the participation of the management or any other person with a material relationship with it. The regular meetings of the boards are sought for brainstorming without being biased by the concerns of the management or its influence.

## **DISCLOSURES**

The rampant misrepresentation of the financial situation of companies, especially in the technology industry, by the use of pro-forma financial statements is not possible now without additional disclosures to compare them with GAAP consistent accounting. Under Section 401 (b) of the Sarbanes-Oxley Act, it would not be possible for pro-forma statements to omit any material fact which misrepresents the fair or true position of the company. In addition, companies are now required to provide quantitative measures to reconcile the pro-forma statements with the GAAP consistent financial statements.

The SEC is also rapidly moving towards real-time disclosures so that each investor has prompt access to information, under Section 409 that will have a material impact on the company. The filing deadlines for quarterly and annual reports have been accelerated by a third. The SEC has also identified items that need to be disclosed in real time.

## **FRAUD**

The premise for fraud control is that managements frequently exploit weaknesses in internal controls for their dubious purposes. PCOAB's Auditing Standard 2, therefore, specifically requires that the assessment of internal controls take into account the susceptibility of the company's processes to fraud. The internal controls should be able to prevent, deter and detect fraud.

## **GOVERNANCE POLICIES**

The Sarbanes-Oxley Act seeks to encourage explicit discussion of the corporate governance policies that will set a direction for the board and the management. The New York Exchange has the operative rules which require that the boards of companies set up a governance committee which will spell out the governance principles which will be used to evaluate the board and the management.

## **EXECUTIVE COMPENSATION**

In order to check fraud from earnings management by senior executives, Section 304 of the Sarbanes-Oxley Act, requires a company which restates its financial statements due to material noncompliance, misconduct, or with any financial reporting requirement, the CEO and CFO must reimburse the company for bonus or other incentive-based or equity-based compensation received during the 12-month period following issuance of the financial statements and profits realized from the sale of equity during the same period.

## **PROTECTION OF WHISTLEBLOWERS**

Sarbanes-Oxley has provided added protection to whistleblowers who can establish a prima facie case of retaliation when they report malfeasance in the company. The instrument for achieving this goal is the change in the burden of proof rules which are now in favor of employees. If they submit evidence that the retaliation was a contributing factor to the adverse employment action, a presumption of retaliation is created. In order to defeat this presumption, the employer must establish, by clear and convincing evidence, that it would have taken the same action with respect to the employee, regardless of the alleged protected activity.

## **COMPENSATION COMMITTEES**

Sarbanes-Oxley does not explicitly spell out rules governing compensation in order not to restrict the freedom of companies to make their decisions. However, the New York Stock Exchange's governance rules require the boards to form independent compensation committees which have the authority to decide on compensation policies consistent with the business goals of their companies. They are also required to make decisions on the incentive component of compensation and ensure that they are effective in achieving the performance goals of the company. Compensation committees are also expected to seek advice from compensation consultants about executive pay.

## **AUDIT COMMITTEES**

Sarbanes-Oxley has sought to govern auditors at the board level in order to avoid the conflicts that can happen with the management. These audit committees are

composed of directors and have the responsibility to ensure that the financial statements of the company and the internal controls are consistent with the regulatory policy. The audit committees are also required to discuss the company's exposure to risk and the means to manage them.

## **DEPARTURES FROM THE PAST**

Sarbanes-Oxley recognizes that the mode of compensation, an increasing share of equity and equity options, in the packages that executives received was responsible for the frauds that were committed at several large companies. This kind of compensation created incentives for fudging the balance sheet and the income statement to engineer stock price increases. In addition, severance packages are overly generous. A survey by McKenzie in 2003, a management consulting firm, found that 52% of the directors of companies believe that executive compensation is way too high. Academic literature also finds significant correlations between a high component of equity compensation and symptoms of fraud such as accounting restatements, high proportions of accruals, capitalization of expenses, etc. A widely quoted study of a professor from the business school of University of Chicago, reports that in a sample of 50 firms accused of fraud by SEC by contrast to another 50 companies which were not, a clear pattern of higher occurrence of higher-than-average component of stock compensation was found in the former sample. Other studies also confirm that companies are more likely to be subject to enforcement action if their boards are dominated by the management and they don't have a block holder or an audit committee.

Severance pay is another contentious aspect of executive compensation often patently unrelated to performance. A striking case is that of the approval of a \$140 million severance package for Michael Ovitz by the Disney Board in response to a request from CEO Michael Eisner, in 1996. Ovitz had hardly worked a year as Disney's president when Eisner decided he wasn't the right man for the job.

