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Remarks by

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Commissioner

Securities and Exchange Commission

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THE LIMITS OF DISCLOSURE

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One of the unanticipated consequences of the affaire d'Watergate has been the staccato-like disclosures concerning the conduct of American corporations overseas. Largely because of investigations by the Securities and Exchange Commission, it has become known that a number of major American companies have been parties to conduct overseas which can at the mildest be described as reprehensible. In addition to that, Senator Frank Church's Subcommittee on Multinational Corporations has elicited extensive admissions by corporate executives concerning the extent to which they have chosen the seamy side in the conduct of their affairs abroad. How much more of this sort of thing will be discovered by Senator Church's Subcommittee or by our Commission is anyone's guess. At the present time, the Commission is conducting further investigations and, quite obviously, Senator Church intends to pursue his course vigorously and extensively.

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These disclosures, along with those concerning illegal political contributions, have created significant problems for everyone. Corporate executives who may have knowledge of similar conduct by their corporations, or who may themselves have instigated or participated in such conduct, wonder whether the wiser course is to make disclosure now or take the risks of having it found out in the course of Congressional or Commission investigatory activities. Members of boards of directors undoubtedly speculate concerning the extent to which, without their knowledge, corporations on whose boards they serve may have engaged in this sort of conduct and they wonder about the extent of their responsibility to have discovered it in the past or to unearth it now and expose it to the public. The dilemma is particularly troubling for those directors who serve on audit committees which are such integral parts of the total corporate accountability process. Attorneys too wonder about the extent to which they should assume an affirmative responsibility to ferret out such information and urge their clients to make it public.

Perhaps the most bewildered by all this have been members of your profession. You are confronted with difficult problems concerning the adequacy of audit procedures - should they be extended or expanded in a manner that will improve the likelihood of discovering this sort of activity - and

problems of materiality - when is such activity, if known, required to be separately and explicitly disclosed? More basically, in what circumstance is this properly a matter of auditor responsibility?

I'm not sure I'm in a position at this time, nor for that matter is anyone at the Commission, to give definitive answers to these questions. However, I would like to ruminate a bit about them with you and suggest some tentative, very tentative, approaches which might ameliorate the harshness of some of the courses advocated.

I mentioned that the disclosures with regard to overseas payments have been a fallout from Watergate. When the Watergate Special Prosecutor discovered that a number of corporations had made illegal campaign contributions, the interest of the Commission's staff was quickened. We initiated an inquiry to determine whether such payments had been disclosed by the accused corporations. We discovered, of course, that they had not been. Upon so concluding, we initiated several actions,notably, those against American Shipbuilding, Gulf, Ashland Oil, Northrop and Phillips Petroleum, alleging failures to disclose material information in the filings with the Commission. The problem of materiality of the undisclosed payments was, of course, considered by the Commission. In virtually all cases the amounts of the illegal contributions, considered in relation to the income of the donors, their net worths, their assets, and other financial measurements, were relatively small

and fell considerably short of conventional standards of financial materiality. However, we recognized that the courts have not defined materiality solely in terms of such financial relationships. Rather, the Supreme Court has spoken of materiality in terms of information that might be important to a reasonable investor and a reasonable investor has been defined by the Second Circuit Court of Appeals as including not only the long-term investor but the Wall Street speculator as well. Thus the question posed to the Commission was this: might it be important to investors to know that the management had violated the election laws of this country by using corporate funds to make political contributions? We concluded that indeed such information is important to investors even though the amounts involved may seem relatively small by some measures.

In the course of the investigations of non-disclosure of political contributions, the Commission found other information that in the long-run is proving to be even more troubling than that related to illegal political contributions. This is information concerning payments overseas which in many instances were disguised and covered up through various bookkeeping deceptions and devices. In one case it was found that over $30 million had been accumulated overseas and used as a source for money fed back into the United States to make the political contributions, as well as for various obscure purposes overseas. A significant

part of this money could not be accounted for by those responsible for its use and to this day there remains some obscurity with regard to the uses to which some of it was put.

