A GAME THEORY ANALYSIS OF CORPORATE DISCLOSURE REQUIREMENTS UNDER THE SECURITIES REGULATION CODE*

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INTRODUCTION

The Securities Regulation Code ("SRC"), dated July 19, 2000, was enacted to achieve "full and fair disclosure about securities."[1] Often referred to as the "truth-in-securities" law,[2] it was envisioned that investors in public companies would be adequately protected by its comprehensive system of mandatory disclosures. For external parties, information would enable them to know the financial performance of issuers, and from thereon, to take appropriate actions in a timely fashion.[3] For honest issuers, stringent disclosure requirements would serve to weed out crooked promoters competing with them for the investor's money.[4] Disclosures are also important from a macroeconomic perspective as they minimize, if not totally eliminate, distortions in the capital market.[5] In fact, it is said that the Asian financial crisis was brought about partly by lack of transparency in the dealings of many firms.[6]

It was with these lofty goals in mind that the SRC was framed. Yet, a little more than five years later, investor confidence in the Philippines is still low, the capital market is sorely underdeveloped, and the newspapers are still replete with instances of sales of fraudulent securities and pyramiding scams. Even the pre-need industry has not been

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[1] Rep. Act No. 8799 (2000) (henceforth "SRC"), sec 2.

[2] R. MORALES, THE SECURITIES REGULATION CODE ANNOTATED 5 (2005).

[3] M. Rahman, "*The Role of Accounting Disclosure in the East Asian Financial Crisis*" *Lessons Learned?* United Nations Conference on Trade and Development (December 1998).

[4] *Tenth Annual Report*, U.S. Securities and Exchange Commission at 14, quoted in Philippine Stock Exchange Inc. v. Court of Appeals, 346 Phil. 218 (1997), & in R. MORALES, *op. cit. supra.* note 2.

[5] SEC Implementing Rules and Regulations of Rep. Act 8799 (henceforth "SRC IRR"), sec. 2.

[6] J. Wolfensohn, *Address to the Overseas Development Council Conference on Asia's Coming Explosion*, Washington, D. C., March 19, 1998, quoted in M. Rahman, *op. cit supra* note 3.

spared as criminal raps have been filed against one pre-need firm for window-dressing its accounts and making fraudulent entries.[7]

The mandatory disclosure regime in the United States, after which the SRC was patterned, has not been very successful either. Enron, one of the biggest and most trusted firms, collapsed amidst charges of misleading investors and reporting inaccurate data. Moreover, such misrepresentations are not confined to a few companies. It is estimated that instances of fraudulent financial misrepresentations have risen by 165% over just five years.[8]

Thus, law-and-economics professors have been advocating a regime of voluntary disclosures.[9] Under this system, firms are free to choose whether they wish to disclose any information at all. This proposed regime is anchored on the philosophy that in the end, it will be in the firm's best interest to disclose. The move to deregulate the issuance of securities also follows a general trend worldwide towards deregulation as a way to adapt to globalization.[10]

This Article is a study of the current mandatory disclosure regime under the SRC from a law-and-economics point of view. Specifically, it will draw on insights from game theory to examine the current disclosure requirements and to show that the current disclosure regime under the SRC is not sufficient to prevent the perpetration of fraud on the public. Game theory will demonstrate that simply requiring firms to disclose certain types of information is ineffective if giving truthful disclosures will not work to their own advantage and will in fact be detrimental to them.

This Article proceeds in five parts. Following the introduction, Part I outlines the current disclosure requirements under the SRC and its implementing rules and regulations. Part II uses game theory to explain the importance of a regulatory structure to solve the classic problem of information asymmetry between issuers and investors, and how such structure should lead to optimal social gains. Part III clarifies why the expected social benefits from disclosure do not always occur, and how a mandatory disclosure regime can even lead to false disclosures. Drawing once more on game theory, Part IV proposes additional measures to give firms sufficient incentives to make truthful disclosures under a mandatory disclosure regime. Finally, the paper will conclude by saying that if implemented haphazardly, a mandatory disclosure regime may actually lead to the making of misrepresentations by issuers, precisely the occurrence that it seeks to prevent. The removal of information asymmetry is a valid objective, but more importantly, the law should alter players' incentives to induce them to make

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[7] *Not Over Yet*, Philippine Business Magazine vol. 12, no. 6, available at <http://www.philippinebusiness.com.ph/magazines/industry_p3.htm>.

[8] E. Beecher-Monas, *Enron, Epistemology, and Accountability: Regulating in a Global Economy*, 37 IND. L. REV. 141, 142 fn. 1 (2003).

[9] R. Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1939-40 (1996); S. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1033 (2000); F. Easterbrook & D. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 682 (1984).

[10] J. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1409 (2002).

transactions whose benefits will redound not just to themselves, but also to society as a whole.

I. OVERVIEW

Securities are "shares, participation or interests in a corporation or in a commercial enterprise or profit-making venture and evidenced by a certificate, contract, instrument, whether written or electronic in character.[11]" Among its most popular forms are shares of stocks, bonds, investment contracts, certificates of participation, derivatives, and membership certificates.

A. REGISTRATION REQUIREMENTS

As mandated by Section 8 of the SRC, securities must be registered with the Securities and Exchange Commission (SEC) before they can be sold or even offered for sale. The basic purpose of the registration requirement is "to ensure that the investor has adequate information upon which to base his or her investment decision."[12] Even if individual investors rarely read the prospectus, market professionals do. The opinions of these professionals will in turn create an informed market.[13]

Among the pieces of information which issuers are required to disclose to the SEC are:

1. any material reclassification, merger, consolidation or purchase or sale of a significant amount of assets not in the ordinary course of business.[14]

2. major risk/s involved in each of the businesses of the company and subsidiaries ... [including] a disclosure of the procedures being undertaken to identify, assess and manage such risks.[15]

3. the effect of such sale of securities on the amount and percentage of present holdings of the registrant's common equity owned beneficially by any group or person who is the beneficial owner of more than five percent (5%) of any class of the registrant's common equity, and by each director[16]

4. any restriction that limits the ability to pay dividends on common equity or that are likely to do so in the future[17]

5. background information on directors, executive officers, promoters and control persons to determine if these persons have adequate background and

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[11] SRC, sec 3.1.

[12] T. HAZEN, THE LAW OF SECURITIES REGULATION 31-32 (1985), cited in R. MORALES, *op. cit. supra* note 2 at 64.

[13] *Ibid.*

[14] SRC IRR, Annex C, part I(A)(1)(c).

[15] SRC IRR, Annex C, part I(A)(1)(c).

[16] SRC IRR, Annex C, part I(A)(1)(c).

[17] SRC IRR, Annex C, part I(A)(1)(c).

experience to develop and operate the registrant's business and make it successful.[18]

6. compensation of the Chief Executive Officer (CEO), the four (4) most highly compensated executive officers, and of all the officers and directors as a group unnamed[19]

7. transactions with or involving the company or any of its subsidiaries in which a director, executive officer or significant stockholder, and members of their immediate family, had or will have a direct or indirect material interest[20]

8. money, property or rights of any kind received or to be received by each promoter from the issuer, and assets acquired or to be acquired from a promoter[21]

After the filing of such registration statement, but before the SEC declares it to be effective, the issuer cannot sell the securities, but can only release certain information on the securities to prospective purchasers.[22] This period is known as the waiting or pre-offering period.[23] Only after the registration statement has been declared effective can the securities be sold or offered to the public within the Philippines. This time frame is called the offering period.[24]

Should the SEC find that the issuer has been engaged or is about to engage in fraudulent transactions, or has made any false representation of material facts in the registration statement, it has the power to reject or revoke the registration of securities.[25] It can even reject or revoke a registration statement if the issuer or any of its officers is convicted of a crime involving moral turpitude and/or fraud.[26] The SEC may also compel the production of all the issuer's books and papers, and examine officers or other persons connected therewith.[27]

B. REPORTORIAL REQUIREMENTS

Under the SRC, issuers are required to submit an annual report to the SEC, including a balance statement, profit and loss statement, and statement of cash flows, to be certified by an independent certified public accountant. Moreover, they should also submit a management discussion and analysis of results of operations.[28] The SRC has also mandated the submission of current reports on significant developments of the

[18] SRC IRR, Annex C, part I(A)(1)(c).
[19] SRC IRR, Annex C, part IV(B)(1).
[20] SRC IRR, Annex C, part IV(D).
[21] SRC IRR, Annex C, part IV(D)(4).
[22] R. MORALES, *op. cit. supra* note 2.
[23] *Ibid.*
[24] *Ibid.*
[25] SRC, sec. 13.1.
[26] SRC, sec. 13.1.
[27] SRC, sec. 13.2.
[28] SRC, sec. 17 (a).

issuer.[29] Such current reports must be submitted as prescribed by SEC Form 17-C.[30] Among the events required to be reported to the SEC are:

1. changes in the issuer's corporate purpose and any material alteration in the issuer's activities or operations or the initiation of new ones[31]

2. any decision taken to carry out extraordinary investments or the entering into financial or commercial transactions that might have a material impact on the issuer's situation;[32]

3. losses of a significant part of the issuer's net worth;[33]

4. acts and facts of any nature that might seriously obstruct the development of corporate activities, specifying its implications on the issuer's business;[34]

5. facts of any nature that materially affect or might materially affect the economic, financial or equity situation of those companies controlling, or controlled by the issuer including the sale of or the constitution of sureties/pledges on an important part of such issuer's assets;[35]

6. Entry into or termination of a material agreement not made in the ordinary course of business;[36]
7. Termination or reduction of a business relationship with a customer that constitutes a significant amount of the company's resources;[37]

8. Events triggering a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation;[38]

9. Material modifications to rights of holders of the company's securities;[39]

Notwithstanding the enumeration, SEC Form 17-C still contains a catch-all provision. SEC Form 17-C prescribes that the issuer report "any fact or event that occurs which would reasonably be expected to materially affect the decision of investors to buy, to sell or to hold securities."[40]

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[29] SRC, sec. 17 (b).

[30] Current Report under Section 17 of the Securities Regulation Code & Securities and Regulation Code (hereinafter SEC Form 17-C), Rule 17(b)(3) thereunder <www.sec.gov.ph> September 30, 2005.

