**Chapter 10**

**Monitoring and control**

**1. What are the interrelation factors on which the effectiveness of the monitoring and control function by investors is based?**

* Property rights established by law or contractual agreement that define the relations between a company’s investors and its management, as well as the existence of such relations between different types of investors.
* Financial systems facilitating the supply of finances between households, financial intermediaries, and corporations.
* Networks of intercorporate competition and cooperation establishing relations between corporations in the marketplace.

**2. Explain the two alternative modes of financial mediation between households (investors) and corporations.**

* The first mode is bank-based finance where banks take deposits from households and channel this savings into loans made to companies.
* The second mode is market-based finance in which households, directly or indirectly through retirement plans, invest in equity or debt securities issued by corporations.

**3. Discuss the five rules that the BRT recommends for fair and respectful treatment of shareowners and their views.**

* Public companies should have procedures for shareholders to communicate with the board and for directors to respond to shareholders’ concerns.
* All communications with shareholders should be consistent, fair, transparent, clear, and candid.
* The established shareholder communication procedures should be readily available to shareholders.
* The company’s board should be notified of all shareholder proposals and the board or its corporate governance committee should oversee the company’s response to shareholder proposals.
* Directors should attend the annual meeting of shareowners and should respond or ensure that management responds to all relevant questions.

**4. What are the policies and procedures that should be established by the nominating committee to better enhance the viability of shareholders’ nominations?**

* Receive shareholders’ nominations for board candidates and proposals for significant strategic decisions.
* Consider nominees and proposals received from small individual investors.
* Communicate with shareowners.

**5. What situations can lead to institutional investor intervention with the invested company?**

Intervention may occur in situations where there are concerns about strategy, operational performance, mergers and acquisitions strategy, inadequate oversight function by independent directors, reported material weaknesses in internal controls, inadequate succession planning, noncompliance with corporate governance reforms, inappropriate executive compensation plans, lack of commitment to social, environmental, and ethical issues, material financial restatements, and corporate malfeasance and fraud.

**6. How can institutional investors participate in the corporate governance of the company?**

* Exercise their right to elect directors.
* Raise their concerns about the company’s governance by either selling their shares or voicing their dissatisfaction.
* Improve the efficiency of the capital markets by transmitting private information they obtain from management to the financial markets.
* Reduce agency problems by possessing resources and expertise to monitor the managerial and oversight functions as well as reduce information asymmetry between management and investors.

**7. Explain the advantages of employee participation in corporate governance.**

* Through ownership of company shares employees have more incentives to align their interests with those of shareholders.
* Employee involvement in corporate governance is a learning process for employees to advance their position and improve the company’s operational efficiency.
* Employee participation in corporate governance can be regarded as an internal mechanism to monitor managerial performance and prevent management opportunistic conduct.

**Discussion Questions**

**1. What factors and opportunities have led to the movement of direct individual ownership of stocks to a more institutional ownership structure?**

Factors contributing to this change are the move toward institutionalization of financial markets through financial institutions, privatization of pension plans, and individual investors’ preference toward long-term investments.

**2. The author states that investors should also share some of the blame for reported financial scandals for their lack of monitoring of their companies’ governance. Do you agree or disagree with this statement? Why?**

Answers may vary. The publicized financial scandals of the early 2000s originated from the use of aggressive accounting and earnings management practices of the late 1990s. Financial irregularities and earnings management practices of many companies definitely sent strong signals of forthcoming financial scandals. Nonetheless, investors either did not want to ask tough questions about their governance or did not care as long as the stock prices were going up. Earnings management practices of prominent companies were reported in the press but investors did not raise many concerns about the irregularities of these companies that were making profit for them. The economic downturn, stock market plunges of 2000 and 2001, failures of Enron, WorldCom, Adelphia, Global Crossing, and others, and ineffectiveness of their corporate governance made investors angry where the roots of these problems trace back to the capital market inefficiency of the 1990s. The two biggest corporate bankruptcies in U.S. history, Enron and WorldCom, and the failures of other high-profile companies primarily caused by fraud, which cost investors and pensioners over $500 billion, made investors take notice and demand corporate accountability.