Increasingly, governance bodies are concerned that executive compensation does not reflect the performance of the chief executive. While equity compensation is a means to address the agency issue by tying the interests of owners and managers, the executives undeservedly also benefit from the overall increase in market indices unrelated to the financial performance of the company. In addition, severance pay, and retirement benefits and a host of other fees paid to former executives are not related to performance. While Sarbanes-Oxley has not specifically mandated any rule for compensation for executives, it does vest authority on compensation committees to decide on executive pay is consistent with the overall interest of the company.

## **SARBANES-OXLEY: IS IT PERFORMING?**

Sarbanes-Oxley sweeping provisions greatly add to the costs of SOX compliance without a doubt. Most companies see compliance including the need of procuring SOX compliance software as a sunk cost for the long-term benefits of credibility and efficiency benefits that will extend over many years. In addition, they expect that the costs of SOX compliance will decline as companies deploy SOX compliance software and learn to

automate their processes. Currently, many companies are unsure about the benefits they will actually reap and the means to automate SOX compliance in a situation where processes are hard to standardize.

According to widely quoted figures from Foley and Lardner, the SOX compliance cost for companies with sales turnover of less than one billion dollars, the SOX compliance cost was about \$2.86 billion in financial year 2003 up from \$2.12 billion in financial year 2002 and the corresponding figures for companies with revenues in excess of \$1 billion is \$7.4 billion. The major components of costs were directors and officers insurance, lost productivity and accounting.

Figures have been presented in a variety of ways depending on how they are collected. Other sources such as Parson Consulting indicate that 50% or more of overall corporate governance cost revolves around process improvement, controls documentation, testing, SOX compliance software procurement and adapting controls to changing needs.

In more recent years, however, companies are also increasingly reporting benefits from their investments in compliance with Sarbanes-Oxley. In a survey of 200 In more recent years, however, companies are also increasingly reporting financial executives by Oversight Systems, 49% of them reported that the risk of fraud and errors has been reduced, 48% of them agree that their financial operations are now more efficient and 31% report lower error rates.

Furthermore, companies will be increasingly focused on lowering costs from automation of their compliance processes through the purchase of SOX compliance software. As many as 60% of them have plans to implement technology to automate their manual processes.

## **ENTERPRISE RISK MANAGEMENT**

Corporations are rethinking their strategies towards the management of risk in the future to effectively comply with the Sarbanes-Oxley Act. Increasingly, companies are implementing Enterprise Risk Management Systems and employing Chief Risk Officers to govern their strategies for risk across the enterprise. Companies do not any longer want to be taken by surprise and incur losses as they are hit by unexpected events. They now realize that their ability to manage risks depends on anticipating risks, detecting their risks more effectively by looking at them in all its inter-dependence and fortifying their systems to withstand shocks. Some of the more sophisticated corporations, such as Microsoft and Boeing, implemented such systems in the past, independent of regulatory policy, while other companies are following in their steps under pressure from new laws and regulatory standards. A recent survey indicates that 50% of financial executives believe that they integrate their SOX compliance with enterprise risk management. This best practice has been spelled out, in all its details, in the seminal document of the Committee of the Sponsoring Organizations of the Treadway Commission on the subject.

The conceptual breakthrough that undergirds the new approach to risk management is the realization that business risks, financial risk, and operational risk feed on each other and compound the impact of any one type of shock to a company. Operational risk, such as fraud in the company, can create a liquidity crisis for the company. Similarly, business risk, such as loss of intellectual property from outsourcing of business processes overseas, could lead to bankruptcy of a company. The vulnerability of companies has increased with the growing reliance on sophisticated financial instruments, an extended enterprise and information technologies. Increasingly, companies realize that they need to create a culture in which employees at all levels respond to unnoticed sources of risk in any corner of the enterprise and communicate it to the rest of the organization. This is facilitated by enterprise risk dashboards which help to communicate potential threats to the company and galvanize organizations to react rapidly before a crisis goes out of control.

An example of enterprise-wide management of risks is the case of TriQuint Semiconductor Inc., a US-based supplier of communications components and modules. As part of its compliance effort, TriQuint is conducting a risk assessment of all the business processes that affect its balance sheet and income statement. That evaluation is helping the company uncover latent risk across all its five divisions. TriQuint's combined Sarbanes Oxley and ERM efforts have helped it to gain insight into risks in the businesses it acquires. Typically, mergers fail when the cultures of two different companies clash. TriQuint has made several acquisitions in recent years, and some of those businesses have operations outside the United States. The company has been able to identify and discuss the risks new acquisitions face, including exposures related to specific cultural and regulatory environments.