In one instance, the lead did not come from Watergate. That, of course, was the United Brands case. There the Commission's staff routinely made inquiries because of the suicide of the chief executive officer and, in the course of those inquiries, discovered that the corporation had made a substantial payment to one or more political figures of a Central American republic in exchange for preferential tax treatment. However, the initial public disclosure of this matter did not emanate from the Commission; rather it first saw light in the financial press.

These disclosures have sparked considerable discussion among all those concerned with the conduct of corporations. In the eyes of many, the Commission has mounted a crusade to impose its conception of morality upon the corporate world, not only in this country but wherever American corporations conduct their business. Others see the emergence of all this as confirmation of the evils they believe to be inherent in the corporate structure of this country and they are renewing their demands for a radical reformation of the manner in which American businesses are regulated and governed.

Amid all this, it is indeed difficult to maintain perspective and balance. I shall try to make some small contribution to that this evening.

First of all, I do not think the Commission is launching a moral crusade. Like any citizens, we have concern about the morality of American business and of those who run it. However, in my estimation, we are not enfranchised by the Congress to impose and police our conceptions of morality or even those which may be prevalent in the American community. Our job first and foremost is to enforce those laws which Congress has mandated that we enforce. A large measure of that enforcement activity relates to disclosure. We have developed in this country the most comprehensive and, I might say, the most effective disclosure system of any country in the world. What we have is the result of a labor extending over forty years. The result has been the development of a vast fund of information about virtually every publicly held company (publicly held in the sense of having more than $1 million of assets and 500 shareholders) so that investment decisions can be made on the basis of fact and not fiction. In some measure the quality of this disclosure system has been the result of vigorous enforcement of its requirements. Happily to a much larger extent it has been the consequence of voluntary compliance by innumerable American corporations;

in some instances, undoubtedly, this compliance has been the result of fear of the consequences of non-compliance, but I would like to think that in other cases it has been the result of a deepened realization of the value of disclosure to not only the individual company but to the health of our securities markets as a whole.

An essential component of the disclosure system has been the development of reliable financial information. This development has been characterized by the elaboration of increasingly sophisticated and, in some cases, very complicated accounting principles, extensive and exacting auditing standards, a huge literature, a large body of competent, skilled and honest financial officers, and a dedicated accounting profession. As a result of many factors, not the least of which has been the enforcement activity of the Commission, the standards of responsibility in the accounting profession have never been higher. This impressive profession and this complex system have been developed to assure that the financial information disclosed by corporations was accurate, complete and reliable. Basic is the idea that all of the funds belonging to the corporation, which in turn belongs to the shareholders, are accounted for within the corporation's system of financial accountability.

It becomes a matter of great concern therefore when we find that significant amounts of money float around outside this system of corporate accountability and are used by one or two or a very small coterie of officers without any necessity to account for that use through normal corporate channels. When such is done, when significant amounts of money are extracted from the system and the uses of the money disguised by false bookkeeping entries, mislabeling, phony subsidiaries and Swiss bank accounts, I think that fact is material to shareholders and should be disclosed. The existence of these practices distresses me perhaps more than the uses to which the extracted money is put. If we tolerate in <u>any</u> measure erosion of the standards of financial responsibility and accounting that we have so laboriously developed in this country, then I think we will be imperiling the integrity of our financial markets, and needless to say, when that is imperiled, our entire economy takes on a different appearance. Thus I think diversions of funds involving amounts significantly smaller than those which in other contexts might be considered material should be disclosed.

When you pass beyond the illegal election contribution in this country and the short-circuiting of the accounting and accountability process, you are confronted with hard and subtle questions. Petty bribery is a way of life in many countries - a hundred dollars to a customs official, fifty dollars to the mailman, a thousand dollars to the tax collectors. And larger bribes are not uncommon, sometimes reaching into six figures. Jack Egan said in The Washington Post last Sunday, "A survey of Washington Post foreign correspondents reveals that payoffs abroad are ubiquitous and a way of life in many countries where they are part of a deeply rooted system of doing business. But there are some notable exceptions." Interestingly the most notable exception was Soviet Russia!