**3. Traditionally, the accountability and transparency between the board and shareholders have not been effective in the sense that the board was not informed of what shareholders were expecting of it and shareholders were not aware of the board’s activities and its effectiveness. What should be done about this communication gap? Substantiate your answer.**

Answers may vary. Shareholders have voting rights to elect directors as their agents; however, individual directors have no direct responsibility or accountability to shareholders. Traditionally, public companies have used a plurality-vote system to elect corporate directors. Under a plurality-vote system, directors can be elected by the vote of a single share unless they are opposed by a dissident director. Conversely, a majority-vote system empowers shareholders to elect the most qualified outside directors. The nominating committee can play an important role in promoting majority voting and developing an efficient mechanism for shareholders to nominate or endorse director candidates. This may give shareholders more responsibility in selecting directors to the board, which may in turn alleviate the communication gap between the board of directors and shareholders.

**4. Investors may think they live in the United States of America but when it comes to electing corporate directors, shareholders’ intended watchdogs in the boardrooms, they are definitely back in the U.S.S.R. Compare or contrast this statement with your own views.**

The ability of shareholders to vote against or fire underperforming directors is limited under the commonly used plurality-vote system. Shareholders do not have access to their company’s proxy materials and are not empowered to nominate their candidates for the board. The increase in corporate governance awareness may result in improved shareholder democracy, giving investors a stronger voice in relation to corporate operations.

**5. Do you feel the extent of shareholders’ participation in the election of directors is limited to the rubber-stamp process of affirmation? Explain the given statement.**

Shareowners are empowered under state corporate statutes to elect directors to oversee management, but in reality, they have no real voice in the nomination and election process. The real election appears to be cast in the boardroom due to the fact that even if the majority of shareholders oppose a corporate-sponsored nominee, that person will still be elected as a director. Until very recently, CEOs/chairs of the board had significantly influenced the nomination and election of new directors. The requirement for the establishment of a nominating committee composed solely of independent directors has provided some structure to the nomination and election process even though in many cases independent directors still serve at the will of the CEOs and other executive directors.

**6. Elaborate on the following statement: “In modern corporations, particularly in the era of technological advances, labor resources are becoming an important part of corporate governance as capital resources.”**

The balance of power and association between property rights, managerial control, and employee participation rights can play an important role in the effectiveness of corporate governance. Employee participation in corporate governance can influence managerial control and authority, and can influence employee cooperation in the implementation of decisions. The shape and extent of employees’ participation in corporate governance is a function of the employee level of investment in the company’s stock through retirement plans and whether their skills are firm-specific. In a situation in which employees invest in skills specific to their company and their retirement funds and pensions are tied to the company’s stock, their incentives to participate in corporate governance are greater. Alternatively, when employees’ skills are portable across companies and their investments in the company are insignificant, they may prefer strategies of exit over voice in response to dissatisfaction and grievances. Thus, employees’ interests in corporate governance are shaped by their economic, investment, and employment ties to the company, as well as their participation in managerial decisions.

**7. The Council of Institutional Investors (CII) recommends six shareholder voting rights. Search the Internet for examples of organizations that implement those recommendations.**

The following are the shareholder voting rights recommended by the Council of Institutional Investors (CII): (1) access to the proxy; (2) one share, one vote; (3) confidential voting; (4) voting requirements; (5) broker votes; and (6) bundled voting. The student can search the business press, an applicable database, or a search engine to find information related to these recommendations as well as examples of organizations implementing such recommendations.

**8. Discuss shareholders’ participation in monitoring their companies’ affairs, decisions, and corporate governance.**

Investors, particularly institutional investors, should be engaged actively in monitoring their companies’ corporate governance and fundamental decisions. Investors should participate in important affairs and engage with companies where value can be added to their investments. By virtue of their influence and power, institutional investors should intervene when ineffectiveness or breakdowns in corporate governance occur to assist in protecting sustainable shareholder value. Individual shareholders can change managerial directions and decisions by selling their shares when there is corporate underperformance, and if the majority of shareholders follow suit, management will be forced to act. In the case of institutional investors where funds are indexed with limited ability to sell, institutional engagement in corporate governance is the only way to correct ineffectiveness in corporate governance.

**9. Describe how shareholder proposals can influence corporate governance**.

The company’s board normally communicates with shareholders in obtaining their approvals on resolutions. Shareholders are also given the opportunity to address issues of their interests through specific shareholder proposals. Traditionally, shareholder proposals have been nonbinding and therefore the board could choose to ignore them even if they received a majority of favorable votes. In reality, for these proposals to influence corporate governance, they should be binding. Recently, proxy voting advisors, such as Glass Lewis & Co. and Institutional Shareholder Services (ISS), have played an important role in influencing board agendas and the proxy process.