## **CHALLENGES CONFRONTING INSTITUTIONAL INVESTORS**

The principles of corporate governance embrace the underlying assumption that shareholders can best look after their own interests provided, they have sufficient rights and access to information. The increased presence of large institutional investors in the last decade fostered the expectation that a new breed of highly skilled and well-resourced professional shareholders would make informed use of their rights, promoting good corporate governance in companies in which they invest in. These principles are reflected to cover disclosure of voting policies, managing conflicts of interest and cooperation between investors. However, institutional investors are not like other shareholders but have a unique set of costs, benefits, and objectives.

Accordingly, they have not always behaved as desired. Institutional investors are financial institutions that accept funds from third parties for investment in their own name but on such parties' behalf. They include pension funds, mutual funds, and insurance companies. By 2009, they managed an estimated US\$ 53 trillion worth of assets in the OECD area, including US\$ 22 trillion in equity. Additionally, there are large investments made by the fund management industry directly under their client's name. This makes institutional investors a major force in many capital markets.

With the goal of optimizing returns for targeted levels of risk, as well as for prudential regulation, institutional investors diversify investments into large portfolios, many of them having investments in thousands of companies. Some managers pursue active investment strategies, but increasingly, they passively manage against a benchmark, resorting to indexing. At the same time, the investment chain has lengthened by outsourcing of management, further distancing investee companies from the beneficial owners. As a result, incentives do not always stimulate institutional investors to engage in monitoring the corporate governance practices of investee companies.

Unlike in the case of private equity and hedge funds, most institutional investors are not remunerated on the basis of the performance of portfolio companies, but on the basis of the volume of assets under management. Moreover, fund performance against a benchmark is reviewed often by investors on the basis of mandates not exceeding three years. Taken together, these factors favor a focus on increasing the size of assets under management and on investing them in indices, rather than on improving the performance of portfolio companies. Incentives for churning of assets and strong conflicts of interest add to those factors and create a challenging context for the notion of institutional monitoring of a large number of companies are significant, while the benefits are shared with all shareholders, creating a free rider problem. This often leads to sub-optimal monitoring and analyst coverage of companies unless collective action is achieved.

A key problem identified is that **domestic investors do not vote for their foreign equity**. Another relevant aspect deals with whether institutional investors are becoming increasingly short-term investors or at least promoting short-term thinking by investee companies. Pension funds, especially defined-benefit schemes should be able to make long term investment to match liabilities to their beneficiaries that stretch over many years. But a number of large institutional investors are not acting in this way.

Nevertheless, large institutional investors are often locked into the shareholding of most large companies on a long-term basis, since for regulatory or other reasons, diversification and index investing is the norm. Thus, they are long-term shareholders even if they buy and sell on a regular basis or lend their shares for a fee. In principle they have incentives to encourage good corporate governance, but such engagement still needs to be encouraged and facilitated.

The nature of institutional investors has evidently evolved over the years into a complex system of financial institutions and fund management companies with their own corporate governance issues and incentive structures. A great deal can be done both by private agents and policy makers to improve the corporate governance outcomes of institutional investors' behavior. In the private sector, enhancing collaboration among institutional investors, as by establishing industry associations to share the costs of monitoring and voting have shown positive results. On the public policy side, prudential regulations sometimes excessively limit holdings by institutional investors in individual companies and restrictions on incentive schemes may also change their behavior in an unintended manner. Given the right set of conditions, institutional investors can play an

important role both in jurisdictions characterized by dispersed or concentrated ownership, their role facilitated by private and/or public policy action.

The effectiveness and credibility of the entire corporate governance system and company oversight will to a large extent depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in companies in which they invest.

However, the forces driving the actions of institutional investors are different from many other shareholders, being determined by a unique set of costs, benefits and objectives. In addition, the funds management industry that does not invest in its own name is also highly significant. An explicit policy goal is to further the development of institutional investors via, for instance, pension funds so as to foster domestic capital markets. However, in other areas the institutions are seen as a weak link in the company landscape related to short terms and to the pursuit of political ends. Thus, some see them as already too powerful and their effects possibly pernicious. Others, by contrast, see them as not being robust enough in promoting good corporate governance and corporate accountability. Not all the arguments relate to good corporate governance per se but to their potential for underpinning growth and development and addressing other issues such as environmental and social goals. However, there is a close relationship between good corporate governance that promotes company performance and accountability and addressing these broader issues.

