DISCLOSURES: THE CORPORATE STRIPTEASE*

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INTRODUCTION

Recent events such as the spectacular collapse of, and the discovery of irregularities in, a number of large American companies have resulted in the call for stricter scrutiny over corporations, especially listed ones, and their compliance with disclosure rules. Worldcom admitted inflating its profits by USD3.8 billion between 2001 and 2002. A similar venture into creative accounting was resorted to by Enron which even resulted in the fall of an erstwhile reputable accounting firm. Adelphia and Xerox followed suit with the latter misstating four years of profits to the tune of USD3 billion.[1] The list only grows longer as regulators re-examine other corporations' books and records. The issue has even crossed overseas to Europe, following allegations that Vivendi Universal, a French firm, had tried to inflate its profits by as much as 1.5 billion euros in 2001.[2]

However, despite the evils that have come to be associated with corporations due to profligate spending and unscrupulous management, these entities are still a preferred business vehicle. While the corporation was once seen as a tool to create profit, it is now described as a "strategically central institution of social justice." And among the challenges of corporate responsibility are "the liberation of the poor through jobs and the creation of new wealth; the success of democracy and human rights ... and the project of building civil society – that network of artistic creativity, good works, and medical research that self-governing citizens choose to initiate by and for themselves. The corporation is the main creator of the wealth that

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[1] BBC Business News, *Wall Street Scandals at a Glance*, Jun. 26, 2002 *at* http://news.bbc.co.uk/1/hi/business/2066962.stm.

[2] BBC Busines News, *Vivendi Shares Plummet*, Jul. 2, 2002 *at* http://news.bbc.co.uk/1/hi/business/2082412.stm.

makes the works of civil society achievable."[3] It is in this light that the corporation will be viewed here, not as a necessary evil but as a possible tool for good. Proper disclosures under a sound regime of corporate governance play a large role in actualizing this thinking.

I. DISCLOSURE AND CORPORATE GOVERNANCE

There is ample statutory basis for the avowed policy of the Securities and Exchange Commission ("SEC") on full disclosure. As provided in section 2 of the Securities Regulation Code ("SRC"):[4]

> SEC. 2. Declaration of State Policy. – The State shall establish a socially conscious, free market that regulates itself, encourage the widest participation of ownership in enterprises, enhance the democratization of wealth, promote the development of the capital market, protect investors, *ensure full and fair disclosure about securities*, minimize if not totally eliminate insider trading and other fraudulent or manipulative devices and practices which create distortions in the free market. To achieve these ends, this Securities Regulation Code is hereby enacted. (Emphasis supplied)

Under the SRC, the SEC is mandated to promulgate the "rules and regulations providing for reporting, disclosure and the prevention of fraudulent, deceptive or manipulative practices."[5] To this end, the SEC has issued the Amended Implementing Rules and Regulations of the Securities Regulation Code ("IRR") last December 30, 2003. The IRR explicitly states the need for the full and timely disclosure of material information thus:

> Rule 2. Interpretation of Rules—Any doubt in the interpretation of these Rules shall be resolved by the Commission in a manner which would establish a socially conscious free market that regulates itself, encourage the widest participation of ownership in an enterprise, enhance the democratization of wealth, promote the development of the capital market, *protect investors, ensure full and timely disclosure of material information*, and/or minimize, if not eliminate, insider trading and other fraudulent or manipulative devices and practices which create distortions in the free market. (Emphasis supplied)

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[3] Michael Novak, *The Moral Heart of Capitalism*, August 16, 2002 *at* http://www.michaelnovak.net/Module/Article/ArticleView.aspx?id=12.

[4] SEC. REG. CODE (hereinafter "SRC"). This is Rep. Act No. 8799 (2000).

[5] § 72.2.

On April 5, 2002, the SEC adopted the Code of Corporate Governance[6] (the "Code") which required covered companies[7] to submit their Manual of Corporate Governance by September 1, 2002. Each Manual was to be made effective January 1, 2003. Explicit in the said Code is the need for full disclosure. As stated in the Code:

> VII. Disclosure and Transparency
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> *A dominant theme in all issues related to corporate governance is the vital importance of disclosure.* The more transparent the internal workings of the company and cash flows, the more difficult it will be for management and controlling shareholders to misappropriate company assets or mismanage the company.
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> *The most basic and all encompassing disclosure requirement is that all material information, i.e., any thing that could potentially affect share price, should be publicly disclosed.* Such information would include earnings results, acquisition or disposal of assets, board changes, related party transactions, shareholdings of directors and changes in ownership. Other information that should always be disclosed includes remuneration (including stock options) of all directors and senior management corporate strategy, and off balance sheet transactions. All disclosed information should be released via the approved stock exchange procedure for company announcements as well as through the annual report.
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> *The Board shall therefore, commit at all times to full disclosure of material information dealings.* It shall cause the filing of all required information for the interest of the stakeholders. (Emphasis supplied)

Full disclosure to a company's stakeholders by the board is, therefore, an essential component of sound corporate governance. One study has pointed out, however, that where ownership and control is concentrated as is the case in Asia, conventional governance mechanisms

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[6] Securities and Exchange Comm'n Memo. Circ. No. 2 (2002).

