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CONFIDENCE IN BUSINESS

An Address By

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It is a pleasure this evening to join your Conference on the theme of the role of public relations planning and restoring confidence in business and government. I will not impose upon your patience by presuming to lecture you with respect to public relations planning, because many of you are far more expert in that field than I. And, your program chairman has probably been wise in not asking me to address the subject of confidence in government. However, confidence in business is, in a real sense, what the federal securities laws and the Securities and Exchange Commission are all about, and that is what I have been asked to talk about, and that is what I shall talk about.

The Securities and Exchange Commission and the federal laws that we administer, were born of a time when confidence in American business had hit bottom. It was a period early in the first administration of Franklin D. Roosevelt, when business, as then conducted by private owners and private managers, was under severe attack, as indeed were the securities industry and our capital markets. As Billboard said in its famous headline, "Wall Street laid an egg" in the great crash of October 1929, and in the years that followed, everything in the economic sphere got worse rather than better, including massive unemployment and general despair whether prosperity could ever return without a fundamental change in our governmental and social structure.

In that context, considering the alternatives being pressed upon it, the Congress was fundamentally and remarkably conservative in its approach to federal securities regulation. Although other, more radical, experiments were tried in selected neighborhoods of economic activity, the basic approach to the role of the federal government with regard to the access of companies to our public capital markets for the process of capital formation, and the process of trading in stocks and bonds already outstanding, was one not of government control but rather private decision-making adequately informed.

Congress did not say that a company must receive the permission of the government in order to raise capital for any specific purpose. Congress did not say that the federal government would decide which investments were good and for whom, and which were not. In the broadest sense, Congress did not say that the federal government would tell business how to conduct itself or tell investors where to put their money. Rather, the Congress said that the federal government would establish a procedure that would give investors access to all of the information they could reasonably need in order to decide where to put their money, and that management should provide shareholders with all of the information they should reasonably need in order to exercise their corporate franchise to elect directors or pass upon other proposals requiring

shareholder vote. The theory was, and is, that business works best and that, overall, the allocation of capital to business enterprises will be most wisely made, when investors and shareholders are fully informed. Fully informed, in this context, also includes information alerting shareholders and others to possible breaches by management of their fiduciary duty and other legal remedies possibly available to some or all holders of a company's securities.

It was recognized, however, from the very beginning that disclosure of material information does more than inform investors, and in the process, incidentally, the public at large. It also has, as a practical matter, a normative function. The opportunity to disclose, or publicize, tends to cause good things to happen. The obligation to disclose, tends to cause bad things not to happen. The dictum of Mr. Justice Brandeis that "Sunshine is the best disinfectant" was clearly on the minds of the draftsmen of our earliest securities laws. It has become something of a cliche in current discourse, and a witness at one of our recent hearings observed that Justice Brandeis was perhaps guilty of a half truth. Sunshine is also pathogenic, he said. Too much sunshine can cause sunstroke or skin cancer. Nevertheless, the fact remains that the obligation to disclose is a potent weapon in the hands of government that can be used, whether or not

it should be used, to affect the conduct of those upon whom the obligation is imposed.

Without getting too technical, the initial thrust of the federal securities laws relating to disclosure was directed toward the process of selling new securities to the public to raise new capital. Here, the patterns of past had led to high pressure selling with little information made available to the buyer. While the common law concept of fraud has been with us for centuries, for various legalistic reasons, it was not on the whole an effective weapon to be used by someone who had bought what turned out to be a "dog" from an effective securities salesman. And the SEC set about, as required by the Securities Act, to see to it that investors would receive a prospectus containing all of the information then regarded as material for an investment decision, and that legal remedies would be made available to investors that would switch the balance, in this area, from caveat emptor to caveat vendor. The burden was clearly on the management of the company and its underwriters to tell the whole story in writing.