[31] SEC Form 17-C, Item 9(a)(1).

[32] SEC Form 17-C, Item 9(a)(3).

[33] SEC Form 17-C, Item 9(a)(4).

[34] SEC Form 17-C, Item 9(a)(6).

[35] SEC Form 17-C, Item 9(a)(15).

[36] SEC Form 17-C, Item 9(a)(19).

[37] SEC Form 17-C, Item 9(a)(20).

[38] SEC Form 17-C, Item 9(a)(21).

[39] SEC Form 17-C, Item 9(a)(22).

[40] SEC Form 17-C, Item 9(a).

C. REGULATION OF PRE-NEED PLANS

Pre-need plans are defined as

> ...contracts which provide for the performance of future service/s or payment of future monetary consideration at the time of actual need, payable either in cash or installment by Planholders at prices stated in the Contract with or without interest or insurance coverage and includes life, pension, education, interment, and other plans which the Commission may from time to time approve.[41]

Such plans are in the nature of investment contracts,[42] which are included in the definition of securities.[43] The SRC itself has no rules regulating pre-need plans, except that it gives the SEC the power to promulgate pertinent rules and regulations, and lays down conditions that such rules must require disclosures to prospective plan holders, and prescribe advertising guidelines.[44]

Under the rules[45] promulgated by the SEC, pre-need plans must also be registered in the same manner as securities under the SRC. However, since these types of contracts normally span more than a decade, and are in some respects, similar to insurance contracts, issuers are required to submit an actuarial feasibility study showing that the business model of the said pre-issuer is viable.[46]

Once the certification is issued, the pre-need company must also comply with the reportorial requirements in the SRC.[47] Moreover, if the information in the registration statement is subsequently found to be or becomes misleading, or may tend to work a fraud or prejudice the investing public, the SEC may investigate the issuer or cancel the registration or permit to sell.[48] The SEC may also compel the production of all the records of the issuer, and examine its officers or any person connected therewith.[49]

D. INSIDER'S DUTY TO DISCLOSE WHEN TRADING

As a truth-in-securities law,[50] section 27 of the SRC obligates insiders to disclose material information to the public. Thus:

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[41] SEC New Rules on the Registration and Sale of Pre-need Plans under Section 16 of the Securities Regulation Code, August 16, 2001, (hereinafter "Pre-need Rules") Rule 1.2, available at <http://www.sec.gov.ph/index.htm?pre-need/new_rules/New_Pre-need_rule14> September 17, 2005.
[42] R. MORALES, *op. cit. supra* note at 11.
[43] SRC, sec. 3.1 (b).
[44] SRC, sec 16.
[45] Pre-need Rules, Rule 14.
[46] Pre-need Rules, Rule 4.1(7).
[47] Pre-need Rules, Rule 6.1(l).
[48] Pre-need Rules, Rule 8.1.
[49] Pre-need Rules, Rule 9.2.
[50] R. MORALES, *op. cit. supra* note 2 at 198.

It shall be unlawful for an insider to sell or buy a security of the issuer, while in possession of material information with respect to the issuer or the security that is not generally available to the public, unless:

(a) The insider proves that the information was not gained from such relationship; or

(b) If the other party selling to or buying from the insider (or his agent) is identified, the insider proves:

(i) that he disclosed the information to the other party, or

(ii) that he had reason to believe that the other party otherwise is also in possession of the information.

A purchase or sale of a security of the issuer made by an insider defined in Subsection 3.8, or such insider's spouse or relatives by affinity or consanguinity within the second degree, legitimate or common-law, shall be presumed to have been effected while in existence but prior to dissemination of such information to the public and the lapse of a reasonable time for the market to absorb such information: Provided, however, That this presumption shall be rebutted upon a showing by the purchaser or seller that he was not aware of the material non-public information at the time of the purchase or sale.[51]

The aim is to prevent insiders from making unfair use of the information. By the mere fact that they possess information which has not yet been disclosed to the public, insiders can "exploit the same to make a profit or to avoid a loss by dealing in the securities whose price would have been materially altered had the information been disclosed in the first place."[52]

Section 27.2 of the SRC classifies information as material non-public if

(a) It has not been generally disclosed to the public and would likely affect the market price of the security after being disseminated to the public and the lapse of a reasonable time for the market to absorb the information; or

(b) would be considered by a reasonable person important under the circumstances in determining his course of action whether to buy, sell or hold a security.[53]

While there is some controversy as to what constitutes material information, the Implementing Rules and Regulations of the SRC seeks to clarify it as characterizing "any fact/information that could result in a change in the market price or value of any of the issuer's securities, or would potentially affect the investment decision of an investor."[54] Sec. 14.1 of the SRC IRR provides further examples:

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[51] SRC, sec. 27.1.
[52] R. MORALES, *op. cit. supra* note 2 at 198.
[53] SRC, sec. 27.2.
[54] SRC IRR Rule 3.1(I).

> A. Any event or transaction which increases or creates a risk on the investments or on the securities covered by the registration;
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> B. Increase/decrease in the volume of the securities being offered at an issue price higher/lower than the range set and disclosed in the registration statement and which results to a derogation of the rights of existing security holders, as may be determined by the Commission;
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> C. Major change in the primary business of the registrant;
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> D. Reorganization of the company;
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> E. Change in the work program or use of proceeds;
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> F. Loss, deterioration or substitution of the property underlying the securities;
>
> G. Significant or ten percent (10%) or more change in the financial condition or results of operation of the registrant unless a report to that effect is filed with the Commission and furnished the prospective purchaser;
>
> H. Classification, de-classification or re-classification of securities which results to derogation of rights of existing security holders, as may be determined by the Commission.[55]

In sum, as long as the information "induces or tends to induce or otherwise affect the purchase and sale of securities,"[56] it is considered material, and should be disclosed.

Insider trading brings criminal,[57] administrative[58] and civil[59] sanctions. An insider who engages in such prohibited trading may be sued by an investor, "who contemporaneously with the purchase or sale of securities that is the subject of the violation, purchased or sold securities of the same class unless such insider... proves that such insider knew the information or would have purchased or sold at the same price regardless of the disclosure of the information to him."[60] Thus, disclosure of the material information is a defense to a suit.

II. ANALYSIS OF CORPORATE DISCLOSURE REQUIREMENTS USING GAME THEORY MODELS

Despite the seemingly comprehensive provisions of the SRC, it will presently be shown why it is currently inadequate to prevent fraud on the public. The tools used

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[55] SRC IRR, Rule 14.1.

[56] SEC Rules Requiring Disclosure of Material Facts by Corporations whose Securities are Listed in any Stock Exchange or Registered/Licensed Under the Revised Securities Act, January 29, 1973, cited in R. MORALES, *op. cit. supra* note 2 at 199.

[57] SRC, sec. 73.

[58] SRC, sec. 54.1.

[59] SRC, sec. 61.1.

[60] SRC, sec. 61.1.

will be game theory analysis.

Strategic behaviour arises when two or more individuals interact, and each one's decision depends on what that individual expects the others to do.[61] Game theory "attempts to simplify a social interaction in which at least two people (called the players) must choose a course of action."[62] The result of the game is called a payoff.[63] Game theory, like any other branch of economics, assumes that players will prefer higher payoffs to lower payoffs. Hence, it assumes that each player will use the strategy that will maximize his payoff, taking into account what he thinks the others will do. The players' choice of strategy will be based on their expected payoff, and what the players predict the others will do. In short, game theory predicts what rational individuals would do to maximize their gains in these situations.[64]

The interaction between issuers and investors will be analyzed using this framework. It will be assumed that being rational individuals, each party will attempt to maximize his own gain. However, a party must take into account his beliefs as to what the other party will do.

Before beginning, it is best to clarify the inherent limitation of this type of analysis. Game theory is an economic model that simplifies a given social situation, eliminating many details that are irrelevant to the current problem.[65] Its essence is to write down the game with the fewest elements that capture the problem.[66] Thus, it does not take into account the irrationality of individuals and imperfect information of specific real life situations.[67] It follows that neither can it, nor does it purport to, predict actual behavior.

Despite these limitations,[68] game theory still provides structured models of optimum behavior that act as "templates or benchmarks against which imperfect organizational behaviour is thrown into relief."[69]

A. PRISONER'S DILEMMA

The best known of the normal form games is Prisoner's Dilemma.[70] Suppose there are two arrested criminals. Both of them have committed a serious crime. Each

[61] D. C. Baird et al., *Game Theory and the Law* 7 (1994).

[62] E. Beecher-Monas, *op. cit. supra* note 8 at 157.

[63] *Ibid.*

[64] P. Murphy, *Game Theory Models for Organizational/Public Conflict*, 16:2 CANADIAN JOURNAL OF COMMUNICATION 1991, available at < http://cjc-online.ca/viewarticle.php?id=29&layout=html>.

[65] D. Baird, *op. cit. supra* note 61 at 7.

[66] *Ibid.*

[67] P. Murphy, *op. cit. supra* note 64, citing M. SHUBIK, GAME THEORY IN THE SOCIAL SCIENCES: CONCEPTS AND SOLUTIONS 368-415 (1982).

[68] For the sake of simplicity, this article is limited to strategic games. The models to be used in this game will assume that each player chooses his plan of action once and for all, and all players' decisions are made simultaneously.

[69] P. Murphy, *op. cit. supra* note 64.

[70] M. OSBORNE & A. RUBINSTEIN, A COURSE IN GAME THEORY 16 (1994).

prisoner is told that if neither of them confesses, both will get a penalty of, say, two years. This is when they are said to cooperate with each other, and each receives a payoff of -2 representing the two years spent in prison. But if one confesses and the other does not, the one who confessed will go free immediately, but the other one will be meted out the maximum penalty of ten years. The one who confessed, or who did not cooperate with the other prisoner, is said to have defected. This defector receives a payoff of 0 representing the fact that he is spared from prison. On the other hand, the one who did not confess, or the cooperator, receives a payoff of -10, representing the ten years he will spend in prison. This payoff of -10 is called the sucker's payoff. If both confess to the crime, or defect on each other, both will go to prison for six years. The prisoners are not allowed to talk and to come to an agreement with each other. The game can be illustrated as follows:[71]

		Prisoner 2	
		Keep Silent	Confess
Prisoner 1	Keep Silent	-2, -2	-10, 0
	Confess	0, -10	-6, -6

Figure 1. Basic Model of Prisoner's Dilemma
where first payoff represents that of Prisoner 1, and
second payoff that of Prisoner 2

Like any other game theory model, the above game assumes that both prisoners are rational and want to spend as little time as possible behind bars. It also assumes that each prisoner does not care how much time the other will spend in prison.