[7] Among those covered are: "[C]orporations whose securities are registered or listed, corporations which are grantees of permits/licenses and secondary franchise from the Commission and public companies. This Code also applies to branches or subsidiaries of foreign corporations operating in the Philippines whose securities are registered or listed."

such as the board are "typically weak" in the face of the "controlling owners' self-interested activities."[8]

A. DISCLOSURE RULES

Under the Revised Disclosure Rules (the "Rules") issued by the Philippine Stock Exchange ("PSE") last October 17, 2003, disclosures are divided into two categories, namely, unstructured and structured disclosures.[9] This article will deal principally with unstructured disclosures. Structured disclosures refer to reports that are periodically required by the Securities and Exchange Commission and which have been adopted by the PSE.[10] This is to assure the public of the availability of continuing adequate information about listed companies.[11]

Unstructured disclosures, on the other hand, serve "to update the investing public with any material fact or event which could reasonably be expected to affect investors' decisions in relation to trading of an Issuer's securities.[12] It is a continuing requirement for Issuers to disclose any material information or corporate act, development or event, within ten minutes from receipt of such information, happening or occurrence of said act, development or event. Moreover, disclosure to the PSE must be made prior to any release to the news media.[13]

The original copy must be filed with the PSE within twenty-four hours. If a disclosure event occurs during trading hours, the Issuer must request a trading halt. If it occurs after trading hours and the Issuer is unable to make a disclosure prior to the pre-open period of the next trading day, the Issuer must request a trading halt. In both cases, the trading halt is lifted

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[8] Joseph Fan & T.J. Wong, *Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia, at* http://econpapers.hhs.se/paper/wdipapers/2001-400.htm (Nov. 2, 2004).

[9] Revised Disclosure Rules, § 2.

[10] § 3, 17.1. Under section 17.10, the PSE has adopted the requirements for filing under the SRC and its implementing rules and regulations on the requirement applicable to the content of the issuer's non-financial and financial statement portions of registration statements, prospectuses, periodic and other reports under SRC Rule 17 such as Form 17-Q, 17-A, 17-C and 17-L, proxy and information statements and any other documents under SRC Rule 12.

[11] § 17.

[12] § 4. This is a new provision taken from SRC Rule 17, No. 2 c (i).

[13] Revised Disclosure Rules, § 4.1.

one hour after public dissemination. If disseminated one hour or less prior to market close, the trading halt shall be lifted the next trading day.[14]

The only exceptions to disclosure are: (1) if the activity or development is still considered soft information or (2) if disclosure would be against the law.[15] The Rules provide for three basic instances when disclosure is necessary:

> (1) the information is necessary to enable the Issuer and the public to appraise their position or standing, such as but not limited to, those relating to the Issuer's financial condition, prospects, development projects, contracts entered into in the ordinary course of business or otherwise, mergers and acquisitions, dealings with employees, suppliers, customers and others, as well as information concerning a significant change in ownership of the Issuer's securities owned by insiders or those representing control of the Issuer; or
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> (2) such information is necessary to avoid the creation of a false market for its securities; or
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> (3) where such information may reasonably be expected to materially affect market activity and the price of its securities.[16]

Often, top management can be faced with the dilemma akin to that of an ecdysiast, and must decide whether to bare a little, more or all about the corporation. Showing too little may earn the ire of the shareholders once the whole truth is known. Showing more may earn their gratitude. Showing everything may place the corporation at a disadvantage with respect to its competitors.

Honesty may come with a penalty. Just recently, Merck & Co.'s disclosure that it was halting the sale of a popular arthritis drug due to health threats resulted in nearly a 27% plunge in its share price, wiping out USD28 billion in market value. Moreover, this has resulted in threats of a class action suit against the company.[17]

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[14] § 4.1.

[15] § 4.1.1 - 4.1.2.

[16] § 4.3.

[17] Rita Rubin, *Merck Halts Vioxx Sales on Health Threats*, USA TODAY, Sep. 30, 2004 *at* http://www.usatoday.com/money/industries/health/drugs/2004-09-30-vioxx-withrdrawn_x.htm.

On the other hand, there are studies showing that better disclosure lowers the cost of raising capital. For one, this enables analysts to be more accurate in their performance forecasts, which leads to greater agreement among them on prospects, risks and value. Companies that perform better with respect to stock returns also display a propensity for better disclosures.[18] And it has been opined that corporate reputation has "a significant economic value" [19] in today's market.

