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TRUTH OR CONSEQUENCES

Address by

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Securities Cooperative
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The enforcement program of the Securities and Exchange Commission is subject to strong opposing views, and it is not surprising that the views expressed frequently convey something about the effect of SEC enforcement on their source. Those subject to Commission jurisdiction suggest that our enforcement remedies are too harsh, while those who have suffered damage as a result of securities law violations assert that our remedies are "just a slap on the wrist." It has been stated that we attack leading firms in the industry because, if we win, the smaller firms will not dare to challenge us and will quickly do whatever we ask. On the other hand, we are told that our sanctions against large broker-dealers appear less severe than those against smaller firms.

We are accused of leniency toward securities violations by banks, and at the same time receive criticism that the SEC should not impose any sanctions on banks because they are subject to regulation by the bank agencies. We are denounced by accountants and attorneys for including them in our enforcement proceedings, while others allege that we protect accountants and attorneys because many at the SEC are members of these two professions.

Some have claimed that a problem with Commission enforcement is that there have always been over-zealous

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staff members whose recommendations are rubber-stamped by the Commission. In contrast is the statement that the Commission has "long enjoyed a deserved reputation among federal agencies for its conscientious and vigorous enforcement of the law." We are accused by detractors of abusing Commission power and expanding it far beyond Congressional intent, but at the same time Congress is in the process of increasing significantly our authority so that we can assume more of a leadership role; and the courts, with very few exceptions, have upheld our actions and have defined our powers as being very broad and flexible.

As I have asserted on previous occasions, constructive criticism is not only helpful, but vital to the proper functioning of governmental institutions in a democratic system. Walter Lippmann expressed this concept very well in stating that:

> If we are to preserve democracy, we must understand its principles. And the principle which distinguishes it from all other forms of government is that in a democracy the opposition not only is tolerated as constitutional but must be maintained because it is in fact indispensable . . .
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> A good statesman, like any other sensible human being, always learns more from his opponents than from his fervent supporters. For his supporters will push him to disaster unless his opponents show him where the dangers are. So if he is wise, he will often pray to be delivered from his friends, because they will ruin him. But, though it hurts, he ought also to pray never to be left without opponents; for they keep him on the path of reason and good sense.

initiated only a few months ago, the Commission has authorized civil injunctive actions against seven corporations and a number of other cases are presently under investigation. I do not believe it is necessary to discuss individual cases in detail because the newspapers have reported the allegations made by the Commission, as well as additional information from other sources, but a few comments on our actions under this program are probably appropriate.

Some of our cases were initiated after it came to our attention that the Watergate Special Prosecutor had brought criminal charges against companies for using corporate funds to make illegal corporate political contributions. We were concerned with such activities and wanted to assure adequate disclosure to shareholders and the investing public. We were further concerned whether such conduct might be indicative of activities in other areas involving the misuse of corporate funds. This concern was confirmed by subsequent investigations.

Whereas one company had pleaded guilty to charges by the Special Prosecutor that it had made an illegal campaign contribution, the Commission charged the same company with a failure to report payments from a secret slush fund aggregating over 80 times the amount involved in the disclosed campaign contribution. We alleged that about one half of this secret fund returned to the United States for political contributions,

and that the other half was disbursed in cash payments overseas.

Another corporation was charged with a failure to report over a quarter of a million dollars in corporate political contributions which were made from a secret fund and with a failure to account adequately on its books and records for many millions of dollars in payments to foreign consultants, agents, and others. In another case, the Commission charged a corporation with failing to disclose an agreement to make secret payments to foreign officials in exchange for favorable government action.

Our cases do not involve only illegal campaign contributions or undisclosed foreign activities of major corporations, but also the undisclosed use of corporate funds by smaller companies for domestic payoffs such as bribes, kickbacks, and other payments to local or municipal officials.

The question has been raised as to whether the Commission has any authority to proceed against such practices, and, if it does, whether it has a responsibility to use that authority. It is very clear to me that the disclosure philosophy, as expressed in both the Securities Act and the Securities Exchange Act over 40 years ago, was a Congressional response to fraudulent and manipulative securities practices of the corporate community as well as the securities industry. The "truth in securities" and "fair and honest markets" concepts

were premised partly on the Brandeis theme that business and social evils could be best dealt with through publicity. Indeed, a House Report for H.R. 9323, which after conference committee amendments became the Securities Exchange Act of 1934, emphasized this disclosure principle by stating, "There cannot be honest markets without honest publicity."