Viewed as a whole, the total payoff is highest when both prisoners keep silent, or cooperate. The payoff is only -4, as compared to -10 when either confesses, or -12 when each one confesses. But since they are not allowed to coordinate their actions, a prisoner will always find it in his best interest to confess or defect. This can be clarified by viewing it from the point of view of Prisoner 1. Since he does not know which action Prisoner 2 will take, he can choose to keep silent and get either a payoff of -2 if Prisoner 2 also keeps silent, or be stuck with the sucker's payoff of -10 if Prisoner 2 confesses. Or he can confess and get either a payoff of 0 if Prisoner 2 also keeps silent, or a payoff of -6 if Prisoner 2 has also confessed. The logical action for Prisoner 1 is to confess. No matter what the choice of Prisoner 2 is, Prisoner 1 will always have the better payoff if he confesses. Hence, the payoff will always be better for the one who confesses, or the defector.[72]

The net result is that both players will defect. Neither player has an incentive to deviate from the chosen strategy of defection,[73] because this is where they will enjoy their best individual payoffs. This situation is called Nash equilibrium.

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[71] D. Baird, *op. cit. supra* note 61 at 33.
[72] E. Beecher-Monas, *op. cit. supra* note 8 at 159.
[73] *Ibid.*

The interaction between issuers and investors can be modelled as a prisoner's dilemma game.[74] Issuers can choose to cooperate or to truthfully disclose to investors. Or they can choose to defect or to deceive their investors. On the other hand, investors can choose to cooperate (i.e. to invest their money) or to defect (i.e. not to invest their money.)

Suppose we have a rational, profit-maximizing issuer. For his business to yield respectable rates of return, the issuer must run his business well. This entails expending substantial time, money and effort. If he uses the money invested wisely, the business will earn +10. The investor and the issuer will split this +10 between them. For the purpose of analyzing this problem, we will credit the capital of +100 to the investor.
But of course the issuer can always defect. If he is able to get +100 from the investor, and then default on the investment agreement, the issuer can keep the +100, plus the +10 that will be earned from investing the +100. The issuer will have a payoff of +110, at the expense of the investor who has a negative payoff of -100.

		Issuer	
		Do not Cheat	Cheat
Investor	Invest	+105, +5	-100, +110
	Do not Invest	100, 0	100, 0

Figure 2. Basic Issuer-Investor Dilemma
where first payoff represents that of Investor, and
second payoff that of Issuer

Thus, the temptation to defect results in payoffs that are far from optional. Given a choice between a payoff of +5 and +110, the rational and profit-maximizing, albeit immoral, issuer will choose to cheat, since he will get a payoff of +110 if he does so. In contrast, he will only get +5 if he does not cheat the investor.

The investor is aware that the issuer will always choose to cheat or defect. If he knows that the issuer will cheat, he will choose not to invest. If he does not invest or he defects, he will have a payoff of +100, representing his +100 that he can just keep under his mattress. In contrast, if he is cheated by the issuer, he might be stuck with a payoff of -100. Thus, the investor's defect position (i.e. not to invest) will predominate. This is a prisoner's dilemma, because in an ideal market, the insiders and the investors would be better off if the investors invested and the issuer pursued profits rather than cheating or creating the illusion of profits.[75]

The lesson from the Prisoner's Dilemma game is clear: Even if each party knows that it will always be in its best interest to cooperate with the other, each party always has a fear of defection.[76] Thus, each party will choose to defect, or to channel

[74] *Ibid.*
[75] *Ibid.*
[76] *Id.* at 171.

their resources elsewhere. Applying the above game, the issuer and the investor know that they will gain the most individually if they cheat on the other. Hence, rather than to be stuck with the sucker's payoff, each will choose to defect. The issuer will not push through with the planned issuance of shares, and the investor will invest his money elsewhere.

B. LAW AS A TOOL TO SHAPE INCENTIVES

In the absence of any regulation, the natural tendency of issuers and investors based on the prisoner's dilemma is to cheat on each other. This is where the law comes in. From the point of view of law and economics, law shapes individuals' "incentives to engage in, or desist from, certain conduct."[77] To avoid the scenario of non-cooperation envisioned by these game theories, the SRC has instituted a system of disclosures to shape the behaviour of issuers and investors. Registration and periodical reporting requirements enable the investors, as well as the SEC, to keep track whether an issuer is doing its best to maximize returns for the benefit of investors, or is already malversing or misusing the money. Instead of making it lucrative for issuers to cheat on their investors, the law aims to eliminate the issuer's choice to mislead and to cheat their investors by compelling them to disclose material information to the public. Section 53 of the SRC gives the SEC the power to investigate suspected violations of SRC provisions. The law also prescribes sufficient penalties for untruthful disclosures. An issuer can be sued by an investor for civil damages arising out of a false registration statement,[78] or out of misleading reports.[79] It is hoped that the threat of civil, criminal[80] and administrative[81] sanctions will reduce the incentive of issuers to mislead their investors and cheat on them. Thus, it can be properly said that law imposes sanctions to shape payoffs and incentives. Moreover, the SRC compels firms to disclose truthful information. Issuers will inevitably possess more information about the securities that they are offering as compared to the investor. Facts concerning the prospects of the firm's projects, its source of income, and the extent of its indebtedness are peculiarly known only to the issuer itself, but not to the investor. The relationship between the issuer and the investor is characterized by information asymmetry, a situation "where one party knows certain relevant things of which the other party is ignorant."[82] The strict requirements of truthfulness on the part of issuers is a recognition that investors will seldom be able to ascertain if the information released by issuers is accurate, complete or current,[83] and acknowledges the information asymmetry between issuers and investors.

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[77] R. Ahdieh, *Law's Signal: A Cueing Theory of Law of Law in Market Transition*, 77 S. CAL. L. REV. 215, 255, citing R. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1650 (2000).

[78] SRC, sec. 56.

[79] SRC, sec. 57.

[80] SRC, sec. 54.2, 7.

[81] SRC, sec. 56, 57.

[82] I. STADLER & J. PEREZ-CASTRILLO, AN INTRODUCTION TO THE ECONOMICS OF INFORMATION: INCENTIVES AND CONTRACTS 6 (2001).

[83] J. Franco, *Why Anti-Fraud Prohibitions are not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, COLUM. BUS. L. REV. 223, 244 (2002).

To illustrate the effect of mandatory disclosure on the incentives of both parties, let us analyze the situation again using Prisoner's Dilemma. With mandatory disclosure requirements, the SRC aims to alter the payoff structure of issuers and investors. Issuers are meted out administrative, criminal and civil sanctions for not disclosing information or for disclosing false information. Suppose that if the issuer cheats, he will be meted the maximum administrative fine of P1, 000,000, as provided in the SRC.[84] We represent this fine as a payoff of -110. Normally, if the issuer cheats the investor, he stands to gain +110. But since he will be meted a sanction of -110, his total payoff from cheating the investor is now zero. The imposition of sanctions will now outweigh whatever profits from cheating the other. Hence, between a payoff of +5 if the issuer does not cheat the investor, and a payoff of 0 if he does, the issuer's preferred strategy is not to cheat the investors. This altered payoff structure can be demonstrated below:

		Issuer	
		Do not Cheat	Cheat
Investor	Invest	+105, +5	-100, 0
	Do not Invest	100, 0	100, 0

Figure 3. Prisoner's Dilemma with mandatory disclosure where first payoff represents that of Investor, and second payoff that of Issuer

Game theory tells us that a mandatory disclosure system will make it more beneficial for issuers to cooperate with their stockholders rather than to defect or to cheat on them. Investors will be assured that their issuer's incentives to cheat on them has been sufficiently reduced. Greater confidence in their issuers will encourage investors to participate in the market.[85] By providing "a focal point around which individuals can coordinate their behaviour,"[86] law has thus served as a tool to encourage the parties to cooperate.

III. WHY CORPORATE DISCLOSURES DON'T WORK

A. CONFLICTS OF INTEREST WITHIN THE CORPORATION

The logic behind mandatory disclosure is that the pain of punishment will outweigh whatever pleasures and profits from breaking the law. [87] However, this theory is "problematic when applied to corporate behaviour."[88]

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[84] SRC, sec. 54.

[85] E. Beecher-Monas, *op. cit. supra* note 8 at 168.

[86] R. McAdams, *op. cit. supra* note 77 at 1651.

[87] E. Beecher-Monas, *op. cit. supra* note 8 at 186, citing M. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 671, 674-76; J. Scholz, *Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory*, 60 LAW & CONTEMP. PROBS. 253, 258 (1997).

[88] E. Beecher-Monas, *op. cit. supra* note 8 at 186.

A fundamental limitation of the prisoner's dilemma game, or any 2x2 game for that matter, is that it presupposes that an individual player comprises of only one person. Thus, it assumes that this person acts only for his interest in order to maximize his individual payoff. Essentially, the models above have uniformly assumed that disclosure requirements give the issuers sufficient incentive to cooperate with their issuers.

Issuers however, are not individual people. Issuers are corporations composed of directors and officers, who may have their own individual interests. Moreover, the interests of directors may sometimes conflict with those of managers. Therefore, even if it is in the issuer's best interest to disclose, it may not be in the best interest of its directors or managers.

For example, directors may have a conflict of interest in deciding whether to cooperate with investors or not. Some of them may want to purchase additional equity for themselves to consolidate control. Hence, they might not want to entice new investors at all, or they might take actions to encourage existing investors to opt out.

Moreover, manipulation of disclosures can lead to substantial stock and financial gains for managers and directors.[89] If managers are paid according to the company's performance or according to the current stock price, they may make decisions that will increase profits or stock price in the short run, without considering that such short-sighted actions may decrease productivity in the long-run. This may be detrimental to the investors. For instance, if managers are given hefty bonuses in the form of stocks, or their pay is tied to the current price of the corporation's stocks, they may be compelled to report that the firm is very profitable, if such false disclosure will increase the price of stock. They may then sell their stock holdings for a tiny profit.