B. NO SELECTIVE DISCLOSURE

Material non-public information about the Issuer cannot be communicated to any person unless disclosed simultaneously to the PSE.[20] However, this does not apply for disclosures to: (1) those bound by fiduciary duties or because of privilege such as auditors, lawyers, investment bankers, financial advisers; and (2) a person who has agreed to keep the information confidential and will not take personal advantage of the same.[21]

There is precedent to the effect that an Issuer may communicate immaterial information to any analyst if this helps him complete a mosaic and thereafter make a conclusion. As held in a case,[22] corporate officers and analysts can have "a general discussion out of which a skilled analyst could extract pieces of jigsaw puzzle (the mosaic) which would not be significant to the ordinary investor but which the analyst could add to his own fund of knowledge and use toward constructing his own judgment."[23] Nevertheless, the Rules have captured this by providing that any briefing with analysts and investors should be disclosed to the PSE at least three trading days prior to its scheduled date.[24]

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[18] Cynthia Glassman, *Improving Corporate Disclosure – Improving Shareholder Value* (Apr. 10, 2003), *available at* http://www.sec.gov/news/news/speech/spch041003cag.htm. Speech delivered at the 23rd Annual Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University School of Law.

[19] Alan Greenspan, *Corporate Governance* (Mar. 26, 2002), *available at* http://www.federalreserve.gov/boarddocs/speeches/2002/200203262/default.htm. Remarks delivered at the Stern School of Business, New York University, New York, New York.

[20] Revised Disclosure Rules, § 4.2.

[21] § 4.2

[22] Securities and Exchange Commission v. Bausch & Lomb, Inc. and Daniel G. Schuman, 420 F. Supp. 1226 (1976).

[23] *Id.*

[24] Revised Disclosure Rules, § 14.

C. A PRO-ACTIVE EXCHANGE — NON-PUBLIC MATERIAL INFORMATION

The PSE will not just sit and wait for disclosures. It can request the Issuer to confirm or deny any material non-public information pertaining to itself or any of its subsidiaries. If the request is made prior to the pre-open period, the reply must be made prior to the start of the said period. If made after trading hours, the reply is due prior to the pre-open period of the next trading day.[25]

Under a new provision in the Rules, in cases of absence of a reply, the PSE shall impose a trading halt which shall be automatically lifted at 10:00 AM The lifting occurs even if no reply is filed. But the PSE must receive a reply not later than 11:00 AM of that day. If there is no reply or if the reply is insufficient to clarify the issue by that time, the Issuer shall be fined PHP30,000 plus PHP10,000 for every 30 minutes of delay thereafter. This is without prejudice to other penalties and/or possible violations.[26]

II. BASIC PRINCIPLES

The basic principle enunciated under the Rules is for listed companies to make full, fair, timely and accurate disclosures of material information.[27] Echoing SRC Rule 3 of the IRR, Issuers must make publicly available all "material information." This pertains to information that will enable a reasonable investor to determine whether to buy, sell or hold securities, or information connected to the exercise of related voting rights. Reasonable steps must be taken to ensure that all investors have equal access to information.[28] The coverage appears overbroad as almost any item of information may be material to a decision to be made over listed securities. As will be discussed, this can be an item of dispute among regulators, the corporation, stockholders and the investing public.

The Amended IRR also requires such "further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading"[29] in addition

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[25] § 4.5.

[26] § 4.5.

[27] § 1.

[28] § 2. This is substantially the same definition found in SRC Rule 3 (1)(e).

[29] SRC Amended Implementing Rules and Regulations (hereinafter "SRC IRR"), Rule 72.1.

to any information required to be included in the report. This is a catch-all provision to insure completeness and covers disclosures to the PSE. The "material" standard is thus made to apply to all information, whether "additional" or not.

A. WHAT IS MATERIAL AND WHEN?

"Materiality" is the common, albeit difficult to pin down, guidepost for disclosures. Despite the attempt at a definition in the Rules, it still provides no set parameters on materiality and remains dangerously open to interpretation. When can it be said that an omitted fact is material or not? The United States Supreme Court has had occasion to rule on a proxy statement that was alleged to be incomplete and misleading. *TSC Industries, Inc. v Northway, Inc.*[30] held:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with Mills' general description of materiality as a requirement that 'the defect have a significant propensity to affect the voting process.' It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.

In any event, the court recognized the dangers of the disclosure of minutiae thus:

> We are aware, however, that the disclosure policy embodied in the proxy regulations is not without limit. Some information is of such dubious significance that insistence on its disclosure may accomplish more hann than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial

[30] 426 U.S. 438 (1976).

information - a result that is hardly conducive to informed decision making.

Elucidating further in *Basic Inc. v. Levinson*,[31] involving the failure of a company to disclose a planned merger, the court stated that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information" and endorsed a "fact specific inquiry." It is worthy to note that the issue of materiality has been characterized as a "mixed question of law and fact."[32]

Due to this lack of set parameters on what would be material, disclosures are to be judged based not on a director's or lawyer's subjective interpretation but based on "the objective reasoning of a reasonable investor." And since "the importance of a particular piece of information depends on the context in which it is given, materiality has become one of the most unpredictable and elusive concepts of the federal securities laws."[33]

The "elusiveness" of a standard is implicitly recognized in the Rules when it stated that the list of disclosable events provided therein should not be considered exclusive. To wit:

> Section 4.4 EVENTS MANDATING PROMPT DISCLOSURE: The following events, while not comprising a list of all the situations, must be disclosed to the Exchange.