The most difficult problems concern payments to agents. In many countries, and in some instances perhaps in ours, it is necessary to employ the services of a national, if only because he knows the way to thread through the bureaucracy. The problem arises when those agents are paid amounts which, because of their size, or the mode of payment (e.g., hundred dollar bills), or their route through numbered Swiss bank accounts, would suggest to any reasonable person there was something questionable afoot.

Unaware that the spotlight would ever be turned upon these payments American corporations have perhaps too unheedingly fallen into the habit of conforming to the customs of the country, and perhaps in some instances, as a consequence of rivalries among American firms or other foreign firms, further fostered the practices. Furthermore, there is some reason to believe that disclosure that such payments have been made would result in expropriation of properties, the toppling of governments and political figures (some perhaps friendly to this country), the curtailment of American overseas activity, the denial of future favor, and in some cases perhaps even loss of life. A cessation of such payments does not of course wipe out the sin of non-disclosure, if such was required under our securities laws, and the results of terminating payments may be the same as those which would follow disclosure.

No matter how one may view the propriety of management's conduct in the past, the dilemma many now face is harsh and puzzling. Of course, expropriation, limitation of activities and the like imperil the interests of shareholders who, along with potential investors, we are supposed to be protecting; on the other hand, if no disclosure is made, the peril of exposure remains with consequent potential loss for those

who bought the company's stock, unaware of the dangers lurking overseas. As long as the illicit conduct overseas is concealed, the market for the company's stock operates with everyone (except management) unaware of the horrendous possibility that at any moment a change of government, a penetrating investigative reporter, a Congressional committee, a jealous competitor, a dissaffected employee may "blow the cover" and precipitate all the adverse consequences I have ennumerated. This is not the kind of market we are comfortable with; it is not the kind of market the Commission has sought for forty years and more to achieve.

We all, I think, acknowledge the proud history of disclosure, the role it has had in developing in this country the soundest and most honest markets in the world. It has not only provided the means whereby sophisticated and unsophisticated investor alike can secure information upon which to base investment decisions, but it has operated to moderate the conduct of corporate management. None of us doubts, for instance, that the requirement that transactions between insiders and the corporation be disclosed has discouraged sticky fingers in the cookie jar. Disclosure has a restraining impact upon corporate conduct, just as it has in government and many other areas of life. The belief in the effectiveness of disclosure is clear in the recent enactments outside the federal securities laws

requiring fuller disclosure of campaign contributions and the sources of income of certain public officials, the pressure for disclosure of information in the files of governmental agencies, the suggestions that increasingly the government's business must be conducted, as it is said, "in the sunshine." And yet, I would suggest, it is not the job of disclosure to outlaw any conduct. True enough, disclosure or the requirement of disclosure may impact conduct; the embarrassment that disclosure would cause may be so great that some conduct may be effectively forestalled or precluded; but this is an incidental effect of disclosure, not its raison d'etre. The essential and basic and perduring role of disclosure policy is to provide information to investors for the purpose of their decision-making, not to decide what is lawful and what isn't, what is moral and what isn't - although, of course, what is legal and what is illegal will have a hand in shaping disclosure policy.

In this problem disclosure policy and substantive law, always interlaced to some extent, are maddeningly jumbled. How shall we sort them out, allocate to each its proper role?

Obviously disclosure of illegal or improper overseas payments will discourage them, with all the consequences that may follow from that. Discouragement of improper conduct may

be a desirable side-effect of disclosure when that conduct is overreaching by insiders, violations of election laws, and the like. But with respect to overseas payments, should the outcome of the game be determined by the disclosure requirements of the securities laws? Are there not concerns and values and national interests involved here that cannot be dealt with simply through the mechanisms of disclosure under the federal securities laws?