The dangerous thing is that it may not matter much to them if the stock price will subsequently plummet if the making of such false disclosure is later revealed. By the time the false disclosure is discovered, they may have already profited substantially from the stock's phenomenal, but temporary, increase in value. In fact, it has been found that bonus plans which depend on reported earnings create incentives for managers to manipulate earnings upwards.[90] Thus, even if it will be theoretically in the best interest of the firm, taken as a whole, to cooperate with its investors, its managers are expected to act opportunistically at the expense of the interests of its investors.[91]

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[89] E. Amistad, *Disclosures: The Corporate Striptease*, 79 PHIL. L. J. 315, 326 (2004).

[90] J. Tsui & F. Gul, *2nd OECD/WorldBank Asian Corporate Governance Roundtable, Corporate Governance and Financial Transparencies in the Hong Kong Special Administrative Region of the People's Republic of China, May 31, 2000*, available at <http://www.oecd.org/dataoecd/57/58/33919929.pdf>.

[91] This conclusion is also an inevitable offshoot of the fact that in corporations, ownership is separate from control. The issuers need the investor's funds. But the funds will be solely in the control of the issuer's managers, and it is impossible to write contracts that will make managers liable for every misdeed that they do. This is known as the agency problem in economics, as predicted by Coase. See R. Coase, *The Nature of the Firm*, 4-Nov. Economica 386-405 (1937); M. Jensen & W. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, JOURNAL OF FINANCIAL ECONOMICS 3, 305-360 (1976); E. Fama & M. Jensen, *Separation of Ownership and Control*,

B. THE PRECISE LIABILITY OF CORPORATE ACTORS AND ISSUES OF CRIMINAL LIABILITY

At this point, it may be argued that even as individuals, dishonest managers and directors can be criminally liable[92] for false disclosures. The argument goes this way. If they are threatened with grave sanctions, it may be in their personal best interest to tell the truth. However, this may not always hold true.

For one, laws regulating corporate conduct do not define the "precise behaviour required of corporate actors."[93] Responsibility is diffused in corporations.[94] A particular manager may find it particularly useful to himself not to disclose information to the rest of the corporation, especially when responsibility for a false registration statement is distributed among other managers, directors, auditing firms, and all other parties who may have certified the accuracy of such statements. For instance, Section 56 of the SRC distributes[95] civil liability for a false registration statement among director, auditors or auditing firms, persons who have prepared or certified the registration statement or any report upon which the report was based, and every underwriter. The punitive effect of making false disclosures is thus reduced for a particular wrongdoer.

The SRC attempts to remedy this anomaly by providing:

> Sec. 73. Penalties. — Any person who violates any of the provisions of this Code, or the rules and regulations promulgated by the Commission under authority thereof, or any person who, in a registration statement filed under this Code, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall, upon conviction, suffer a fine of not less than Fifty thousand pesos (P50,000.00) nor more than Five million pesos (P5,000,000.00) or imprisonment of not less than seven (7) years nor more than twenty- one (21) years, or both in the discretion of the court. <u>If the offender is a corporation, partnership or association or other juridical entity, the penalty may in the discretion of the court be imposed upon such juridical entity and upon the officer or officers of the corporation, partnership, association or entity responsible for the violation, and if such officer is an alien, he shall in addition to the penalties prescribed, be deported without further proceedings after service of sentence</u>. (underscoring supplied)

JOURNAL OF LAW & ECONOMICS 301-325 (June 1983); A. Shleifer & R. Vishny, *A Survey of Corporate Governance*, JOURNAL OF FINANCE 737-783. (June 1997).

[92] SRC, sec. 54.2, 73.

[93] E. Beecher-Monas, *op. cit. supra* note 8 at 186; J. Scholz, *Cooperation, Deterrence, and the Ecology of Regulatory Enforcement*, 18 LAW & SOC'Y REV. 179, 258 (1984).

[94] E. Beecher-Monas, *op. cit. supra* note 8 at 186.

[95] As worded, sec. 56 provides that any person suing for damages from a false registration statement may recover from the persons enumerated therein. It does not specifically provide if such liability is joint or solidary. art 1207 of the CIVIL CODE provides that unless specified, liability is presumed to be joint. Hence, it is submitted that liability under sec. 56 is joint.

However, as can be gleaned from the above provision, the imposition of imprisonment or fines on natural persons is largely discretionary.[96]

Moreover, directors and managers can always invoke many existing defences laid down in Philippine jurisprudence. For instance, it is well settled that directors are not liable for mistakes of judgment.[97] This is known as the business judgment rule.[98] Material information is loosely defined as "any fact/information that could result in a change in the market price or value of any of the issuer's securities, or would potentially affect the investment decision of an investor."[99] This leaves much to the discretion of a director or manager. A director can always claim that he did not disclose information since he did not deem it material enough to be disclosed.

In some cases, ignorance may even be bliss. If, in the first place, a director was not aware of such material information, then he could not reasonably be expected to disclose it. In this case, ignorance can be interposed as a defence.[100] Moreover, he might purposely keep himself uninformed. If a manager will be held liable for not disclosing material information, then he has every incentive not to seek out such material information as long as he can get away with it. For instance, unintentional errors in financial statements, such as misinterpretation of facts, is required to be disclosed in SEC Form 17-C.[101] But such investigation into an alleged error may compel an affirmative action to disclose any errors, not to mention the fact that it might erode the corporation's credibility, and create doubt as to the accuracy of all other disclosures made by the corporation. Conducting an investigation may also expose the manager or director concerned to criminal liability if he withholds information gleaned from such an investigation. Hence, he is better off keeping himself ignorant about certain material facts. Certainly, the risk of discovering incriminating information, and of being exposed to liability for not exposing such information, is a powerful deterrent to the conduct of any investigation.[102]

C. THE HIGH PRICE OF HONESTY

Making disclosures, especially if they are truthful, accurate and timely costs money. While disclosure is useful to both parties, making disclosures does not come cheap. There are direct and indirect costs when an issuer makes accurate disclosures. These costs greatly decrease the incentives of issuers to disclose, and reduces their over-

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[96] E. Amistad, *op. cit. supra* note 89 at 331.

[97] Steinberg v. Velasco, 52 Phil 953 (1929); Montelibano v. Bacolod-Murcia Co., 95 Phil. 407 (1954); Otis v. Pennsylvania Railroad Co. 61 F. Supp. 905, affirmed 155 F2d 522 (1946); & Litwin v. Allen 25 N.Y.S. 2d. 667 (1940).

[98] I J. CAMPOS & M. CAMPOS, THE CORPORATION CODE 642 (1990).

[99] SRC IRR, Rule 3.1 (I). The concept of materiality will be further discussed in Part III (D).

[100] R. MORALES, *op. cit. supra* note 2 at 312. This statement was made with respect to the liability of controlling persons under sec. 51 of the SRC, but it is submitted that Morales' statement can also be applied to liabilities under sec. 73.

[101] SEC Form 17-C, Item 10.

[102] E. Beecher-Monas, *op. cit. supra* note 8 at 194.

all payoff. In some cases, the negative incentives from making disclosures may cancel out the positive incentives.

1. Costs of gathering information

The SRC, as currently worded, obliges the issuer to file a registration statement with the SEC,[103] and to make periodical reports on its financial conditions and other material information.[104] These periodical reports include not only an annual report,[105] but quarterly reports as well.[106] The issuer bears direct costs for compiling, disseminating and verifying all the information required to be in these statements.[107] Disclosures also entail the services of a plethora of lawyers and accountants. These professionals will decide if a certain piece of information is material, and will determine if all the information to be disclosed is accurate. There are also expenses for printing and mailing disclosure documents.[108]

Costs may also come in the form of the opportunity costs. Disclosure takes much time and effort from the professionals mentioned above, not to mention from those of the company's own employees. All these time spent on disclosures could have been channelled to more productive ventures.

2. Proprietary costs

Disclosures also entail indirect costs. The SRC and the pertinent SEC regulations require the disclosure of information deemed material. However, material information is usually sensitive information. These material and sensitive information required to be disclosed include matters pertaining to company reorganization,[109] major risk/s faced by the company and procedures being undertaken to manage such risks,[110] material alterations in the issuer's activities,[111] and termination of a business relationship with a significant customer.[112] Pieces of information like these are of value not only to investors, but to the issuer's competitors as well. Hence, disclosure can be said to entail proprietary costs.[113] The more detailed the disclosures, the greater the proprietary costs. Thus, even if disclosing information will encourage investors to invest, even the most well-meaning issuer will not find it in its best interest to disclose, and will hence, stay away from tapping the public for investors. This might explain why, even with the SRC,

[103] SRC, sec. 8.1.
[104] SRC, sec. 17.
[105] SRC IRR, Rule 17.1 (A)(i).
[106] SRC IRR, Rule 17.1 (A)(ii).
[107] J. Franco, *op. cit. supra* note 83 at 270. In 1980, it was estimated that direct costs of disclosure in the U.S. amount to one billion dollars, excluding opportunity time. S. PHILLIPS & J. ZECHER, THE SEC AND THE PUBLIC INTEREST 27-51 (1981), cited in F. Easterbrook & D. Fischel, *op. cit supra* 9 at 707.
[108] F. Easterbrook & D. Fischel, *op. cit supra* 9 at 707.
[109] SRC, sec. 14.1.
[110] SRC IRR, Annex C.
[111] SEC Form 17-C, Item 9(a)(1)
[112] SEC Form 17-C, Item 9(a)(20)
[113] J. Franco, *op. cit. supra* note 83 at 271.

the banking system is still the primary source of funding for businesses in the Philippines instead of the capital market.[114] Certainly, firms will be more willing to disclose sensitive information only to the banks that they deal with, rather than to release information to the general public and concomitantly revealing sensitive information to their competitors.

To perceive how the costs of disclosure can alter the parties' payoffs, we go back to the prisoner's dilemma game. This time, however, we factor in the costs of making disclosures.