The IRR similarly provides that the current report or SEC Form 17-C can only provide an "illustrative, non-all inclusive, list of events which shall be reported ... Merely because an event does not appear in that list does not mean that it does not have to be reported if, in fact, it is material."[34]

1. Silence

Silence may be golden with respect to disclosures. Investors should not read too much importance in a company's silence on certain corporate developments. In the United States, it has been held that "'[n]o comment' statements are generally the functional equivalent of silence" and that

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[31] 485 U.S. 224 (1988).

[32] *Id.*

[33] Robert Thomas & Jack Hicks, *The Materiality Standard for Intellectual Property Disclosures*, Notes Bearing Interest, 23 NCBA NEWSLETTER BUS. LAW SEC. No. 1, at 207 (Feb. 2002).

[34] SRC IRR, Rule 17.1.

"[s]ilence, absent a duty to disclose, is not misleading."[35] In fact, a no comment policy is preferable as a denial "is a factual statement that must be complete and accurate for anti-fraud purposes."[36] But even if the company has been prudent enough, it is still duty-bound to clarify any news report on any "alleged material event," if this could "create public speculation if not officially denied or clarified."[37] The company should then take care that its denials or clarifications are in accord with the Rules.

2. When is it timely?

Another problem is determining when a new prospect or development becomes firm enough to merit disclosure. It should be noted that the only exceptions to disclosure are: (1) if the activity or development is still considered soft information; or (2) if disclosure would be against the law. In the remarks to the draft rules, soft information was defined as "information that is not definite in nature where it is in the company's and shareholder's interest to wait until it is certain before it is disclosed to the public" and "includes forward looking or predictive information, subjective or evaluative information, uncertainties and developments in process."[38] Who can say when something is in a party's best interest? Or will reasonable interest suffice as a standard? What if the company's and the shareholder's interests are not necessarily intertwined?

The American Court has previously rejected a "bright-line" rule with respect to soft or preliminary information on a possible merger.[39] Petitioners in that case were arguing that merger discussions only become material once an "agreement in principle" on price and structure has been reached. The three rationales advanced for this test relate to (1) the possibility of investors being overwhelmed by too much information, (2) the need to maintain merger discussions confidential, and (3) the utility of having a set rule for determining whether a disclosure should be made.

The court rejected all three reasons. The first presumes "investors to be nitwits" who are unable to appreciate that merger discussions are risky until closed even when told. Secrecy was "inapposite to the definition of

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[35] Winthrop, Stimson, Putnam & Roberts, Bulletin No. 00-9, Jun. 28, 2000.

[36] Daniel Aronson, *Proposed Rules Regarding Selective Disclosure and Insider Trading Offer Clues on SEC's Vision, Present Challenges for Issuers, at* http://www.gtlaw.com/pub/articles/2000/aronsond00c.htm (last visited Nov. 2, 2004).

[37] SRC IRR, Rule 17.1.

[38] PSE Memo for Brokers No. 245-2002 (Oct. 8, 2002).

[39] Basic Inc. v. Levinson, 485 U.S. 224, 239 (1998).

materiality" since arguments on whether a disclosure is premature must be considered under the duty to disclose. As to the preference of having a set rule to follow, "ease of application" is not sufficient to justify its adoption since an "approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding as materiality, must necessarily be overinclusive or underinclusive."

So the rule appears to be that there are no set rules. As stated in one case, the American SEC "itself has despaired of providing written guidelines ... and instead has chosen to rely on an after-the-fact, case-by-case approach, seeking injunctive relief when it believes that the appropriate boundaries have been breached." [40]

B. DISCLOSURE LANGUAGE

Even if the corporation has said it all, the way it has been said may still fall below the standard of full disclosure. Lawyers, because of their defensive outlook, have been identified as part of the reason for poor corporate disclosures. But they can be part of the solution by "helping management tell a good and fair story" without resorting to "boilerplate, wordiness, and incomprehensible statements."[41]

On the other hand, the manner of delivery can make all the difference. Is it still the truth if you sugarcoat it a little, such as to refer to a restructuring with all its negative connotations as a "deferred repayment plan"? Or even to say that while the dates for certain debt maturities have arrived without any payment being made, their postponement is under negotiation instead of saying there has been a default on the part of the company? Does the company need to say things outright and should not the public infer the obvious? Is there room to validly argue for substantial as against full compliance with respect to disclosures? Would the valid interest in the company's survival outweigh disclosure obligations?