Thus, disclosure requirements, established and periodically revised by Congress and administered by the Commission, have been designed to provide a continuous and comprehensive system whereby current material information is available to assist and enable investors to make prudent investment decisions. The need for, and importance of, disclosure to investors was explained rather well by a spokesman for the Committee on Stock List of the New York Stock Exchange at the time the Exchange Act was being considered. He stated that the ownership of large corporations "is in the hands of millions of relatively small investors who have no direct contact with management and whose only knowledge of the company is derived from its financial reports." He added that such reports should be "fully and fairly informative" with the objective of giving "to stockholders, in understandable form, such information in regard to the business as will avoid misleading them in any respect and as will put them in possession of all information needed, and which can be supplied in financial statements, to determine the true value of their investments."

There is widespread agreement that disclosure is necessary to ensure honest securities markets and many agree that the disclosure efforts of the SEC have been fairly effective. Nevertheless, there is still debate as to whether particular information is material and thus requires disclosure. Traditionally, materiality is thought of as pertaining to financial and economic information. It should be recognized, however, that materiality cannot always be defined in terms of a percentage of assets, sales, loans, net income, or some other item on a financial statement. The courts have struggled with this concept and have generally established a broad test of materiality as being any fact which a reasonable investor might consider important in making an investment decision.

Given this broad standard, there seems little question that an investor might consider it important to know that the management of his company is misusing corporate funds to engage in conduct involving possible criminal activity. Such conduct, even if the monetary amounts involved are not large, reflects on the integrity of management, particularly in connection with proxy solicitations, and disclosure may well have a significant impact on investor views regarding management's qualifications. Furthermore, the weighing of expected economic rewards against economic risks is fundamental to any investment decision, and, while management has claimed

that they are engaged in secret payoffs and other illegal activities in the shareholders' economic interest, such activities increase the risks of doing business without informing shareholders of such risks.

These risks include the possible exposure of the corporation to civil liability which may result in large judgments against the corporation. In addition, any unlawful or necessarily secret activity or payment creates the opportunity for individual and corporate blackmail and further demands on corporate funds can be expected as is evident from recent newspaper accounts. Moreover, if a corporation is allowed to do business in a foreign country, obtains special treatment, or is profitable only as the result of payoffs to foreign, national, or local officials, shareholders should know that the corporation's prospects could be adversely affected if future demands are not met or if the unlawful activities are discovered. Whether shareholders would desire to risk the profitability of their company or perhaps its entire operation in order to acquire possible short-term economic gains should not be determined secretly by management, but by the shareholders after full and fair disclosure.

In view of the Congressional mandate that the Commission promote and maintain securities markets that are fair and honest, it is imperative that we be sensitive and fully aware of practices and conduct which undermine the

integrity of the marketplace and destroy the trust and confidence of investors in American business.

Although I believe that the management of most corporations maintain high ethical standards, I have been disturbed and somewhat disillusioned by the failure of corporate management in some public companies to recognize their disclosure responsibilities and by the efforts undertaken to create and maintain slush funds for payoff activities. We have found that corporate records contain false entries involving exotic foreign corporations and Swiss bank accounts in order to create secret pools of cash. Once these funds have been established outside the corporate records, management then has complete discretion to direct payments to whomever and for whatever purpose it desires without any documentation for such payments. In fact, a major corporation reported that when corporate officials returned their secret cash fund to the corporate coffers, company auditors were handed $750,000 in $100 bills.

The practice of maintaining slush funds for illegal and questionable purposes, not only on an international or national level, but also on a local community level is rationalized as a customary, and indeed necessary, method of doing business, and, therfore, it is claimed that such expenditures represent ordinary business costs. A recent London Evening Standard article entitled, "No bribes please, we're

British," told of an incident where the sale of six airliners was at stake. The local person responsible for the purchasing decision demanded an executive jet as his personal payoff, and, while the British "blushed in confusion," it is reported that the Americans simply sent the jet and got the deal. The same article suggested also that it is a fact of life in the Middle East that there is no chance of making a deal "without paying the going bribe for the job." Similar expenditures on a national and local level are justified on the same basis.