At this moment there is reason to believe that substantial segments of American enterprises may be jeopardized by disclosure of the circumstances under which they have been established and maintained. The suggestion has been made - by myself among others - that in determining the materiality - and thus the necessity for disclosure - of the payoffs and bribes and other payments overseas the relevant question is whether they relate to a significant part of the business of the payor.

The argument is made that if the continued existence of a significant business overseas depends upon illicit or improper payments, then those payments should be disclosed since that business is peculiarly unstable, less predictable, more hazardous than a business that depends upon superior technology or sales-manship or executive skill. Management is thus placed in a

harsh dilemma: materiality stems from a likelihood that the payments - and their secrecy - are a prerequisite to the continued prosperity of the enterprise abroad; termination of the payments - or their disclosure - will likely impact adversely the operations; thus conduct dictated by the determination of materiality-disclosure - causes the very event upon which materiality depends - truly a "Catch 22" worthy of Joseph Heller and his characters.

Undoubtedly the likelihood of disclosure of illicit or improper overseas payments has been increased by the events of the last couple of months, apart from SEC investigations. Reporters are hot on the trail of these matters; governments (and their opponents) overseas are driven to investigate the extent to which payments have tainted their political processes; Congress is excited, particularly at this time when the role of the multinational corporation is of increasing concern. Thus the likelihood of the information remaining out of the public print is substantially reduced, and concomitantly the adverse consequences of disclosure mount in probability. Alluring as this standard is - that illegal or illicit payments tied in with a significant amount of business abroad must be disclosed - it is not a sufficient solution; it is not sensitive to the consequences that would follow from its implementation, and it in effect relegates to those responsible for making disclosure policy the burden of also making policy concerning the conduct American companies may engage in overseas.

What then should be done? I think frankly this is a problem that cannot be adequately dealt with within traditional disclosure doctrine; it involves too many facets and circumstances that lie outside our traditional disclosure experience. Disclosure is not an absolute; in many situations it can be such simply because it is impossible to identify any conflicting or competing values.

These considerations drive me to the conclusion that only Congress can resolve these issues, at least as to the future. The Congress preeminently in our constitutional government has the chore of conciliating conflicting values in our society. It falls to them to determine what sort of conduct we want our corporations to engage in abroad. In some instances, what we call bribery is not even illegal overseas; if, nonetheless that is conduct Congress thinks American enterprises should not engage in, then it should so decree. If American corporations are not to seek business with heavy payments clearly intended for further distribution Congress should decide that after considering all the consequences of that policy, and let then transgressions become the material of disclosure. The Defense Department in its armament procurement program has established standards for commission payments; perhaps those guidelines should be expanded and universalized.

Burdening disclosure, and the processes of the SEC with the responsibility of making these determinations, or at least, implicitly so deciding by mandating disclosure of such conduct, is in my estimation the wrong way to proceed. We must give careful consideration to the multiplicity of factors that play upon this. These practices have gone on, according to all we know, for some time. It ill behooves us to attempt a resolution of them within a few weeks or days and through the use of a single resource, disclosure, to the exclusion of all else.

What of what has gone before? And for that matter, what should be our course in the future if Congress doesn't act? Relentless requirement that any questionable payments be now disclosed in detail may result in impairment of the value of investments abroad, political upheavals, and serious consequences for American enterprise; it couldalso preclude, or at least make moot, thoughtful consideration of all dimensions of the problem for the purpose of formulating policy.

With the genie out of the bottle the likelihood of disclosure is considerably enhanced with all the consequences to investors that may flow from that; consequently it is tempting to conclude that the only policy now should be rigorous requirements that such payments be now disclosed <u>in extenso</u> if a material amount of business depends on them.