In an apparent response to contrived but still legitimate obfuscation, the United States SEC has issued a "A Plain English Handbook"[42] on how

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[40] *Id.*, citing Securities and Exchange Commission v. Bausch & Lomb, Inc. and Daniel G. Schuman, 565 F.2d 8 (1977).

[41] Glassman, *supra* note 19.

[42] UNITED STATES SECURITIES AND EXCHANGE COMMISSION, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS (Aug. 20, 1998), *available at* http://www.sec.gov/pdf/handbook.pdf.

to create clear SEC disclosures. It should make everyone recognize that full, fair and accurate disclosures can largely be a function of language. The Handbook explains that using plain English does not mean excluding complex information as this should be included in disclosure documents. But the information must be clearly presented in an orderly fashion, for investors to have the "best possible chance of understanding it."[43]

A corporation also has to consider not only the language it uses but also it audience. As Warren Buffet states when he is writing Berkshire Hathaway's Annual Report, disclosures should be so worded so that even his sisters, who are not experts in accounting or finance, can understand them. There must thus be a "sincere desire to inform."[44]

III. INTELLIGENT OFFICERS, BOON OR BANE?

Having discussed the rules, the focus moves to the people obliged to obey them.

It should follow as a general rule that a company's stakeholders would prefer to have intelligent executive officers at its helm, individuals capable of guiding the company to better performance results. Interestingly enough, one study posits a contrary view. Citing the cases of Enron and Worldcom, it argues that higher cognitive ability in managers can result in the "likelihood of success of a disclosure strategy that misleads investors." And this ability is even linked to the tendency to boost stock prices since this can affect managerial compensation.[45] It has been reported that managers with bonus plans linked to reported earnings are more likely to manipulate earnings upwards.[46] It is thus reasonable to conclude that this manipulation extends to disclosures which can result in substantial stock and financial gains.

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[43] *Id.*, ¶ 5.

[44] *Id.*, ¶ 2.

[45] Avanidhar Subrahmanyam, A COGNITIVE THEORY OF CORPORATE DISCLOSURES 3-4 (May 30, 2004), *available at* http://207.36.165.114/NewOrleans/Papers/8101531.pdf.

[46] JUDY TSUI, 2ND OECD/WORLD BANK 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/pdf/M000015000/M00015743.pdf.

Both means and motive now come into play. Intelligence would thus appear to be the means to commit the crime of disclosure misrepresentation, as it were, and the financial rewards, the compelling motive.

Would the alternative be to appoint a management of dunces? The answer is obvious. Not only would it place the company in jeopardy but there is likewise no proof that integrity is really a function of intellect. But it does highlight the difficulty that competence while desirable and commendable in management, provides no assurance that disclosures will be "full, fair, timely and accurate." CEOs may always succumb to pressure from the investment community to meet their expectations and thus be drawn to "accounting devices whose sole purpose is arguably to obscure potential adverse results." And auditors, who are supposed to catch and bring to light such practices, have sanctioned the same in order not to lose valued clients.[47]

A. RISKS AND REWARDS

In fine, the risks and rewards of being an officer or a director can dictate, to a large extent, his disclosure behavior on the company's behalf. Unfortunately, some risk mitigation mechanisms adopted for their protection and to attract executive or director talent may in fact militate against transparency. For example, the standard indemnification provision in the by-laws of a corporation may provide him with the comfort of telling less than he should.[48]

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[47] Greenspan, *supra* note 20.

[48] A sample provision reads: "Each director and officer of the Corporation, whether or not then in office, and in the event of his death, his legal representatives, shall be indemnified by the Corporation with respect to any acts or omissions alleged to have occurred subsequent to the adoption of these By-Laws, against (1) all costs and expenses, reasonably incurred by or imposed upon him in connection with or resulting from any action, suit or proceeding prosecuted to final determination on the merits to which he or his personal representative may be made a party by reason of his being or having been a director or officer of the Corporation or of any other Corporation which he serves as a director or officer at the request of the Corporation, except any costs or expenses incurred by or imposed upon him in relation to matters as to which he shall be finally adjudged to be liable, and (2) all costs and expenses incurred by or imposed him in connection with or resulting from any such action, suit or proceeding which is settled with the approval of the court having jurisdiction thereof, but only in such amount

On top of such indemnity protection, corporations likewise secure Directors and Officers' Liability Insurance ("D&O Insurance"). D&O Insurance is "essentially a form of malpractice insurance for corporate boards of directors." It provides coverage for "acts, errors and omissions by individual company directors and officer to the extent those acts are committed in the scope of their employment."[49] However, securing such insurance, which is usually borne solely by the company, could invite a director's silence when his voice is most needed by minority shareholders or the general public since his risk for personal liability is diminished.

In turn, and as previously discussed, the rewards tied to the value of share prices can make keeping the public in the dark a lucrative proposition. The threat of criminal prosecution may not even be enough. Historically, corporate executives and white-collar criminals have received lighter punishments than other criminals. For example, a person convicted in the 1990s savings and loan scandal "received 36.4 months in prison for stealing

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(which shall not include any sum ordered to be paid to the Corporation by him) as such court shall determine and find to be reasonable in the circumstances.