We review the situation where we do not consider the costs of disclosures.[115] If the issuer makes disclosures, and does not cheat the investor, he stands to earn +5. But if he chooses not to disclose, and instead cheats on the investor, he will get a payoff of +110, but will be also be fined -110 under a mandatory disclosure regime. Hence, his total payoff from cheating will be -90.

Now let us factor in the cost of disclosure. Disclosure entails expenses, opportunity costs, and the risk that the issuer's competitors will eventually use the disclosed information against the issuer itself. We assign a value of -10 to reflect the manifold costs of making disclosures. Hence, if the investor cooperates, he gets +5, but since he incurred costs amounting to -10, his total payoff is now -5. This is now less than the zero payoff from cheating the investor. In this case, the issuer will be better off cheating the issuer.

		Issuer	
		Do not Cheat	Cheat
Investor	Invest	+105, -5	-100, 0
	Do not Invest	100, 0	100, 0

Figure 4. Prisoner's Dilemma with mandatory disclosure, and costs associated with disclosures where first payoff represents that of Investor, and second payoff that of Issuer

D. WHEN IS INFORMATION MATERIAL?

As discussed, the SRC mandates the disclosure of material facts, as enumerated in the SRC itself, its implementing rules, and the various annexes required to be appended to regular reports. There is little issue about the content of financial statements, as they include the usual balance sheets, profit and loss statements, and cash

[114] Interview with Lilia Bautista, Chair of the SEC, Managing Corporate Governance in Asia Quarterly Report, Vol. 6, 2002-2003 C, <http://www.rvr.aim.edu.ph/quartely%20report/MCGA%20Quarterly%20report_volume%206.doc> October 2, 2005.

[115] Please refer to Figure 3.

flows.[116] However, the SRC and its implementing rules also mandate the disclosure of all other non-financial material information.

The problem is that material information is not specifically defined. What constitutes material information lies largely in the discretion of the issuer. According to the SRC IRR, information is material if it can "result in a change in the market price or value of any of the issuer's securities, or would potentially affect the investment decision of an investor."[117] It has been ruled that as long as the information "induces or tends to induce or otherwise affect the purchase and sale of securities,"[118] it is considered material, and should be disclosed. Note that these definitions remain "dangerously open to interpretation."[119] To remedy this ambiguity, Sec. 14.1 of the SRC IRR provides the following examples:

> A. Any event or transaction which increases or creates a risk on the investments or on the securities covered by the registration;
>
> B. Increase/decrease in the volume of the securities being offered at an issue price higher/lower than the range set and disclosed in the registration statement and which results to a derogation of the rights of existing security holders, as may be determined by the Commission;
>
> C. Major change in the primary business of the registrant;
>
> D. Reorganization of the company;
>
> E. Change in the work program or use of proceeds;
>
> F. Loss, deterioration or substitution of the property underlying the securities;
>
> G. Significant or ten percent (10%) or more change in the financial condition or results of operation of the registrant unless a report to that effect is filed with the Commission and furnished the prospective purchaser;
>
> H. Classification, de-classification or re-classification of securities which results to derogation of rights of existing security holders, as may be determined by the Commission."[120]

However, this list is not exclusive,[121] and does not conclusively point out what is material or not. Such an open-ended list of material information is an acknowledgement that the definition of materiality is open to interpretation and debate. Materiality is a "mixed question of law and fact."[122] The problem remains: how can the issuer be expected to know if information will induce an investor to buy, when there are

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[116] SRC, sec. 17.1
[117] SRC IRR, Rule 3.1(I)
[118] Rules Requiring Disclosure of Material Facts by Corporations, *supra* note 56.
[119] E. Amistad, *op. cit. supra* note 89 at 322.
[120] SRC IRR, Rule 14.1.
[121] SRC IRR, Rule 14.1.
[122] Basic Inc. v. Levinson, 485 U.S. 224 (1998).

different kinds of investors, not all of whom may be rational? Even assuming that investors are rational, there are different types of rational investors. What may be important for risk-averse investors may be irrelevant for the risk-neutral. There are also some types of investors who are only after short-run gains, so they might not need information about long-term reforms being undertaken by the company. In the same vein, investors who are in it for the long haul may not be interested to know if a director has resigned from the board, an event that is required to be disclosed by the SRC IRR.[123] Hence, the importance of a piece of information depends on the context in which it is given[124] and the receiver of the information.

The inherent ambiguity of the definition of materiality is manifested even in SEC rulings. For instance, logistics operator International Container Terminal Services Inc. (ICTSI) applied part of its additional paid-in capital to cover its retained earnings deficit. [125] ICTSI did not disclose this Board resolution, on the ground that it did not deem it material. ICTSI reasoned that when such information was subsequently disclosed, there was no effect on the share price of ICTSI anyway. The SEC en banc agreed with ICTSI. It absolved ICTSI of a P1 million fine, which was initially imposed by the SEC Corporation Finance Department. The SEC en banc acknowledged that while "it is an important corporate action, ... (it is) not in fact 'material' to require disclosure on SEC Form 17-C...[and] is optional on the part of the issuer to report such important events."[126]

However, the fact that there was no actual change in share price does not mean that such information was not material. Material information does not require that the price of the issuer's securities actually change, as it suffices that it "could result in a change in the market price or value of any of the issuer's securities, or would potentially affect the investment decision of an investor."[127]

This case only demonstrates that what is material is not always conclusive or clear. Hence, ICTSI or any other issuer cannot be faulted if it reasonably believed that a piece of information was not material. What constitutes material information lies largely within the discretion of the issuers.

Consequently, investors cannot be similarly faulted if they have less confidence in the truth and the comprehensiveness of these disclosures, knowing that these lie largely in the discretion of the issuer. This takes away much of the effectiveness of mandatory disclosures in increasing investor confidence and in promoting cooperation between issuers and investors.

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[123] SEC Form 17-C.

[124] R. Thomas & J. Hicks, *The Materiality Standard for Intellectual Property Disclosures, Notes Bearing Interest*, 23 NCBA NEWSLETTER BUS. LAW SEC. NO. 1 207 (2002), cited in E. Amistad, *op. cit. supra* note 89 at 323 fn. 33.

[125] A. Flores, *SEC reverses ruling on ICTSI fine*, available at <http://www.manilastandardonline.com:8080/mnlastd/ContentLoader?page=business01_aug19_2003> October 7, 2005.

[126] *Ibid.*

[127] SRC IRR, Rule 3.1 (I).

Such an ambiguous standard of materiality may even lead over-cautious issuers to disclose too much information. The potential liability of a violation of the SRC can be significant, and the standard of materiality is low, so the corporation and its management may be held liable for even insignificant omissions.[128] Since any rational issuer would seek to avoid liability, there is a possibility that issuers would choose to err on the side of caution. Management will naturally fear exposing itself to substantial liability, so it will tend to "simply bury the shareholders in an avalanche of trivial information- a result that is hardly conducive to informed decision making."[129]

E. A QUESTION OF TIMELINESS

Another contentious issue is exactly when material information should be filed.

There is no controversy on the filing of annual and quarterly reports. Annual reports are supposed to be filed within one hundred five (105) days after the end of the issuer's fiscal year.[130] Quarterly reports must be filed within forty five (45) days after the end of each of the first three quarters (3) of each fiscal year.[131] The controversy is with regard to current reports. The SRC IRR does not specify exactly when current reports should be filed, as it merely requires such reports to be made, "as necessary, to make a full, a full, fair and accurate disclosure to the public of every material fact or event that occurs, which would reasonably be expected to affect investors' decisions in relation to those securities."[132]

It might be pointed out that the Rules further clarify that such current disclosure must be made promptly to the public through the news media, and if the issuer is listed on an Exchange, within ten (10) minutes after occurrence of the event.[133] But these "clarificatory" standards beg the question. Exactly what is meant by prompt? Is it prompt when a disclosure is made one week later? Or does promptness require that it be made instantaneously? Moreover, we go back to the earlier issue of materiality. Exactly when does information become material enough to influence an investor?

The SEC has yet to issue clear rules on exactly when information becomes material, other than the general standard of materiality, namely, that it "could result in a change in the market price or value of any of the issuer's securities, or would potentially affect the investment decision of an investor."[134] But once again this standard is nebulous. The Philippine Stock Exchange has attempted to lay down a standard for its members. The Exchange has opined that soft information need not be disclosed. Information is still soft when it is "not yet definite in nature where it is in the company's and shareholder's interest to wait until is certain before it is disclosed to the public," and

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[128] TSC Industries Inc. v. Northway Inc. 426 U.S. 438 (1976).
[129] *Ibid.*
[130] SRC, IRR Rule 17.1 (A)(i).
[131] SRC, IRR Rule 17.1 (A)(ii).
[132] SRC, IRR Rule 17.1 (A)(iii).
[133] SRC, IRR Rule 17.1 (A)(iii).
[134] SRC, IRR, Rule 3.1 (I).

"includes forward looking or predictive information, subjective or evaluative information, uncertainties and developments in process."[135] Instead of clarifying the ambiguity, this guideline raises more questions. When does information definitely become definite? What if the company's and the shareholder's interests are not aligned?

For instance, suppose the issuer is exploring the possibility of merging with a competitor. Merger is explicitly required to be disclosed via SEC Form 17-C.[136] Certainly, a merger will affect the market price of an issuer's securities and the investment decision of an investor.[137] The issue is exactly when this information becomes material enough to be disclosed. Is the fact of engaging in exploratory talks material enough by itself? Or does it become material only when an agreement has been reached? Further questions can be raised: what kind of agreement must be reached so that the information is no longer soft information? Does information become definite and material when the parties agree to merge, or must they agree first on the price? This was precisely the issue raised before the US Supreme Court in Basic Inc. v. Levinson.[138] In this particular case, the Court rejected the contention that merger discussions become material once an agreement in principle on price and structure has been reached.[139] Instead, the Court ruled that there should be no "bright-line rule" with respect to information on a proposed merger, and enunciated that the question of timeliness of material information must be analyzed on a case-by-case approach.

