NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

THOUGHTS ON BUSINESS ETHICS IN A PRIVATE ENTERPRISE SYSTEM

Address by

John R. Evans
Commissioner

New York Chapter
Brigham Young University
Management Society
New York, New York
June 21, 1982

I consider it a great honor to be with you today at this first meeting of the New York Chapter of the Brigham Young University Management Society. My comments may well stimulate thought in an area that is fraught with controversy. I think we would find broad agreement that the topic of this seminar, "Ethics in Business", is very important. It is important in a religious or moral sense because of the effect it can have on the lives and goals of individuals, and in an economic sense because of the effect it can have on business and commerce. However, due to the fact that ethics involve moral ideals and goals, human motives of choice, and patterns of right and wrong conduct, it is very difficult to reach agreement on a general definition of ethics, let alone the standard that should be maintained in business dealings. I believe the definition given by Dr. Albert Schweitzer is a reasonable one. He said, "In a general sense ethics is the name we give to our concern for good behavior. We feel an obligation to consider not only our own personal well being, but also that of others and human society as a whole."

Those who have attended the Brigham Young University have been exposed to a high ethical standard. Because it is sponsored and directed by the Church of Jesus Christ of Latter-day Saints, the BYU embodies the principles of the Church. In addition to providing an opportunity to gain knowledge in subjects that will assist students to earn a livelihood and contribute to society in a material way, the enhancement of ethical or moral conduct in personal and business relationships is considered to be one of its most important purposes.

The ethical standard that is taught is contained in an Article of Faith which in part states, "We believe in being honest, true, chaste, benevolent, virtuous and in doing good to all men . . . ." This is not just a concept to be discussed in religious gatherings, but part of a basic philosophy to be practiced in all personal and business activities. The difficult question is, how can such a philosophy be practiced in a competitive free enterprise economic system?

Some would argue that business activity should be based entirely on the concept of "caveat emptor" and that market forces of supply and demand should not be hampered by ethical considerations or broad social policies because any external restrictions or requirements reduce the efficiency of the free marketplace in allocating resources and producing goods and services. Adam Smith is usually credited with being the founder of this laissez-faire economic theory with its "invisible hand" that automatically guides the economic process to provide the greatest good for the greatest number. But

---

The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

even Adam Smith did not advocate that businessmen should seek their personal interest to the exclusion of the public interest. Similarly, although I firmly believe that a competitive free enterprise economy is the most efficient system, it is obvious that private business activities often result in adverse effects on public health and welfare. These costs must be included in the price of production if resources are to be most efficiently allocated.

These observations raise several questions. Can such costs be voluntarily included in a competitive economic system? Isn't the prime motivation in such a system the potential for personal economic rewards? Are not such rewards based to a significant degree on paying the least for the elements of production and obtaining the most for goods and services produced? How can business decisions based on such concepts take into account ethical principles which would include all costs associated with production as well as considering the well being of others and human society as a whole? Can a business voluntarily include these expenses and remain profitable if others do not also voluntarily include them?

These are not merely philosophical questions. Rather, they lead to the concrete conclusion that in a society where everyone does not have and practice the same ethical standards, basic standards of conduct for all must be established by an appropriate process or authority. This same concept applies to families, tribes, communities, states, nations and on an international level. In the case of private entities, including businesses and self-regulatory organizations, such standards become codes of ethics, rules of business practice or self-imposed regulations. In sovereignties, standards take the form of laws or rules and regulations that have the force of law.

Some commentators suggest that there is a basic ethical difference between standards embodied in law and those established by individuals, families, religious institutions, and business or professional organizations. Although there are important differences, I do not find distinctions on the basis of ethics to be very meaningful. As Woodrow Wilson stated, "The law that will work is merely the summing up in legislative form of the moral judgment that the community has already reached." The enactment of an ethical standard into law does not reduce the morality of those who would conform their actions to the standard in the absence of law. In a government of the people like that which we enjoy, laws are the result of a consensus which is based on value judgments held by the governed. That process usually results in legal standards that are not as high as some believe appropriate or as low as others desire. If those who abide by the higher ethical standards cease to maintain them, the very nature of the consensus process will result in an erosion of existing community standards. This being true, law cannot fully supplant or compensate for a lack of personal ethical standards. Moral virtues, such as honesty, integrity, or loyalty to an ethical standard cannot be legislated. However, law can regulate behavior and it is the only practical means to embody the divergent views of a pluralistic society into a workable framework for all. Thus, government regulation of business is necessary and fulfills a legitimate and beneficial function.