No present or future or officer of the Corporation (or of his legal representatives) shall be personally liable for any act, omission, step or conduct taken or had in good faith which is required, authorized, or approved or in otherwise in compliance with or in reliance upon a resolution, rule or order to determination issued or made by a department, agency, board, commission or authority pursuant to any statute of the Republic of the Philippines, any province or any other political subdivision thereof, whether or not such regulation, rule, order or determination shall have been subsequently amended rescinded or determined by judicial or administrative authority to be invalid or illegal, or which is taken in contesting in good faith the validity or legality of any such regulation, rule, order or determination. In any action, suit or proceeding based on any act, omission, step or conduct, as in this paragraph described, the provisions hereof shall be brought to the attention of the court. In the event that any of the foregoing provisions of this paragraph is found by the court not to constitute a valid defense on the ground that such provision is not applicable to the particular class of plaintiff, each such director or officer (or his legal representative or assign) shall be reimbursed for, or indemnified against all expenses and liabilities reasonably incurred by him or imposed on him, in connection with or resulting from any such action, suit or proceeding (other than for any sum ordered to be paid to the Corporation by him). Such expenses and liabilities shall include, but shall not be limited to judgments, court costs and attorneys' fees. The foregoing rights of indemnification shall not be exclusive of any other rights to which any director or officer (or his legal representatives) may be entitled as a matter of law or of any rights of indemnification to which any director or officer (or his legal representatives) may be entitled under any By-Law of the Corporation."

[49] Carol Zacharias, *New Rules, New Responsibilities*, J. ACCT. ONLINE, Aug. 2000, *at* http://www.aicpa.org/pubs/jofa/aug2000/zachar.htm.

USD100,000 or more" while a burglar for the amount of USD300 or less during the same period could expect at least 55.6 months.[50]

B. CONSEQUENCES

With respect to unstructured disclosures, violations of the listing agreement and any other terms of the Rules committed within a 12-month period will call for the imposition of the following penalties against the Issuer:[51]

First Violation	–	PHP50,000
Second Violation of A Similar Nature	–	PHP75,000
Third Violation	–	Suspension of Trading for 1 month
Fourth Violation	–	Ground for Delisting

An additional fine of PHP1,000 is to be imposed for each trading day during which the offense continues until and including the day on which it is rectified. Failure to pay within one month from imposition of the penalty and any additional fine will result in suspension of trading.[52]

The PSE has apparently not been remiss in its enforcement of the disclosures rules. The earliest figures, which is for the year 2000, shows that it has imposed fines in the amount of PHP1,112,000. For unstructured reports for the year 2002, the total fines were in the amount of PHP680,000. This is a drop from PHP1,339,000 in 2001. Figures for 2003 show the total fines to be in the amount of PHP436,000.[53] The numbers seem to be declining steadily which indicates a healthier compliance with, and respect for, the Rules.

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[50] Catherine Valenti, *As Former ImClone CEO Waksal is Indicted, Fate of Alleged Corporate Criminals Hang in the Balance*, Aug. 7, 2004, *at* http://i.abcnews.go.com/sections/business/DailyNews/corporatepunishment_020807.html.

[51] Revised Disclosure Rules, § 2.

[52] *Id.*

[53] Some fines were imposed prior to the Revised Disclosure Rules.

IV. LIABILITY AND CHARGEABLE KNOWLEDGE ISSUES: PROBLEM AREAS

If penalties ranging from fines to delisting are to be imposed on the company, a test may be necessary to determine when it is chargeable with knowledge, unless no distinction is to be made between the corporation and its directors or officers.

Consider an instance where a director sits both in the board of the parent and of a significant subsidiary. Due to his position at the subsidiary, he learns of a material fact which has a significant impact on the parent. At that precise moment, is the parent company chargeable with the knowledge of the said director which he acquired in another capacity? Can the director legitimately claim that there is no duty to disclose until he learns of the subject information at the parent's board? Can the company use as a defense the fact that only one officer had knowledge of the material fact and not the board as a whole? Can it invoke its separate corporate personality to insulate itself from the acts or omissions of its officer?

It must be noted that the Rules only speak of the Issuer and provides no penalties against officers and directors. Can the stockholders legitimately complain that their investments should not suffer, as when delisting is the imposable penalty, if this is due to the failings of management and of the board?

One relevant provision in the Code in relation to disclosure however seems to cover only culpable violations where any person, including corporate officers, manipulate security prices by making a "false or misleading statement with respect to any material fact, which he knew or had reasonable ground to believe was so false or misleading, for the purpose of inducing the purchase or sale of any security listed or traded in an Exchange."[54] If the disclosure is merely false or misleading and there was no purpose to induce, then there seems to be no violation. This is akin to the requirement for scienter, a requirement for securities prosecution in the United States. Scienter is a "mental state embracing intent to deceive, manipulate, or defraud."[55]

The Amended IRR does expressly provide that any misleading statement, misrepresentation or omission in any disclosure signed and filed with the SEC and the PSE is the joint responsibility of the Issuer and the

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[54] SRC § 24.1 (iii)(d).