F. THE DIFFICULTIES OF VERIFYING INFORMATION

Aside from issues on what disclosures should be made and when information becomes material, there is also an issue of verifiability. Disclosures are meaningless unless they are true. Firms may be compelled to disclose information under the SRC, but there is still a possibility that they can just as easily disclose wrong or misleading information. True, there are penalties for making misrepresentations.[140] An issuer can be sued by an investor for damages arising out of a false registration statement,[141] or for damages arising out of misleading reports.[142]

However, these preventive and/or corrective measures presuppose that corporate disclosures are verifiable pieces of information. The average investor is not inclined to inspect the books and records of the issuer. It would be asking too much if an investor was obliged to verify the disclosures himself. After all, he is investing precisely to passively receive an income stream. Otherwise, if an investor were to constantly monitor his investments, then he might as well devote his time to start his own business and be an issuer himself.

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[135] PSE Memo for Brokers No. 245-2002 (October 8, 2002), cited in E. Amistad, *op. cit. supra* note 89 at 324.
[136] SEC Form 17-C, Item 9 (a)(18).
[137] SRC IRR, Rule 3.1 (I).
[138] 485 U.S. 224, 239 (1998).
[139] E. Amistad, *op. cit. supra* note 89 at 324.
[140] See for example SRC, secs. 56 & 57.
[141] SRC, sec. 56.
[142] SRC, sec. 57.

Moreover, assuming that investors are so inclined to verify corporate disclosures on their own, most investors do not possess the expertise and skills to inspect a business venture so as to enable them to predict future profits and risks.[143] Thus, the SEC, a specialized body, is given powers to investigate if a disclosure is truthful.[144] However, in the event of such a suit for damages, even the SEC may find it difficult to verify disclosures. With more reason will a regular court be unable to make such verifications. This is because in securities markets, only a limited amount of information can be verified at all.[145]

To fully understand the concept of verifiable information,. we use another popular game theory concept: the story of the apple vendor.[146] Suppose a seller is selling a sealed box which can contain up to 100 apples. The seller knows the exact number of apples in the box. The seller is saying that the box contains 100 apples, so he is selling the box at a price equal to that of 100 apples. But the buyer has no way of knowing if there are indeed 100 apples in the box unless he buys the whole box at that price and counts the apples himself. Should it turn out that there are actually only 99 apples in the box, and the seller had misrepresented the number of apples in the box, the buyer can sue the seller. The number of apples in the box is easily verifiable. The buyer can simply present the apples to the court, and the judge can verify if the box indeed contains only 99 apples simply by counting. In this case, the liability of the seller for damages can be easily ascertained.

However, suppose the buyer did get 100 apples, but he is unsatisfied with their quality. He may have intended the apples to be used in making apple pies, or for gift baskets. Even if he sues the seller over the poor quality of the apples, these qualities may not so easily be determined by the court.[147]

It is the same with securities. In most cases, material information is not just about quantitative information such as profit and losses for the year. Rather, what makes mandatory disclosures so complicated is that a lot of the information required to be disclosed is qualitative, and hence, cannot easily be verified either by the investor or even by the court later on.

For instance, SEC Rules require the disclosure of "acts and facts of any nature that might seriously obstruct the development of corporate activities, specifying its implications on the issuer's business."[148] This kind of information is within the sole knowledge of the issuer. The issuer decides for itself if an act will seriously obstruct its business. Moreover, the issuer cannot always accurately specify its implications on its business. Even if the issuer is able to determine the precise effects of an intended action, and will truthfully disclose this to its investors, the average investor has no way of

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[143] F. Easterbrook & D. Fischel, *op. cit supra* 9 at 674.
[144] SRC, sec. 53.
[145] F. Easterbrook & D. Fischel, *op. cit supra* 9 at 674.
[146] D. Baird, *op. cit. supra* note 61 at 89.
[147] E. Beecher-Monas, *op. cit. supra* note 8 at 169.
[148] SEC Form 17-C, Item 9(a)(6).

verifying this kind of information. Suppose it turns out that the information was incorrect. The investor subsequently sues the issuer for damages arising from misrepresentation under Section 56 or Section 57 of the SRC. But it is doubtful if the investor can recover. In a subsequent litigation, it would be very difficult and expensive for a court to make informed judgments about such an intricate issue.[149] Hence, such information is practically unverifiable.[150]

Carried to an extreme, the presence of unverifiable information about securities can lead to a lemons problem[151] where only low quality securities are sold. Since disclosures are not always accurate and cannot always be verified, low-quality issuers can easily get away with making false disclosures. If this happens, there might be no way to separate low quality issuers from the high-quality issuers who always strive to disclose correctly. High-quality issuers may thus be unable to convince buyers of their true worth. Logically, they cannot demand a high price for their securities. They will not be able to fetch the correct price for their securities, so they will choose to keep off the market, and resort to borrowing from banks to finance their projects. Ultimately, only low-quality issuers are left, and only low-quality securities or "lemons" are sold.[152] This is the familiar lemons problem, which might ultimately stunt the growth of the capital market.

G. ADVERSE EFFECTS OF DISCLOSING CONFLICTS OF INTEREST

Under the SRC, an insider may buy or sell securities of the issuer, if the insider discloses the pertinent material information to an "outsider" he will be transacting with. [153] The law expects that once the outsider has been fully informed by the insider, he can make a more informed decision as to whether to trade with the insider. The SRC aims to reduce the information gap between the informed and the uninformed,[154] and hopes that outsiders will be able to discount such information and make better subsequent decisions.[155] If the outsider still decides to sell or purchase securities notwithstanding the disclosure, he should be the one to bear any negative consequences.[156] In short, it is a case of caveat emptor.

However, a mandatory disclosure regime takes it for granted that outsiders will be able to sufficiently assess the disclosed information and make prudent decisions on the basis thereof. Disclosure will be effective only if the recipient of the information will be able to understand how the conflict of interest has influenced the insider. It is

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[149] D. Baird, *op. cit. supra* note 61 at 110.

[150] E. Beecher-Monas, *op. cit. supra* note 8 at 169.

[151] G. A. Akerloff, *The Market for Lemons: Quality Uncertainty and the Market Mechanism,* 84 Q.J. ECON. 488 (1970), cited in E. Talley, *Disclosure Norms,* 149 U. PA. L. REV. 1955, 1998 (2001).

[152] E. Talley, *op. cit. supra* note 151 at 1998.

[153] SRC, sec. 27.

[154] P. M. Healy & K. G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature,* 31 JOURNAL OF ACCOUNTING & ECONOMICS 405, 412 (2001), cited in D. Cain, et al. *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest,* 34 J. LEGAL STUD. 1 (2005).

[155] D. Cain, *op. cit. supra* note 154 at 3.

[156] *Ibid.*

imperative that the recipient of such disclosed information must be able to correct for the influence of bias.[157] Studies show that such adjustments are likely to be insufficient.[158] Generally, people cannot easily unlearn or block out biased advice, even if they have been made aware that it is biased.[159]

Moreover, the outsider may be more likely to exaggerate or underrate his disclosures to neutralize the anticipated warning effect of the disclosure. For instance, the insider may say to the outsider "I want to sell you my shares in Company X for P100 per share. Note I sit on the Board of Directors, so I know that the company will be adversely affected by an upcoming price ceiling to be imposed on products being sold by our company." This is the type of material information required to be disclosed in insider trading.[160] But the director may add, "But I anticipate that we can still maintain our current level of profits because the company is very competitive, and we might be retrenching employees soon." In this case, there is nothing to prevent the insider from underrating the effect of his disclosure; all that the SRC requires him to do is to disclose information that will materially affect the market price of the security.[161] Carried to an extreme, corporate disclosures in insider trading may tempt insiders to give even more biased advice to counteract the diminished reliance that they expect the outsider to accord on it.[162]

H. THE MORAL HAZARD IN DISCLOSURES

Another game theory concept in analyzing the effectivity of disclosure requirements is the presence of moral hazard. Moral hazard is called a problem of hidden action.[163] This is especially pronounced when a principal entrusts the performance of an action to an agent. The problem exists when the action of the agent is not verifiable, or when the agent receives private information after the relationship has been initiated.[164] For instance, both the principal and the agent may have the same information when the contract is initiated. The information asymmetry arises because after the contract has been signed, the principal cannot observe or verify the action or effort of the agent, or at least, the principal can no longer control the action.[165] A traditional example is the case of insurance contracts. An insurer cannot learn exactly how an individual will behave after the insurance contract has been purchased.[166] Hence, once a person is insured, he has an incentive to be less careful, because he knows that any losses that he will suffer will be defrayed by insurance.

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[157] *Ibid.*

[158] *Id.* at 6.

[159] T. Wilson and N. Brekke, *Mental Contamination and Mental Correction: Unwanted Influences on Judgments and Evaluations*, 116 PSYCHOLOGICAL BULLETIN 117 (1994), cited in D. Cain, *op. cit. supra* note 154.

[160] SRC IRR, Rule 14 (1)(A); R. MORALES, *op. cit. supra* note 2 at 202.

[161] SRC, sec. 27.2.

[162] D. Cain, *op. cit. supra* note 154 at 7.

[163] D. Baird, *op. cit. supra* note 61 at 153

[164] I. STADLER & J. PEREZ-CASTRILLO, *op. cit. supra* 82 at 9.

[165] *Ibid.*

[166] D. Baird, *op. cit. supra* note 61 at 153.

In this respect, disclosure requirements are similar to insurance contracts. Note that the SRC only requires the disclosure of information.[167] As long as the issuer discloses correct, accurate and current information, it has no other liabilities. It can act as prudently or as recklessly as it wishes, as long as it discloses its actions to the public and to the investors, subject only to the risk of a derivative suit.[168] By themselves, disclosure requirements serve as a kind of insurance, insofar as it absolves the issuer from liability.

The moral hazard problem is also present when it comes to insider trading. As discussed, there is no liability for insider trading if the insider discloses the information to the other party. The net effect is that insiders will not have an incentive to eliminate conflicts of interest,[169] since they can dispose of such conflict-of-interest concerns by the mere expedience of disclosing them.