I believe very firmly that free market forces should be permitted to operate to the maximum extent possible. In addition, individuals should have the opportunity and be encouraged to establish business standards for themselves, and also to participate in organizations which develop industry-wide standards. Government should be the regulator of last resort. As the British Statesman Edmund Burke observed:

> "Men are qualified for civil liberty in exact proportion to their disposition to put moral chains upon their own appetites. Society cannot exist unless a controlling power upon will and appetite be placed somewhere and the less of it there is within, the more there is without. It is ordained in 'he eternal constitution of things that men of intemperate minds cannot be free. Their passions forge their fetters."

The appropriate scope of government intervention depends on what is done by individuals and private sector organizations. Indeed, the role of government should expand and contract readily to meet changed conditions. Thus, basic regulatory statutes should not proscribe in detail, but should establish broad goals and provide authority for a regulatory agency to deal with the details of administration in a flexible manner under effective Congressional oversight. Providing for industry self-regulatory organizations can also minimize government involvement and maximize the use of industry expertise in establishing and enforcing business standards. There is, however, a natural tendency for self-regulators to establish rules that protect the position of existing particiants contrary to the public interest. Thus, government agency oversight of their rules is necessary.

One of the most efficient means of bringing about appropriate business behavior is by requiring disclosure of material information as is done by secu'ities laws. This approach enhances the operation of market forces and enables ethical beliefs of the general population to have an effect on business practices. Disclosure is more important in this latter respect than it would have been several decades ago.

In an earlier time when personal and business activities took place primarily in the local community, and were well known by neighbors, friends, relatives, and other close associates, the reputation of an individual and his business ethics were virtually inseparable. Such forces as the family, the church, and community social pressures were generally effective in promoting proper dealings even when personal integrity was lacking.

However, as our society has become more complex, more transient, and impersonal, the influence of these forces on the conduct of individuals has declined. As business institutions became national and international in scope, their activities became more diverse, and the actions of individuals were submerged within corporate complexes. Individual responsibility became so diffused that, absent public disclosure one could engage in business conduct which was not socially acceptable without being personally accountable to society for his actions.

Disclosure of material business information provides investors with the opportunity to refrain from investing in firms that engage in activities with which they do not agree. In addition, disclosure has the effect of discouraging practices that are not in accord with accepted ethical standards.

It has been argued that the SEC improperly uses its disclosure authority to establish ethical standards for public corporations. Naturally, members of the Securities and Exchange Commission have our own personal ethical standards, but we are not authorized to impose them on businesses. Our decisions must be based on provisions of law which we have the authority and responsiblity to administer and court decisions interpreting that law.

Among other things, securities laws authorize the Commission to require the disclosure of information necessary to carry out the purposes contained therein, and to adopt rules as necessary or appropriate in the public interest or for the protection of investors. The purposes referred to are generally to provide full and fair disclosure of the character of securities, to prevent frauds in the sale thereof to provide for the regulation of securities markets and to prevent inequitable and unfair practices in those markets.

As might be expected, there are those who would like the Commission to use its disclosure authority to help enforce all statutes that are applicable to business. However, the Commission has stated its position that:

> "the discretion vested in the Commission under the Securities Act and the Securities Exchange Act to require disclosure which is necessary

> or appropriate in the 'public interest' does not generally permit the Commission to require disclosure for the sole purpose of promoting social goals unrelated to those underlying these Acts."

This position does not, of course, restrict the Commission from requiring disclosure that has an effect on corporate conduct. The Commission may specifically require the disclosure of any information that meets the broad standards I have described.

In the absence of a specific requirement, public corporations must disclose all "material information", which has been defined as that information which a reasonable person would consider important in making an investment or corporate suffrage decision. In other words, disclosure generally is required if there is a substantial likelihood that it would be viewed by a reasonable investor as significantly altering the "total mix" of available information. Information may be "quantitatively" or "qualitatively" material. It is quantitatively material if it has economic significance to a corporation's business. For example, a $10 million expense item normally would not be quantitatively material to Exxon because of the size of its operations. The same expense, however, would be material to a company whose total annual sales are $100 million. Information may be qualitatively material if it is relevant to the competency or the integrity of management. This could include such things as the integrity of a company's books and records, the adequacy of its accounting system, and questionable or illegal activities of management. Determining whether information is material under either of these standards often requires difficult judgments of those considering whether disclosure is required. It must be obvious that because qualitative materiality deals with factors that are harder to measure, such as competence and integrity, it is much more difficult to determine.

Despite the fact that the law with respect to qualitative materiality is unsettled, many investors consider the quality of management to be the most important factor in their decisionmaking. For instance, some court cases have held that shareholders are entitled to a truthful presentation of information impugning the honesty, loyalty or competency of those who have a fiduciary duty in their corporate activities, and that because of the relationship of questionable or illegal payments to the integrity of management, such payments must be disclosed.