[55] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

reporting director, officer or substantial stockholder.[56] And under the SRC, any violation of the IRR will result in the imposition of fines or imprisonment. But the court has discretion whether to impose the same upon the corporation and its officers. In this instance, no scienter appears to be needed for as long as there is a misleading statement, representation or omission.

A. REMOVAL AS REMEDY

Stockholders can always vote out an erring director. But this is may not be expeditious enough. A two-thirds vote of the outstanding capital stock is required through a special or regular meeting to remove directors.[57] Depending on the notice requirements in the by-laws, this may take some time. And it clearly provides no clear protection for shareholders in the minority or for the public in general. Even if the board is replaced, executive officers with term contracts may enjoy some measure of security of tenure in the absence of termination provisions in their engagement.

B. A SUIT TO FIT: DERIVATIVE OR CLASS ACTION LAWSUITS

According to a study, active shareholders through their own private actions are effective agents for corporate governance. And their legal action can complement the weak enforcement of laws and rules.[58] One available remedy for minority shareholders in cases where there is a breach of fiduciary duty is through the filing of a derivative suit for and in behalf of the company. Such a suit has been defined by the Supreme Court as:

> [A]n action brought by minority shareholders in the name of the corporation to redress wrongs committed against it, for which the directors refuse to sue. It is a remedy designed by equity and has been the principal defense of the minority shareholders against abuses by the majority.[59]

Indeed, this is the very essence of a derivative suit:

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[56] SRC IRR, Rule 17.1(B).

[57] CORP. CODE, § 28. This is Batas Blg. 68 (1980).

[58] Jang Hasung, *Empowering Shareholders' Rights: Derivative and Class-Action Lawsuits*, (Nov. 11-12, 2002), *available at* http://www.oecd.org/dataoecd/49/28/2484625.ppt. Presented at the "OECD Asian Roundtable on Corporate Governance," Mumbai, India.

[59] Western Institute of Technology, Inc. v. Salas, G.R. No. 113032, 278 SCRA 216 (1997).

> An individual stockholder is permitted to institute a derivative suit on behalf of the corporation wherein he holds stock in order to protect or vindicate corporate rights, whenever the officials of the corporation refuse to sue, or are the ones to be sued or hold the control of the corporation. In such actions, the suing stockholder is regarded as a nominal party, with the corporation as the real party in interest.[60]

However, any relief that may be granted under the suit does not directly redound to the benefit of a shareholder since the cause of action is actually the corporation's:

> The requisites for a derivative suit are as follows: a) the party bringing suit should be a shareholder as of the time of the act or transaction complained of, the number of his shares not being material; b) he has tried to exhaust intra-corporate remedies, i.e., has made a demand on the board of directors for the appropriate relief but the latter has failed or refused to heed his plea; and c) *the cause of action actually devolves on the corporation, the wrongdoing or harm having been, or being caused to the corporation and not to the particular stockholder bringing the suit.*[61] (Emphasis supplied)

Hence, a derivative suit is not a proper fit for shareholder action against improper disclosures. A shareholder class action can provide a distinct advantage. Any awards regarding losses are paid to the plaintiffs and not to the company which would be the case in a derivative suit. A study shows that a majority of the securities class actions filed in the United States in 1999 involved corporate disclosures.[62] However, the foregoing involved a specific American statute for such actions, namely, the Private Securities Reform Act of December 1995.[63]

Although without clear precedent in this jurisdiction, Rule 3 of the Rules of Court does appear to provide basis for the filing of such a complaint for corporate malfeasance relating to disclosure which results in damages to stockholders:

> Section 12. Class suit—When the subject matter of the controversy is one of common or general interest to many persons so numerous

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[60] First Philippine Int'l Bank v. Court of Appeals, G.R. No. 115849, 252 SCRA 259 (1996).

[61] San Miguel Corp. v. Khan, G.R. No. 85339, 176 SCRA 447 (1989).

[62] MUKESH BAJAJ, SUMON MAZUMDAR, & ATULYA SARIN., SECURITIES CLASS ACTION SETTLEMENTS: AN EMPIRICAL ANALYSIS 4 (2000).

[63] *Id.*, at 2.

> 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.