Moreover, the problem is especially pronounced in many[170] investment contracts with boilerplate provisions. Examples of boilerplate provisions are combined disclaimers (issuer makes no representations other than those in the document), no-reliance (investor acknowledges that he relies on no other statements) and merger (the investment contract represents the entire agreement).[171] U.S. courts have uniformly declared that issuers cannot be liable for losses suffered by investors if subscription agreements clearly state that the investments are "speculative investments which involve a high degree of risk of loss."[172] These boilerplate provisions have the effect of rendering issuers virtually liability-proof,[173] much like an insurance contract. The issuer will therefore tend to be less prudent in minimizing risks, protected as he is with boilerplate provisions.

I. THE PRECISE USEFULNESS OF DISCLOSURES

Moreover, just because an issuer has complied with disclosure requirements does not mean that investing in its securities is safe. Note that the SEC does not pass on the merits of the securities, nor does it determine if the security is a good investment.[174] Disclosure regulations could communicate the wrong impression to unsophisticated investors. They might be led to believe that unscrupulous prospects have been removed from the market.[175] Hence, they might adopt higher risk investment strategies, believing that the regulations themselves will protect them from possible loss. This is especially

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[167] SRC, secs. 8, 17, & 27.

[168] Western Institute of Technology v. Salas, 343 Phil. 742 (1997).

[169] D. Cain, *op. cit. supra* note 154 at 7.

[170] R. Prentice, *Contract-based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337, 349 (2003).

[171] *Id.* at 339.

[172] Carr v. CIGNA Securities, Inc. 95 F.3d 544, 548 (7th Cir. 1996). See also Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1033 (2d Cir. 1993).

[173] R. Prentice, *op. cit. supra* note 170 at 345.

[174] R. MORALES, *op. cit. supra* note 2 at 65.

[175] R. Romano, *Protecting Investors in a Global Economy: The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 405 (2001).

true for developing countries like the Philippines where the level of investor sophistication is still low.[176]

IV. TOWARDS A MORE EFFECTIVE SYSTEM OF DISCLOSURES

To be sure, the mandatory disclosure regime has many weaknesses. So far, it has not been effective at preventing securities fraud. However, the solution is not to scrap mandatory disclosure, but to improve it. Some recommendations are provided as follows.

A. BRUTE FORCE APPROACH

It is a fundamental principle of game theory that each party will always seek to maximize his payoffs. As has been shown, if the costs of disclosure is greater than the expected gains, the issuer will opt not to disclose. Issuers may determine that the potential gains from deception outweigh the adverse consequences.[177] In this case, a brute force approach[178] might help tilt the scale.

The old law, the Revised Securities Act, allowed administrative fines for false disclosures. However, the fines could range only from P200 to P50,000, plus P500 for each day of continuing violation.[179] By today's standards, these penalties are not sufficiently punitive to deter violators. The SRC has sought to correct this anomaly, and has prescribed the following administrative penalties: "(i) Suspension, or revocation of any registration for the offering of securities; (ii) A fine of no less than Ten thousand pesos (P10,000.00) nor more than One million pesos (P1,000,000.00) plus not more than Two thousand pesos (P2,000.00) for each day of continuing violation;..."[180]

However, the foregoing penalties prescribed in the SRC may not be sufficient to tilt the scale. Ideally, to eliminate the incentives of issuers to cheat, the benefits to be enjoyed by issuers from cheating investors must be adequately outweighed by the penalties to be imposed on them,

Considering the scale of frauds perpetrated on the public, even P1,000,000 might not be enough to deter fraudulent issuers. Consider the recent BW Resources scam. It is possible that the perpetrators of this scam earned at least P1 billion.[181] Hence, a one million-peso fine under the SRC may not be sufficiently punitive.

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176 Ibank, *Opening New Investment Possibilities*, June 21, 2004, available at <http://www.ibank.com.ph/Inside%20i/Press062104.htm.>.

177 J. Franco, *op. cit. supra* note 83 at 269.

178 E. Talley, *op. cit. supra* note 151 at 1999.

179 R. MORALES, *op. cit. supra* note 2 at 322.

180 SRC, sec 54.1.

181 J. Lim & C. Pascual, *The detrimental role of biased policies: Framework and Case Studies*, available at <http://www.tag.org.ph/pdf/PCPS-Study3.PDF> October 7, 2005. The paper does not specify the profit earned by the fraudsters in the BW case, but it can be extrapolated from the figures given by the authors that these profits run into billions. We adopt a conservative estimate of P1 billion.

To illustrate further, we analyze the situation again from a game theory point of view. In the previous examples, we assumed that if issuer and investor cooperate, both will gain +5 each. We also assumed that the issuer incurs costs of -10 to disclose. If the issuer cheats the investor, he stands to gain +110. If the law penalizes him P1,000,000, we can assign this penalty a value of -110 also.

But suppose the gain from cheating is more than +110. Suppose that the issuer stands to gain +200 from cheating the issuer. If the fine is only up to -110, the issuer will still stand to gain +90. Hence, the issuer will still cheat if the penalty is not sufficiently punitive.

		Issuer	
		Do not Cheat	Cheat
Investor	Invest	+105, -5	-100, +90
	Do not Invest	100, 0	100, 0

Figure 5. Prisoner's Dilemma with mandatory disclosure, costs associated with disclosures, and a limited fine where first payoff represents that of Investor second payoff that of Issuer

Thus, it is recommended that the administrative fine be not limited to P1,000,000. Rather, the scale of penalties must be tied to the amount of money earned from violating the SRC. This would take the form of adopting Sec. 54.1(iv), which imposes the following penalty for violating Sec. 34: "(i) In the case of a violation of Section 34, a fine of no more than three (3) times the profit gained or loss avoided as a result of the purchase, sale or communication proscribed by such Section;...."[182]

Perhaps, imposing a similar penalty of two times the profit gained would serve to deter fraudsters. If the issuer gains +200 from cheating the investor, he will be fined -400. Certainly, his net payoff of -200 will deter him from cheating. Thus, under a system, which imposes fines based on the fraudulent gains of the issuer, the incentives of the issuer will be altered, and will reflect a predisposition not to cheat.

		Issuer	
		Do not Cheat	Cheat
Investor	Invest	+105, -5	-100, -200
	Do not Invest	100, 0	100, 0

Figure 6. Prisoner's Dilemma, with mandatory disclosure, costs associated with disclosures, and a fine dependent on the benefits of cheating where first payoff represents that of Investor second payoff that of Issuer

Although the BW scam is mainly a case of manipulation of stock prices, it is submitted that the magnitude of the scandal involved reflects the fact that frauds of such scale can be perpetrated on the public.

[182] SRC, sec. 54.1.

The SRC has also prescribed that investors may sue for damages from issuers and its officers who have made untrue statements or who omit to state a material fact.[183] Since neither the SRC nor its implementing rules specify what is meant by damages, it is submitted that this may mean damages as understood in civil law, meaning actual, moral and exemplary damages, among others.[184]

With respect to civil liability arising from such frauds, it may not be enough to prescribe that damages can be recovered from the fraudulent issuer. Actual damages are limited to such pecuniary losses as are actually suffered by the injured party.[185] Moral damages may be recovered by an investor on the ground that the misrepresentation to him was a breach of contract where the issuer acted fraudulently or in bad faith."[186] However, it may be hard to prove actual damages. Stock prices rise and fall for a variety of reasons, only one of which is fraudulent representations, so it may be difficult for courts to award damages.

B. STRENGTHENING THE ENFORCEMENT MECHANISM

But then again, even with increased penalties, a weak enforcement system may render these stiff penalties nugatory. The magnitude of the consequences of being punished should be discounted by the likelihood of actually being detected.[187] Deterrence is after all, a function of both increased penalties and increased enforcement.[188] Weak market institutions and a poor regulatory structure[189] lead to a low probability of getting caught, and may be inadequate to outweigh the benefits of cheating for issuers. The SEC's enforcement actions should be strengthened through effective coordination with the Department of Justice, the Supreme Court, the Philippine National Police and the National Bureau of Investigation to ensure that cases of financial fraud are adequately investigated and prosecuted.

Weaknesses in the enforcement mechanism could also be remedied by active shareholders who will vigilantly monitor and deter issuer fraud. The legal action of aggrieved investors can complement weak enforcement mechanisms.[190] In the United States, prosecution for securities fraud requires proof that the defendant possessed a "mental state embracing intent to deceive, manipulate or defraud.[191] However, it is submitted that such a suit may prosper in the Philippines even if intent to deceive or defraud is absent or cannot be proved. Regardless of whether the SRC requires such intent to defraud, there are adequate remedies under other Philippine laws. For instance, an aggrieved investor may directly sue an erring director or officer:

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[183] SRC, secs. 56 & 57.
[184] See CIVIL CODE, Title XVIII.
[185] CIVIL CODE, art. 2199.
[186] CIVIL CODE, art. 2199.
[187] J. Franco, *op. cit. supra* note 83 at 269.
[188] E. Beecher-Monas, *op. cit. supra* note 8 at 203.
[189] J. Lim & C. Pascual, *op. cit. supra* note 181.
[190] J. Hasung, *Empowering Shareholders' Rights: Derivatives and Class-Action Lawsuits*, available at <http://www.oecd.org/dataoecd/49/28/2484625.ppt>.
[191] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

> Sec. 31. LIABILITY OF DIRECTORS, TRUSTEES OR OFFICERS. - Directors or trustees who willfully and knowingly vote for or assent to patently unlawful acts of the corporation or who are guilty of gross negligence or bad faith in directing the affairs of the corporation or acquire any personal or pecuniary interest in conflict with their duty as such directors or trustees shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members and other persons.[192]

The basis of such suit would be that a director would be guilty of gross negligence or bad faith if he failed to take reasonable measures to ensure that stockholders are fully apprised of corporate affairs.

However, a single investor may not have sufficient incentive to bring such a suit. Lawsuits take time and money, so the expected gains may pale in comparison to the legal costs.[193] The remedy of small investors would be to band together and file a class action for damages. Such class actions, similar to those filed against College Assurance Plans by its planholders,[194] are authorized under the Rules of Court:

> Rule 3, Sec 12. When the subject matter of the controversy is one of common or general interest to many persons so numerous that it is impracticable to join all as parties, a number of them which the court finds to be sufficiently numerous and representative as to fully protect the interests of all concerned, may sue or defend for the benefit of all. Any party in interest shall have the right to intervene to protect his individual interest.