I would suggest another course which may not, given the practicalities of our time, be feasible or even realistic. Perhaps we can tailor a disclosure pattern that will prevent the adverse consequences I have discussed while at the same time protecting the interests of investors. Such a pattern would require the disclosure by corporations of the extent to which their business overseas depended upon or had been secured as the result of payments disclosure of which would jeopardize that business; the names of the recipients and the countries in which the related business was done would not be demanded and the payments would not have to be characterized otherwise than by indicating that, to the extent true, their detailed disclosure or their discontinuance would adversely impact the business to which they related. The disclosure would indicate the approximate total volume of business, and the profitability of it, related to such payments, without detailed narration. In the past we have usually required that an issuer in disclosing "let it all hang out." I would suggest in these matters we should somewhat more discerningly decide what an investor really wants to know and not require disclosure of details of only peripheral importance to his investment decisions.

Overseas business is afflicted with many hazards not common in this country: threats due to changes in political leadership, dangers of harsh taxation, the rise of anti-American sentiments, expropriation. In Global Reach, the authors state, "Fear of nationalization is a conventional element of corporate planning. For good reason. In the last four years, according to a State Department study, 34 countries in Latin America, Asia, and Africa have resorted to a variety of measures designed to take over or force out U.S. controlled operations in their territory with a value of some $1.2 billion." Generally these rather general hazards have not been translated into harmful specific disclosures. I would suggest that the hazards posed by the practice of illicit payments need not be related with the sort of specificity that can have only peripheral interest to investors, but might significantly impact other values and considerations.

The difficulty with this approach is this: will others concerned with the matter feel they can exercise a similar restraint? Will Congress in dealing with its responsibilities feel that the detailed information must be publicly disclosed or will it feel some information might better be brought out in executive session? Will the media feel compelled to dig until they have found the last trace of detail concerning these matters?

These are questions obviously I cannot presume to answer. The Congress must be the final determinant of the course of any investigation it deems in the public interest; the press must likewise be the final determinant of its responsibility.

A further danger, of course, lies in litigation. There the courts would, I would hope, exercise sound judgment in determining whether some information is not better left out of the record because of its marginal relevance in determining the question of fraud upon investors.

It is apparent that not all companies have been seduced by the overseas sirens. We have information concerning a number of companies which have steadily resisted all efforts to involve them in questionable activities overseas and which have nonetheless prospered. Certainly among business executives there are many who deplore what their fellow businessmen have done. I'm sure that respectable leadership in many countries does not look lightly upon the activities of American businessmen which corrupt their nationals and which sully their political processes And certainly this kind of activity, which often becomes known, if not broadly, at least in some circles, does little to help the reputation of American business abroad. In this day when image is so important, certainly the image of Americans in general, American businessmen in particular, is not polished by this conduct.

Distressing as this has all been to so many, I think it provides a unique occasion for American business, regardless of what Congress does, to reexamine the manner in which it has conducted its affairs, both at home and abroad, and determine whether perhaps, little by little, under the excuse of protecting shareholders and advancing American interests abroad, practices have been too lightly embarked upon which, started small, have grown to troublesome proportions. I suspect that virtually every company in the country which has significant business overseas and seem to be susceptible to disclosure under the which might appear to be susceptible to disclosure under the standards intimated in the cases we have filed, is reexamining the bases of its business abroad, the extent to which it has been lulled into courses of conduct that are offensive to it but which it believes have become increasingly necessary to preserve business abroad. There is an opportunity now for American businessmen to clean the stable and rid themselves of practices and demands which have probably been offensive and burdensome to many of them. I don't think that American businessmen are comfortable or happy with pay-off and slush fund practices; I think many of them have been conned by

subordinates, who often substitute pay-offs for honest endeavor, into believing that this is the only way to do business. I would suggest that American businessmen should reexamine how they have conducted their affairs and how they should modify their course in the future. It may well be that as one of the by-products, quite incidental from the standpoint of the Commission, of the present focus upon disclosure requirements as they relate to overseas activities, will be the development of a sounder basis upon which American business is done abroad. While this is not what the Commission seeks, if it flows from our activity, I think it will be a fortunate consequence for all Americans and especially for American businessmen.