In other words, if someone's palm is not greased with a payoff, contracts cannot be obtained, tax concessions or discounts will not be allowed, necessary permits and licenses will not be granted, and so on. Furthermore, it is argued that even though a corporation detests and condemns such conduct, it becomes a necessary evil because, if the corporation does not engage in such activities its competitors will, and thus the corporation will lose the business. If such an attitude pervades the corporate community and dictates methods of doing business, it results in a situation where the competitor who engages in the most unethical or immoral conduct thereby sets the business standard at the lowest common denominator.

The use of corporate funds for bribes, kickbacks, payoffs, and other illegal and dishonest business practices is destructive of our economic system. Even if such secret payments are prevalent and considered to be a normal part of

business operations in particular foreign countries and in this country, dishonesty is not fundamental to business operations and exists only because it is allowed to exist and is condoned. Such non-productive expenses result in higher costs and higher prices and are of major concern not only to investors, but also to the general public. Moreover, to the extent business decisions are made on the basis of a kickback, payoff or bribe, and not on the fundamental economic forces of price and quality of goods and services, graft and dishonesty are rewarded, and the very essence of a competitive free system, which is to promote efficiency, fair dealing, low prices, and quality goods and services, is frustrated and destroyed.

There are also some adverse effects on the public which cannot be measured in monetary terms. We have been the recipients of a great American heritage which includes the world's highest standard of living, a powerful defense establishment, and an economic capability that is envied by others throughout the world, but I believe the most important element of American greatness is the moral integrity of a free people. While a totalitarian or closed society may be able to operate through force and fear, a free or open society cannot be established nor long exist without mutual trust and confidence, and there is little question that high ethical or moral standards of behavior are the only foundation upon which trust and confidence can be built.

My answer to the question of whether the SEC has any responsibility to use its legal powers to encourage high ethical and moral standards of corporate conduct is an emphatic "Yes." Furthermore, I believe we are in a unique position to do so without having to establish such standards, and we don't need to be apologetic or defensive about our actions.

I agree with Henry Clay when he stated in 1829 that:

> Government is a trust, and the officers of the government are trustees; and both the trust and the trustees are created for the benefit of the people.

I also agree with Roscoe Pound's statement that:

> In its beginnings law is a means toward the peaceable ordering of society. It stands behind religion and morality as one of the regulative agencies by which men are restrained and the social interest in general security is protected.

The law, ethics, and morality are so interrelated that they cannot be separated. Rules of law and of business practice must be based on common understandings of social and ethical values, and it seems rather fundamental that the activities of corporations and those who direct their operations must comport with such standards.

In a society where one's professional or business activity was limited primarily to a local community in which one's conduct was well known to neighbors, friends, relatives, and other close associates, the reputation of an individual

and his business ethics were virtually inseparable, and such forces as the family,the church, and community social pressure were effective in enforcing proper dealings even when personal integrity was lacking.

However, as business institutions incorporated and became national and international in scope, their activities became more diverse, and the actions and decisions of individuals were submerged within corporate complexes. By its very nature, the corporation became a composite of individual efforts, and responsibility was 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.

Accountability to the family, the church, and the local, national, and international community for the use of corporate funds can be brought about by strict Commission enforcement of full and fair public disclosure of all material corporate activities. Because it is in the self-interest of corporations and individuals to have a reputation for integrity in their business dealings, such accountability provides a powerful incentive to refrain from practices which do not meet accepted standards of ethical and moral behavior. In addition, while laws and government regulations cannot stamp out dishonesty, Commission actions enforcing disclosure of improper activities can assist honest corporate management to maintain

high ethical business standards by providing them with an economic and legal incentive to resist the temptation, and a basis on which to refuse requests, to use corporate funds for illegal campaign contributions, payoffs, kickbacks, bribes, and other improper purposes.

By requiring such disclosure, not only will investors have access to information which can be helpful in making prudent investment decisions, but the trust and confidence of investors will be encouraged, and thus the availability of capital to our business enterprises will be increased. In the process, we will promote the proper functioning of market forces in the economy, reduce the necessity of increased government regulation of business activities, support improvements in moral standards and ethical behavior in our society, strengthen the free political processes in this country, and we will be doing our part to assure that the great heritage we have received will be passed on to future generations.

We cannot afford to do less.