It may be worthwhile for Congress to pass a similar law explicitly granting this avenue of relief to the investing public. While any investor can file his own personal action for damages,[64] it has been observed that such actions, as well as derivative suits, are not effective for minority shareholders in recovering losses from illegal and fraudulent acts. Invariably, the legal costs to them would exceed their losses.[65]

C. INSIDER INFORMANTS: WHISTLEBLOWER STATUTES

As a response to corporate scandals, the United States passed the Sarbanes-Oxley Act of 2002 ("SOX") which contains protection provisions for corporate whistleblowers. It provides "a general framework for ensuring that employees (including attorneys and auditors) disclose information which may harm investors."[66] It may be worthwhile to examine whether its "whistleblower" provisions should considered here for possible adoption. This is based on the theory that a corporation's adherence to full disclosure may be best addressed by those inside the company. As a counterpoint to "insider trading," "insider informing" could be the answer. A company's healthy conscience made out of informants is infinitely better than just having the commandments at hand with every intention to violate them.

The Act provides for the creation of audit committees which will have procedures for employees to file confidential and anonymous submissions regarding questionable accounting or auditing matters.[67] There will be no cover under the mantle of attorney-client privilege. All attorneys must report "evidence of material violations of securities laws or breach(es) of fiduciary duties or similar violation by the company or any agent thereof" to the company's chief legal counsel or chief executive officer.[68] Corporate

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[64] CORP. CODE, § 31.

[65] *Id.*

[66] Stephen Kohn, *The Sarbanes-Oxley Act ("SOX"): Legal Protections for Corporate Whistleblowers*, *at* http://www.whistleblowers.org/html/sarbanes-oxley.html.

[67] Sarbanes-Oxley Act, § 301 (2002), *available at* http://www.sarbanes-oxley.com/section.php?level=1&pub_id=Sarbanes-Oxley.

[68] § 307.

whistleblowers are civilly protected from discrimination and discharge.[69] Aside from this, company or employer retaliation against employee whistleblowers is also made a criminal offense.[70]

There is also the negative view that a whistleblower atmosphere may not be conducive to governance, where an executive must always be looking over his shoulder, and is always at the risk of being second-guessed and where hindsight is also to be unfairly used against him. As previously opined, we should be hesitant in adopting wholesale western models.[71] We have to bear in mind that in Asia, unlike the Western model, business transactions are "relationship-based."[72] Moreover, doing business here requires, among others, "building interpersonal trust and harmony."[73]

CONCLUSION

Disclosure disputes on materiality bring to mind the old question of how one can determine whether or not something is pornographic. As stated by Justice Potter Stewart in his concurring opinion in *Jacobellis v. Ohio*, "I shall not today attempt further to define the kinds of material I understand to be embraced ... [b]ut I know it when I see it."[74] Will the regulators be able to know when a material disclosure has been made only once he sees it? To determine liability for inaccurate and timely disclosure, another question that could be very well be asked is similar to what was posed in the Watergate affair: "What did a director or officer know and when did he know it?"[75]

The absence of set standards does not augur well for a regime of full disclosure. Can one say a disclosure has been fair and complete after the fact when it may already be too late, with millions gained or lost? It seems difficult, if not inadvisable, to leave such discretion wholly in the hands of regulators much less to those regulated by them. It would almost seem be to be a given that there should be clear rules and limits for all to follow.

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[69] § 806.

[70] § 1107.

[71] Washington Sycip, *Managing Corporate Governance in Asia*, *at* http://www.ey.com/GLOBAL/Content.nsf/Philippines/Managing_Corporate_Governance_in_Asia_-_Speech_by_Mr_W_SyCip (last visited Nov. 3, 2004).

[72] FAN & WONG, *supra* note 8, at 9.

[73] *Id.*

[74] 378 US 184 (1964).

[75] The question posed to President Richard Nixon in the Watergate affair was "What did the President know and when did he know it?"

However, leaving room for interpretation can also work to the public's benefit. Liability cannot be denied merely because an event is not included in a list for as long at it is material depending on the specific circumstances of each case.

As savvy investors and players have learned, information is a precious commodity. The truth not only sets one free, it enables one to earn a tidy profit as well. And the amount of return on investment could very well turn on how much faith one can have in a corporation's words. This can be a tenuous basis for parting with cash, whether hard-earned or not, and bodes ill for the development of the capital market. The structures currently in place for committees, disclosures, governance, penalties and threats of prosecution are all geared to engender this faith.

In the end, there is no escaping the fact that honor and integrity cannot be legislated into being. Rules "cannot substitute for character."[76] Even an auditor admits that it will all boil down to "doing the right thing, being fair to all concerned, being truthful and transparent, and being accountable for one's own actions."[77] And faced with the limits of the law, a corporation's stakeholders can only look to directors and officers who will obey both its letter and spirit.

Only then can they be assured that they are getting their money's worth, after realizing that despite living in a capitalist world where there can be a surfeit of laws and rules, there are just some things money cannot buy.

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[76] Greenspan, *supra* note 20.

[77] Cecile Galvez, *Can Trust Be Regulated? Corporate Governance in the Philippine Context*, The SGV Review Issue No. 1, 9 *at* http://www.ey.com/global/download.nsf/Philippines/Corporate_governance_in_the_Philippine_context/$file/Corporate governance in the Philippine context.pdf (Nov. 2, 2004).