Everything relating to management, however, is not equally important. Courts have generally held that adjudicated illegal acts by management in their corporate capacity must be disclosed because they are material to managements' integrity. Generally courts have also required disclosure of lawsuits which are merely pending against directors and officers if they allege serious illegal acts. However, one court deemed a very serious adjudicated crime, bank robbery, not to be a material matter required to be disclosed because it occurred sufficiently long ago. And some courts have not required disclosure of serious corporate misconduct by management when such action has not been adjudicated to be illegal. For instance, in a 1979 case, a court in the Southern District of New York concluded that unless there are affirmative statements as to its integrity, management is not required to disclose certain antisocial or illegal policies.

Reports by the news media that this last approach is shared by some members of the Commission staff have caused public concern. One statement attributed to an internal staff memorandum to the Commission was that "it would be inappropriate to allege disclosure violations based on unadjudicated illegal or improper conduct by a company's officers and directors unless there were affirmative representations as to managements' honesty and integrity in some document." According to this view, there is no implied representation of management integrity running to the market which would be rendered misleading by the failure to disclose illegal or unethical conduct by management. I want to make it clear that this is not a view held by all of our staff nor is it an official Commission position. Indeed, although this is a very difficult area with important ramifications, I cannot readily accept the concept that there is no implied representation of management honesty or integrity. In order to adopt this concept, I would have to believe, as some critics of the SEC assert the Commission does believe, that businessmen are dishonest or antisocial or that corporations are essentially immoral. But in my opinion, most business men and women are honest and law abiding and expect the same of others.

I believe that honesty and compliance with law are fundamental principles upon which all business and other relationships in a free society are based. When a law is enacted, it establishes a standard which by definition applies to everyone within its scope. As Theodore Roosevelt stated, "No man is above the law and no man is below it; nor do we ask any man's permission when we require him to obey it." Thus, there is no need for anyone to represent explicitly or implicitly that laws are applicable to him. If some kind of representation is thought to be necessary, rather than suggesting that management should not be held accountable to disclose illegal acts unless there is an affirmative representation as to its honesty and integrity, it would seem more appropriate that management be held accountable unless there is a prior negative representation as to its honesty and integrity.

In conclusion, let me share with you some of the comments the Commission has received in response to the statements which the press attributed to some of our staff. One person wrote:

> "I have been a commercial banker for 27 years mainly because I have always believed that honesty and integrity are the very heart of the foundation of banking. For the SEC to now condone and advocate unlawful behavior by a bank as reasonable and standard business judgment is a flagrant and irresponsible act of either disdain or ignorance.
>
> You have done an immense disservice to the public as well. Our industry does not need this kind of false and damaging publicity."

A letter from a businessman stated:

> "I find it hard to believe that someone employed by the SEC could have said that corporations had minimal obligations to disclose illegal conduct where management had never represented that it had 'honesty and integrity.' Please say that no one wrote this. Otherwise, criminals who had never represented themselves as being honest and having integrity 'could be judged to be innocent of wrongdoing.'
>
> I'm part of management of my company. I was never asked to represent myself as being honest yet I'm sure that I'm expected to be honest. Or am I wrong about that? Should I consider being evasive and immoral when I next transact a deal for my company since the SEC would hold my firm harmless?"

A law professor wrote:

> "[I]t really is striking to see laid out in black and white what is usually said explicitly only by economists (and Marxists), that there is no obligation to obey the law in a market-based society, and to see it said by, inter alia, the Office of General Counsel, the lawyers. It makes rather difficult any sort of preaching to people engaged in welfare fraud, shoplifting, or long distance telephoning through fictitious billing, don't you think? . . .
>
> A company that violates tax and exchange control regulations is not a bad corporation. It is not to be thought that anyone is actually implying that officers and directors of [the company] are people of honesty and integrity. Management

> made a reasonable business judgment in taking the most profitable course despite the knowledge that it was probably unlawful. The thing to do is to try to get away with it."

Finally, a television commentator said:

> "According to a published report, which sources tell me is on the mark, the commission sees nothing wrong with companies breaking the law, and it won't insist that corporate managers be honest.
>
> Quoting from documents, the story says that, since [the company's] management had never claimed honesty and integrity, it had no duty to say when it was being honest. And transferring money, in violation of the law, was, according to the commission, reasonable and standard business judgment.
>
> Sources at the SEC say that the case was just a matter of law . . . that the Commission didn't think it had the authority to sue [the company]. But the Commission has also set up new guideposts, which every corporate manager is going to study very closely. And it won't do anybody any good . . . not the stock market, not investors, not even company managers. And to happen at the crown jewel of Washington's agencies. Well, it's just a shame."

It is important to remember that none of the statements referred to in the press and in these responses are attributable to members of the Commission, nor have they been adopted as Commission policy. Moreover, the letters fail to address some tough legal questions. Nevertheless, these and other comments received do indicate serious concern. Whether such views are representative of public opinion, with respect to disclosure policy, I don't know. Certainly, careful thought and analysis is required to resolve these issues.