**True or False**

1. American households are more likely to have direct ownership of public company stock now than in 1950.

2. Shareowners with significant ownership positions theoretically have more incentives and opportunities to engage in the monitoring function.

3. The publicized financial scandals of the early 2000s originated from the use of conservative accounting and earnings management practices of the late 1990s.

4. Property rights establish the legal relations between a company’s investors and its management as well as the relations among different types of investors.

5. Bank-based finance is a mode of financial mediation where banks take deposits from households and channel this savings into loans made to companies.

6. The use of plurality voting rather than majority voting substantially increases the ability and influence of shareholders over who is actually elected to the board.

7. Involvement of institutional investors in the monitoring function of corporate governance limits agency problems associated with the separation of ownership and control in public companies.

8. The chief compliance officer is accountable to the mutual fund’s board and can be terminated by the board or a shareholder coalition.

9. Due to the rash of financial scandals of high-profile companies, investors have become more active in monitoring the corporate governance of companies.

10. Employee participation in corporate governance can be regarded as an external mechanism to monitor managerial performance and prevent management opportunistic conduct.

11. Mutual funds must either establish a code of ethics or disclose in their annual report why they have not adopted such a code.

**True or False**

1. False

2. True

3. False

4. True

5. True

6. False

7. True

8. False

9. True

10. False

11. False

**Multiple Choice Questions**

**1. Which of the following groups typically own the most public corporation shares?**

1. Directors, officers, employees.
2. Individual outside shareholders.
3. Financial institutions.
4. All of the above typically own a similar amount.

**2. \_\_\_\_\_\_\_ establish(es) the legal relations between the investors of a corporation and its management.**

1. The articles of incorporation.
2. Property rights.
3. The corporate charter.
4. Proxy statements.

**3. \_\_\_\_\_\_\_ provide a means of financing and corporate ownership that fundamentally constitutes the supply side of capital markets.**

1. Property rights.
2. Intercorporate networks.
3. Financial systems.
4. None of the above.

**4. The relation between the company and other corporations or organizations is determined by:**

1. Intercorporate networks.
2. The structure of power and opportunity.
3. Corporate governance.
4. None of the above.

**5. Providing timely access to information, enhancing shareholders’ rights, and promoting shareholder democracy can result in:**

1. Positive effects on corporate governance.
2. Negative consequences such as directors challenging the CEO’s preferences.
3. An increase in the likelihood that a merger or acquisition will ensue.
4. All of the above.

**6. Which of the following would be considered a method of institutional investor intervention?**

1. Meeting with directors, particularly independent directors, lead directors, or the chairperson of the board.
2. Making a public statement in advance of annual shareholder meetings.
3. Submitting resolutions and proposals for vote at shareholders’ meetings.
4. All of the above.

**7. The first level of agency problems is associated with:**

1. Potential conflicts of interest between individual investors and their trustees and fiduciaries.
2. Potential conflicts of interest between professional money managers and corporations and their corporate clients.
3. Ownership society.
4. Monitoring public companies’ governance, affairs, and business.

**8. Which one of the following is among the plans considered by the SEC:**

1. Standardize exchange governance by requiring U.S. stock exchanges to file quarterly reports with regulators.
2. Ensure that a majority of directors are not independent.
3. Ensure that members of the nominating, governance, audit, compensation, and regulatory committees are not entirely independent.
4. Limit exchange members’ ownership interest to 35 percent.

**9. The core principles do not provide considerations for:**

1. Board independence & leadership.
2. Board processes & evaluation.
3. Individual director characteristics.
4. Shareowner rights.

**10. Employee performance of an assigned job should be compensated through:**

1. Salary-based pay.
2. Stock ownership to encourage employees to devote and retain these skills in the company.
3. Stock options.
4. Fringe benefits.

**11. Shareholder rights are enhanced by providing means for:**

1. Asking questions and raising concerns.
2. Tabling resolutions.
3. Voting in absentia.
4. All of the above.

**12. Only large shareowners and particularly institutional shareholders have incentives and resources to monitor companies’ governance and other shareholder benefits because:**

1. Corporate ownership in the United States is highly dispersed and diffused.
2. The incentives and opportunities for individual investors to monitor the company’s governance are very remote.
3. Individual investors cannot afford the high costs of monitoring.

d. All of the above.

**Multiple Choice Questions**

1. c.

2. b.

3. c.

4. a.

5. a.

6. d.

7. a.

8. a.

9. d.

10. a.

11. d.

12. All of the above.