This process still continues and is still important. It has in the past led to certain conflicts with members of the public relations fraternity, inasmuch as it requires that the selling effort be made only by means of the prospectus

and not by means of press releases, or speeches, or other devices having the effect of selling literature, but not subject to the process of filing and review with the SEC. I think, on the whole, we have achieved a reasonable understanding in this area, and I do not sense that it is an issue of great concern today.

In the course of time, and also with the help of some amending legislation, the Commission has come to emphasize more and more the continuous disclosure obligations of publicly-held corporations, requiring the filing and the publicizing of information on an annual, quarterly or current basis, unrelated to whether or not at the time the corporation is engaged in the selling of new securities to the public. This process, in its entirety, has led, and is leading, to something of a revolution, in a quiet and nonviolent sense, in the overall reporting and publicizing obligations of our publicy-owned companies. And most of the controversies today relate not so much to what must go in a prospectus, as to what must go in the annual report as filed with the SEC, the quarterly reports, and the other public reports made by companies.

All of this constitutes a well-established apparatus and way of life involving top company mangement and its professional advisers. An immense body of law has grown up in the field, and it is univerally recognized that it has been

a great thing for the financial printers and the lawyers, and others. It is perhaps not so universally agreed that it has done its main task. That is to say, questions continue to be raised both as to whether it is worth it and whether it is enough. These questions, important as they are, are not easy to answer in a conclusive way. One is left with a question of judgment.

If it is true that the alternative to full and complete disclosure is something far more repressive, even extending to government ownership on a larger scale than we now have, then the mission of the SEC has been achieved. These other more drastic, and, in my opinion, more undesirable, measures have not been taken and, with all of our turmoil today, do not seem to be presently proposed in any serious manner.

Whether the disclosure process has led to wiser collective decisions on the allocation of capital is less demonstrable. Those who believe the government could do a better job -- who certainly do not include myself -- have not been able to prove their case by what has occurred, but neither has it been disproved, since it has not been tried. Whether the process has generated confidence in investors, that, at the very least, they will not be cheated and lied to, and that beyond that they are being fully informed of everything that they ought to know, and their rights and interests are being preserved, is the most difficult and contentious problem of all.

Obviously, the system has not prevented some massive frauds. We have all read the headlines of recent years, and we must recognize, that despite all that has been done in the last forty-one years to guard against it, there is still some cheating going on, some of it as bad as anything that our securities markets have ever seen. This has frankly been discouraging and has led some to argue that more drastic measures are clearly needed.

Our present system relies, first of all, upon the legal requirement that the affairs of publicly-owned companies be accurately and fully described, and the penalties imposed upon the management of companies for failure to do so. It relies upon the requirement for an audit of a company's financial statements by independent public accountants. And it relies, less obviously or formally, upon informed legal counsel to advise companies on what compliance with our laws entails.

Our approach to demonstrated failures in the system has been, and is, to increase what we call our enforcement activity. We investigate departures from full disclosure, and where appropriate, we bring law suits of a civil nature or recommend that the Department of Justice consider criminal action. While perfection is not achievable in any human affairs, we remain strongly of the opinion that this is the best method available to the government.

From time-to-time, the idea is pressed by certain members of Congress and others, that the system is weak, especially in

relying upon the private sector to do the auditing and reporting job. It was suggested even in the 1930's that at least the annual audits of publicly-held companies should be conducted by a government body rather than by independent public accountants in the private sector. The prevailing view then was that this was neither necessary or desirable.

This continues to be our view for certain very practical, as well as philosophical, reasons. On the practical side, I simply do not believe that the government, whether our agency or some other agency, could develop and maintain the crews of hundreds of accountants necessary to duplicate the work now being done by our accounting firms, and there is no reason at all to expect that, in the long run, such a government force would do a better job. Government accountants, particularly large stables of government accountants, are not necessarily smarter, more energetic, or more honest, than private accountants.