With the goal of optimizing returns for targeted levels of risk, institutional investors pursue a range of portfolio diversification strategies, which in some cases have led to highly diversified portfolios, many of them having investments in several thousand companies. Though many managers pursue active investment strategies and use benchmarks for the purpose of assessing performance, some investors seek portfolios that are passively managed against a benchmark, in which case managers typically must purchase all the equities in the share index (e.g. S&P 500). The level of diversification can therefore be extreme. With the emergence of a broad universe of professional investment managers and increasing access to information, active strategies, on average, do not significantly outperform the market on a net-of-fees basis. At the same time, and investors have increasingly channeled funds into lower cost, passive diversification funds. This trend towards passive diversification may not be conducive to the promotion of good corporate governance.

Diversification, in a number of cases, is also driven by prudential regulation such as capping the percentage of a company's equity that can be held by an institutional investor, and not just by individual investor concerns. The review of various countries around the globe noted the benefits of permitting pension funds to take a significant stake in companies. The investment chain has lengthened by outsourcing of management to include investment managers and sub-advisors, further distancing investee companies from the ultimate beneficiaries. As a result, at every stage of the process there are possibilities that incentives will not encourage institutional investors to take an interest in the corporate governance practices of investee companies.

Institutional investors acting as agents for ultimate beneficiaries are very often not directly remunerated on the basis of the performance of portfolio companies whether based on company performance or better corporate governance practices. The exception is certain private equity and hedge funds where performance incentives are powerful, often 20% of fund performance. Rather, they are remunerated often on the basis of management fees based on the volume of assets under management. In the US, performance-based fees are generally not allowed for mutual funds unless the fee also penalizes the manager for poor performance (i.e. a fulcrum fee). Moreover, fund performance (either absolute or relative) is reviewed often by investors and mandates usually last only around three years. Taken together, the incentive structure often favor a focus on increasing the size of assets under management, not necessarily bad but also not necessarily an incentive to improve performance of portfolio companies, The incentive structure might also contribute to churning of assets (i.e. buying and selling often) where it is possible to increase the commissions from transactions. Indeed, a number of institutional investors often exceed their own announced turnover targets. Average holding periods have declined around the world to under one year on average although a great deal of the decline might be due to the rising importance of high frequency traders, another asset class. In addition, the incentive structures influencing many institutional investors and fund managers are influenced by conflicts of interest including their own ownership by banks and insurance companies, their relationship to company sponsors of pension plans and the fact that they may control many funds that can trade between themselves. Such incentives might work to the disfavor of investors.

In such a system, the costs involved in monitoring the corporate governance practices over a large number of companies are significant, but the benefits will be shared with all (i.e. the free rider problem). This implies that monitoring and analyzing coverage of companies will be sub-optimal unless arrangements can be put in place to promote collective action. This does not mean that institutional investors can or should avoid monitoring and engagement with their investee companies since there are private returns to them and there can be fiduciary duties such as with private sector pension funds (ERISA) in the US that may be fulfilled through voting. But it does mean that such activities might not be pursued as effectively and as energetically as otherwise would be the case.

In the public and policy debate, too much time and effort is being taken up in trying to solve the perceived problem of short-termism by appealing to the notion of a long-term shareholder who is often compared favorably with "patient family owners." However, a long-term shareholder is clearly not necessarily a long-term engaged investor and efforts to give incentives to hold shares may not achieve their objective. The real problem of short-termism may well lie in the executive suites of companies and financial institutions with an emphasis on short payback periods. Nevertheless, in a world of fast-moving technologies and competition, defining short-termism is still a challenge.

The principles that cover institutional investors are focused on "bread and butter" corporate governance issues such as voting at company meetings, the nomination and election of board members and to making their views known on remuneration policy. They

support acting in cooperation which might take matters much further by underpinning more engagement, while leaving open the concept of long and short-term.

In sum, the nature of institutional investors has evolved over the years into a complex system of financial institutions and fund management companies with their own corporate governance issues and incentive structures. Investment chains have lengthened, increasing the number of institutions between the final beneficiary and an investment in an enterprise. At each point, the incentive system might not lead to good corporate governance outcomes. Investment strategies have also evolved with passive investing through indices and exchange traded funds becoming more important so as to lower costs and increase returns to beneficiaries. Against this background, the old question of investor oversight of company boards needs to be examined. With respect to the exercise by institutions of their voting rights, turnout at company meetings has increased in recent years and there are dedicated corporate governance investors. However, cross-border voting remains costly and uncertain. Whether all these developments are sufficient to improve corporate governance outcomes or whether they are just going in the right direction is an open question, but a great deal depends on expectations. If the expectation is that institutional investors act as stewards of companies, then progress might have been limited.

### **Textbook:**

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