Class action suits should be highly encouraged by the government. It has been suggested that Congress pass a specific law allowing class actions for investors.[195] Other measures could be taken to increase coordination among similarly aggrieved investors. For instance, the SEC can establish a desk not only to receive complaints about erring issuers, but also to direct individual complainants to fellow complainants in the same predicament so these investors can coordinate their efforts in obtaining redress. The SEC can even establish an online forum at its website to provide a common "meeting place" where investors can organize. The increased probability of class action suits will contribute to effectively deterring self-interested behaviour under a mandatory regime.

C. HARNESSING THE POWER OF REPUTATION

Parties often have repeated dealings with one another.[196] Indeed, many issuers are repeat players who will make subsequent issuances, so they will work hard to develop a reputation for disclosing candidly.[197] The benefits of cheating once are far outweighed by the reputational costs. This simply means that once the market knows

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[192] CORPORATION CODE, sec. 31.

[193] E. Amistad, *op. cit. supra* note 89 at 333.

[194] C. Ordinario, *CAP Shrugs Off Petition, Says Case is a Nuisance*, available at <http://www.manilatimes.net/national/2005/apr/29/yehey/business/20050429bus1.htm>.

[195] E. Amistad, *op. cit. supra* note 89 at 333.

[196] D. Baird, *op. cit. supra* note 61 at 159.

[197] E. Talley, *op. cit. supra* note 151 at 1958.

that an issuer has cheated, it is unlikely or very difficult to get investors to buy its issuances again, no matter how much the firm has reformed.[198] But then, even if a firm will not be making issuances in the future, its reputation will certainly affect its stock price, and in turn, affect its chances for obtaining funding from banks and other private creditors.[199]

Unfortunately, many fraudulent issuers are fly-by-night operators who seldom last longer than a year.[200] Hence, it is imperative that prospective investors be notified as soon as possible of new issuers. A centralized monitoring system for investors can be established under the auspices of the SEC. This will be modelled after the Credit Management Association of the Philippines (CMAP). The CMAP keeps something akin to a database of delinquent borrowers all over the country, which it forwards to banks. These delinquent borrowers will subsequently have difficulty opening accounts, applying for credit cards and availing of loans. Furthermore, since financial institutions share this kind of information, the erring debtor would also have difficulty securing credit lines from suppliers. More than the threat of having a case filed against them, the possibility of being blacklisted by financial institutions belonging to the CMAP system is perhaps the most effective reason why debtors settle their accounts as soon as possible.

A similar mechanism for investors can be established. An investors' association can keep a regular list of fraudulent issuers. At present, the SEC website has a list of corporations with revoked registrations or against which it has issued cease and desist orders.[201] However, since it takes some paperwork before the SEC can issue a cease-and-desist order or revoke a registration, a private investor's association can provide more timely information, especially with respect to new issuers against whom no formal complaints have been lodged yet. Another alternative could be to establish an online forum at the SEC website where investors can share information with each other expeditiously.

D. WARRANTIES

Warranties in investment contract are another mechanism to make disclosures work. While investing is a without-recourse transaction, the ability of a party to add warranties and other penalties may signal certain positive attributes about the issuer.[202] Issuers can be required to warrant that its disclosures are fair representations of its financial condition, or that the firm has no knowledge of any material adverse developments. If these representations turn out to be false, the investors can recover

[198] M. Gulati, *When Corporate Managers Fear a Good Thing is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 691 (1999).

[199] *Id.* at 730. A case in point is that of Enron. Monas asserts that "Enron's ability to obtain financing was linked to its stock price and that was the trigger for its bankruptcy." E. Beecher-Monas, *op. cit. supra* note 8 at at 148, fn. 37.

[200] A. Flores, *A Year of Scams*, available at <http://www.manilastandardonline.com:8080/mnlastd/iserver?page=business03_jan14_2003>.

[201] See <www.sec.gov.ph>.

[202] D. Baird, *op. cit. supra* note 61 at 152.

damages from the firm based on this warranty.[203] Honest issuers can offer these warranties more cheaply than crooked issuers, since they will face less suits for false disclosures.[204]

On the other hand, boilerplate provisions, disclaimers or waivers should be outlawed. Fraudulent investors are most likely to include such disclaimers in their contracts.[205] If an issuer lies and is able to convince an investor to purchase stock, the issuer can also convince the investor to sign a contract "representing that these lies were not made or relied upon."[206] Sellers of bogus securities may defraud the public with impunity, simply by placing such clause in the prospectus.[207] Although an outright waiver against future fraud is void under Philippine law,[208] a boilerplate provision may similarly eliminate any protection for investors. An example of such a boilerplate provision would be one providing that the investor did not rely on the issuer's oral representations, and that "no promise or inducement for this agreement (had) been made to buyer except as set forth herein."[209]

Interestingly, Annex D as required by the SRC Rule 30.2-3 contains something tantamount to a boilerplate provision. Annex D requires client agreements to contain the following: "This risk disclosure does not purport to disclose all the risks and other significant aspects of investing in these securities. You should undertake your own research and study on the trading of high risk securities before commencing any trading activity." [210]

While this provision does not automatically mean that an issuer will automatically engage in fraud, it does shift much of the responsibility to the investor. Hence, the issuer will be more inclined to be careless with the risk disclosure, protected as he is with this caveat. It is suggested that this provision in Annex D be eliminated.

E. INVESTMENT BANKERS AND SYNDICATION

Issuers should also be encouraged to sell their securities through investment bankers. Investment bankers inspect the firm's records, use their own money in buying the stock for resale, and "put their reputations on the line in making representations to customers."[211] The larger the investment banker, the more effectively can it verify the firm's prospects. Thus, investment bankers form syndicates to distribute securities. The more investment bankers behind an offering, the more reputation is at stake. Thus, it is said that "syndication increases the amount of reputational capital put behind the

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[203] M. Kahan, *Games, Lies and Securities Fraud*, 67 N.Y.U. L. Rev. 750, 758 (1992).
[204] D. Baird, *op. cit. supra* note 61 at 124.
[205] R. Prentice, *op. cit. supra* note 170 at 357.
[206] *Ibid.*
[207] Arnold v. Nat'l Aniline & Chem. Co., 20 F.2d 364, 369 (2d Cir. 1927).
[208] CIVIL CODE, art. 1171.
[209] R. Prentice, *op. cit. supra* note 170 at 346.
[210] SRC IRR, Annex D.
[211] F. Easterbrook & D. Fischel, *op. cit supra* 9 at 675.

offering."[212] In this way, investors buying through such syndicates will have more confidence that disclosures of issuers have been thoroughly checked for errors and misrepresentation.

F. ALIGN INTERESTS OF MANAGERS AND INVESTORS

As discussed, the incentives of issuers and investors must be sufficiently balanced so that they will cooperate with each other. It has been pointed out though that issuers are composed of different groups with conflicting aims. The objectives of managers may be different from the objectives of investors. Thus, the SRC can mandate certain safeguards to align the interests of managers and investors.

For instance, managers and directors should be required not only to hold substantial quantities of the firm's stock, but they must also be prohibited from disposing of them until they resign from the firm, or at least not until an appreciable length of time. If the firm does poorly, the managers and directors lose with the other investors.[213] Another would be to require that compensation schemes tied to a firm's earnings be modified. For instance, to avoid the incentive to manipulate stock prices upward to obtain big year-end bonuses, such compensation schemes must be based on long-term performance. Thus, managers will make decisions bearing in mind the long-term benefits, and will not be resort to merely creating the illusion of profits.

G. HIGH PAY-OUT POLICY

Issuers can also be encouraged to adopt a high pay-out policy,[214] that is, they can commit to pay dividends consistently, instead of accumulating retained earnings. Thus, issuers will be forced to seek funding from the capital markets repeatedly to continue operations and undertake new projects. If an issuer regularly returns to the capital market, the firm repeatedly undergoes scrutiny by new investors.[215] Hence, given the fact that it will be constantly analyzed, the firm will find it in its best interest to disclose properly, and to act for the best interest of its investors even during the times when it is not making any offerings to the public.

Currently, registration fees are imposed regardless of the number of times that an issuer has applied for registration. The SRC can be amended such that registration fees on subsequent issuances within a period of one or two years can be waived or discounted.

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[212] *Ibid.*

[213] *Id.* at 676.

[214] *Id.* at 676.

[215] *Id.* at 676, referring to F. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984).

CONCLUSION

A mandatory disclosure scheme can yield optimal gains not only for an issuer and its prospective and current investors. More importantly, it will also yield optimal gains for current and prospective investors of all other issuers. A system which mandates and is able to draw out honest disclosures from all issuers allows meaningful comparison among firms which are similarly-situated. Since it compels every issuer to disclose the same types of information, an analyst will be able to compare all relevant firms and make an informed judgment as to which issuances to buy.[216] After all, standing alone, disclosures from a firm are useless unless it is compared to industry standards. For instance, a disclosure that Issuer X is earning P1 billion per year is useless, for it does not say anything about how Issuer X is faring relative to its competitors. An investor can only make an informed judgment as to whether to buy from Issuer X once it is able to compare firms and discover that the P1 billion of Issuer X is puny compared to the P5 billion per year of most of its competitors. In the end, investors will be able to make more informed judgments when they are able to compare among firms.

However, as has been demonstrated, a mandatory disclosure regime, if it fails to properly take into account the incentives and payoffs for issuers, managers, directors and investors, may actually lead to the making of misrepresentations, precisely the occurrence that it seeks to prevent. When Congress makes laws or when the SEC issues implementing rules, they must carefully consider that there are costs in making disclosures, and that disclosure, to the extent that they reveal proprietary information or give a false sense of security to investors, may actually have negative effects. Laws must not be short-sighted, or else they might backfire. To compel issuers to disclose material information and to remove the inevitable information asymmetry between issuers and investors are laudable aims, but these are not ends in themselves. Rather, they are merely means to an end, and the end is to ensure that the incentives of all relevant parties are sufficiently balanced to lead to optimal gains to themselves and to society as a whole.

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[216] S. Hannes, *Comparison Among Firms: (When) Do They Justify Mandatory Disclosure?* Paper 125 (2004), available at <http://law.bepress.com/expresso/eps/125> September 16, 2005.