What the government can do, and do effectively, is to investigate the work of the private accountants when there is some reason to believe that investigation is necessary, and it can also be made more clear what the private accountant's duties are, and what will be the consequences of his failure to perform them. This is the road to improvement that we are pursuing. It is

not dramatic or revolutionary, but we think it is the best that we can devise, and certainly better than the government alternative. It will not prevent all abuses or solve all problems, but neither would any other system.

How much confidence in business has all of this created and maintained? It is a complex question, because confidence in business means many different things. If confidence in business and our capital markets means confidence in investors that they are being told what they ought to know and that they will not be cheated, I think we have done a pretty good job and that there is a fair degree of confidence. Of course, if confidence means that investments in corporate securities will prove to be profitable, that is another thing. None of our activities are directed toward, nor have any direct effect on, market prices for common stocks or the rate of inflation or the continued solvency of corporate issuers. They are all the result of other forces, and considering what has happened to stock prices, interest rates and inflation in the last five years, one cannot be surprised if there is a certain lack of confidence in corporate securities as the best possible places to put your money.

From my point of view, however, it is significant that investors at large have suffered losses rivaling those caused by the crash of 1929 and the subsequent depression, without raising any hue and cry for revenge and

and radical reformation. There must be widespread confidence that, although the system on the whole did not produce very good results for the investor, the effects were the result of forces other than widespread misconduct on the part of business management or those in the securities industry. If our federal securities laws have contributed to this maintenance of social stability and the avoidance of radical change, as I think they have, then they have been a success in a very important way.

But confidence in business can also mean something broader and more profound. Is there confidence that American business as presently constituted is being managed, on the whole, so as to produce the optimum social, as well as economic, benefits? In this sense, the question goes beyond simply whether a given business is being operated honestly and to the maximum benefit of the holders of its securities.

These concerns, which certainly do exist in the minds of many citizens, for the quality of business conduct as it affects our environment and the lives of people, is presenting new problems, and even dilemmas, for our Commission. We are being pressed to move into areas of disclosure requirements that go beyond what we have traditionally regarded as of interest to investors, and we are, in effect, being pressed to use the disclosure process for purposes beyond that of investor protection. That is to say, we are being pressed to use the

disclosure process deliberately for its normative function to encourage what may be regarded as right conduct and to discourage wrong conduct.

A well-publicized example of this has been the proposals that we require regular disclosure by publicly-owned companies of their activities in certain areas.

The most strongly-pressed proposals have been those of certain environmental proponents, relating to what they argue is proper compliance with national environmental policy, and the proposals of other groups relating to application of the equal employment opportunity laws. For several years, these groups have been urging the Commission to require corporate annual reports to include detailed, specific information with respect to every instance in which the reporting company has failed to comply with those particular laws. The Commission has been resisting.

The Commission did amend its reporting forms expressly to require disclosure of employment and environmental problems where there was reason to expect that the deficiences might lead to an economically-material effect upon the assets or earnings of the company. This was clearly within our traditional policy, and, indeed, such matters probably were required to be disclosed under our general provisions, even without the express requirement. This did not satisfy the proponents, and they continue to press for detailed information

even in situations where there is no reason to believe that the company's non-compliance will hurt it financially in any significant way. Their argument is that, drawing upon our traditional concern for informing investors, many investors today are concerned not just with money and the earning prospects of the issuer, but with the issuer's conduct. All investors, they argue, are not simply "economic man." They include "ethical man." The ethical investor wants to know whether a company is in complete compliance with our state and national policies regarding equal employment and environmental protection, and he should be provided with this information.

When we rejected these proposals, a federal court decided that we had not given adequate consideration to them, and that we should do something more. Our response at this point was to convene a public proceeding regarding these proposals, but also in general regarding disclosure of environmental, equal employment, and other socially-significant matters. We received over 340 comments from various members of the public, either by way of letters or by way of testimony, at our extensive hearings. We are still in the process of analyzing all the material and searching for some reasonable conclusions.

Why did we resist such obviously good things? It certainly is not because we favored discrimination in employment

or polluting the environment. What we feared was that, once we should move away from the traditional formulations of materiality, where would we end? What is the limit to the aspects of corporate behavior, however trivial in relation to the overall size and activities of a company, that some investor might find of interest to him? Faced with the complaint in many quarters that we are already requiring more information of a detailed nature than any reasonable person can absorb or use, is it reasonable and beneficial to investors that we add still more? Or should we move away from investor protection, seize the phrase "public interest" as it appears in our statutes, and frankly state that we are going to require disclosure of equal employment matters, for example, not to inform investors, but to embarrass companies into full compliance with national policy.

While we are deliberating these major and fundamental questions, other matters presenting disclosure problems have been forced upon us. The most interesting of these relates to corporate activity in violation of our laws against political contributions or official or commercial bribery, within the United States, and various illegal or improper payments made by corporations in other countries. We have taken, and are taking, forceful actions to require the disclosure of such payments by certain companies, and in so doing, it is apparent that we are causing a change in business conduct of this type.

These enforcement activities of ours have encountered a variety of defenses and complaints, some of which are quite inconsistent. While the first excuse of the management of the companies involved tends to be that "everybody does it, why pick on us", they go on to say that a public admission that they were doing what everybody does, would be disastrous. They argue that we are destroying the reputation of American business abroad, and the confidence of the public in business. They also argue that, as long as the numbers come out right in their financial statements, and they have behaved properly under the federal income tax laws, the additional fact of the illegality or impropriety of the bribe or other payment is not in itself material, or even if material, the harm of disclosure outweighs any possible benefits.

These answers are not all easy to dispose of, although we find the situation far more complex than we had ever imagined when we first knocked on the door of the Watergate Special Prosecutor, who had learned of illegal political contributions to President Nixon's campaign committee. We have found, for example, that not everybody does what everybody is supposed to do. Much depends upon the industry in which the company is engaged, the country in which it is doing business, and upon the nature of the foreign competition, and upon the attitude of management. Furthermore, it is not always the payment itself that is of the greatest concern to us and, we think, to investors.

A program of illegal or improper payments seems frequently to lead to, if not require, a process of laundering money to produce unaccounted-for cash and the falsification of accounts. This sort of thing seems clearly intolerable to us under any decent system of financial accountability. It produces circumstances in which the top management does not even know whether significant sums of money were spent for bribes, or what-not, or whether the money stuck to other fingers along the way, since no proper records were kept.

Beyond the financial accountability problem, however, many of these instances seem to present clear cases of materiality, even under the most crass and coldly economic standard. And I don't mean that the sums involved in the improper payments are in themselves material, but the business obtained thereby may well be. Where business is obtained, or concessions procured, by bribes which, if exposed, would create upheaval, retaliation and loss of business or loss of assets, that seems to us material.

Where there is a serious problem of accountability for funds, and we have brought an enforcement action for an accounting, this has lead to the production of audit reports in considerable detail. Certain major companies have come in voluntarily, in connection with registration statements to sell securities, and reported to us the existence of some improper payments abroad.

In one current example, the board of directors has adopted a resolution directing a cessation of all such improper payments in the future. The company has further assured us that the payments do not involve any business activity in the particular country that makes a material contribution to the company's revenues or income nor are a material amount of the company's assets located in that country. Further, it appears that the payments do not involve any defalcations. Also, the company has undertaken to conduct an independent investigation to ascertain the facts and will make a detailed report of its findings.

We, on the other hand, have agreed -- based on the company's assurances and undertakings in this particular case -- to "generic" disclosure pending the completion of the company's inquiry -- that is to say, disclosure of the fact that certain improper payments in a general aggregate amount have been made in certain countries without requiring the disclosure of names and places. Of course, if a company is not willing to make such a declaration of cessation, we might have a different attitude, including an insistence upon disclosing that it is the policy of the company to obtain business abroad through bribing government officials.

Has all this activity in this field increased or decreased confidence in business? Certain men of affairs in foreign countries have expressed their astonishment at the

behavior of those crazy Americans. In their view, apparently, every sophisticated person knows that certain little things are necessary to make life go on that decent people don't discuss in public, and that the public neither should, nor necessarily want to, know about. Certain foreign governments, whose members have been disclosed as having accepted bribes, have certainly not displayed any gratitude to us for bringing this to light. On the contrary, they have expressed resentment and indignation, as well as denial. We have been informed of a strong rumor in Central America that the SEC has been working for the CIA to effect the removal of heads of state, and one African republic published a full-page advertisement in American papers claiming that the accusations of bribes of its officials were not only untrue, but part of a United States Government plot to keep the emerging nations weak and unemerging. There are others, however, who more quietly say that the reputation of American business and the United States Government has been damaged by the willingness of some of our companies to get business through corrupt means, and that a cessation of these activities, while possibly harmful in the short run with respect to our exports and balance of payments, will in the long run be beneficial.

But aside from these effects abroad, what has been the effect domestically? Disclosure of these activities has led some members of Congress and some editorial writers to express their outrage in very strong terms, and to suggest stronger measures than those which we seek through our civil litigation and disclosure policies. It may have led some persons to think that this merely confirms their suspicions that business management on the whole is dominated by greed, and is lacking in ethics and any sense of public or social responsibility.

We cannot, and do not, seek to control what conclusions people derive from material information that our processes bring to their attention. But, we are convinced that, over any period of time, confidence in business is not generated by cover-up. While the pain of disclosure may lead to a temporary lack of confidence, over the long run, I think our people will have more confidence in the proper conduct of American business if they are further confident that, were the conduct otherwise, they would know about it. That is what we are trying to achieve.

Confidence in business, like adequate disclosure, is not a fixed or simple thing. The causes of doubts and disenchantment with business management vary according to many circumstances. The basic confidence that people should have

in business is that business is effectively managed, not just efficiently, but honestly, and I think on the whole we have had that confidence, and that it will be regained. Beyond that, is the style, the felt needs, of any particular period. To regain and retain public confidence, businessmen must be sensitive to the climate of opinion of the age in which they are operating. This is true of their activities. It is also true of their disclosure policy. They must tell the public what people want to know.

The general reaction to Watergate was certain to lead to some over-correction, some excesses. I think we are seeing them today. The so-called "public's right to know", which, when translated, seems sometimes to be merely the newspaper reporter's right to a hot headline, is likely to be overdone a bit. The so-called "government in the sunshine" bills which would subject all of our deliberations, with certain limited exceptions, to public observation, we think are contrary to the best quality of administration on our part. But there is today a strong and clear desire for candor, and impatience with flim-flamming, a lack of credibility in anyone who tries to get the public to believe that everything he has done is right, and that everything he proposes to do will be successful. Some business managements and their public relations people are attuned to this new spirit, and their relations with the public and with the investing community are being benefited by it.

I think the new spirit is good and essential. I think collectively we are tired of not really knowing what our business leaders are up to, or why they are up to it. We are tired of being treated like children or fools who are expected to believe any self-serving pap that is generated by the company's releases and speeches. We are willing to accept the fact that everything has not been and will not be done perfectly; that the best intended and most careful prediction may not necessarily come about; that business leaders like everybody else are going to guess wrong from time to time. But we don't want the bad news hidden from us. And most of all, we want to be confident that the people that are managing our money and property, and thus our economic activities, are trying to do it for our benefit, not just for theirs, and that they are behaving in a legal and ethical manner.

By accepting this attitude for today and the future, rather than fighting every suggestion or demand on our part for further disclosure, we believe that businessmen and their public relation advisers can contribute enormously to the confidence of the American people in American business.