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Washington, D. C. 20549
(202) 755-4846

CHANGING CONCEPTS OF BUSINESS ETHICS AND THE RESPONSIBILITIES OF BUSINESS ADVISORS

An Address By

Ray Garrett, Jr., Chairman

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The program for this Institute listed four of the Institutes organized by our Section, and they showed somewhat more of a pattern than I had remembered. The first -- which, I believe, was the first national institute put on by any ABA section, after the old regional meetings were abandoned in favor of this sort of thing -- was on the then recent decision of Judge McLean in the Bar Chris case. Neil Kennedy, of loving memory, was asked if he could think of anything to get the national institute program moving, and he supposed that he could assemble a respectable group to discuss Bar Chris, even on short notice.

In those days -- with so many working on '33 Act registration statements, conscious of working on too many too fast, and secretly feeling a bit guilty about it, but getting away with it, so it seemed, and the paucity of decisions under Section 11, none really probing the painful depths of due diligence in detail -- Bar Chris was a bomb that sent tremors all through the Street, the board rooms, and the accounting and legal professions. The result was a land office business for the institute. Over a thousand worried lawyers and others journeyed into the Grand Ballroom of the Waldorf for two and a half days of exposition and speculation on that one opinion.

We may never top the opener, as they say in show biz. We may match the crowd some day, but possibly never the aggregate anxiety packed into one room. It produced some memorable moments. Milt Freeman disposed of the whole matter neatly. He said, "The lesson of Bar Chris is clear. Never work on the registration statement of a company that goes broke the next year." Al Sommer awakened the pretty jaded Saturday morning assemblege by opening his remarks at a time when the horse was long since dead by comparing himself to the fifth husband of a much-married movie star who observed on his wedding night that he knew what to do but didn't know how to make it interesting -- a joke that I have heard more often than I have cared to since then.

The event is also memorable to me for a more private happening. On the first night of the Institute, a Thursday, I had got mixed up with bad company -- old friends who were determined not only to dine well but thereafter to remake the world, or at least that part of it within reach, which was a lot. In consequence, on Friday morning, I did not feel like an Eagle Scout eager to be first at Reveille. But I made it, got through my modest bit, and sat down to relax, watch the other fellows work, and contemplate the promised coffee break. When the break came, dear, sweet Neil Kennedy, who was presiding that morning, came quietly over, put his hand on my shoulder in that palsy way that always starts my adrenalin, and let me have it. "Ray, old buddy", purred Neil, "I've got to leave to get out to my son's graduation. You take over." Well, I did, and we made it to lunch, when there was a changing of the guard. It was at lunch that it occurred to me that Neil had known for about three years that he couldn't stay in New York City until noon on that day. Funny he hadn't mentioned it before.

I won't forget our first Institute.

After this came institutes on Officers' and Directors' Responsibilities, Corporations under Attack, and Revolution in Securities Regulation. There have been some others -- highly successful -- on other subjects, but this is a fair concentration on corporate problems. But not technical problems. It has been a more searching concern. They have not been devoted to how to accomplish a three-cornered merger where state law does not permit it, or how to get rid of non-redeemable preferred stock with accrued and unpaid dividends -- the sort of really meaty stuff that we corporate lawyers love. Rather they have been devoted to a deeper examination of the role of the business corporation in our society than we have been accustomed to or than lawyers generally feel comfortable with.

There has been a neck-saving and hide-protecting aspect to this, and properly so. Lawyers must pay some attention to their own well being and search the boundaries of threats to the economic security of themselves and their families. But it would be a gross disservice to the intent of the earlier institutes and of this one to take this as the sole or even dominant focus of attention. While no human being -- which, despite our detractors, includes a lawyer -- can ignore the brooding omnipresence of possible liability for money damages in crushing amount -- I believe the primary thrust of these institutes has been, and is, to get a clearer view of what society, and the law, expects of lawyers, accountants, other advisors to corporations as well as corporate officers and directors.

Attitudes have, indeed, been changing. I am reaching the age where I enjoy putting down younger men by observing, whenever I can, which is most of the time, that whatever idea they come up with is not really new. Someone thought it and gave voice to it before. It is, of course, usually the fact. Virtually every criticism now being made of our business corporations and every suggestion for change can also be found in the voluminous reformist literature of the past century or more. But, while this is an interesting observation, it is little more than that. It is trite today to repeat Everett Dirksen's remark about an idea whose time has come, but the significance of ideas does not vary as much according to their logical validity as their popular acceptance. When someone today urges consumer, conservationist, or labor representation on the board of directors, for example, it is no answer to point out that this was suggested by a French philosopher in the 1890's and rejected. It is not being entirely rejected today. The widespread discontent with the behavior of much of modern business is leading to a reexamination of the legitimacy of corporate ownership and management and the premises that guide its conduct.

There is a degree of anomoly in the modern, publicly-held corporation. It is surely an institution that would never have been invented by anyone setting about to plan the organization of a society and its economic activities. He would, no doubt, have invented business units under common management and directed to a more or less specific productive or distribution function. The Soviets, for example, have found something like a corporation essential to organize and accomplish steel production, et cetera, but obviously not with stock ownership and the theoretical devotion of management to the monetary interests of the stockholders.

To persons who don't like the way business is behaving it is frustrating to discover that so much of it is conducted by a normally self-perpetuating management claiming to derive its authority from, and to be guided by the welfare of, a large and ever-changing mass of stockholders, most of whom management never sees or wants to see, or could see if it did want to.

Consider this imaginary dialogue.

The environmentalist says to the large steel company, "Stop polluting the lake."

And the steel company says, "We'd like to, but it would be expensive and reduce the profits of our owners."

The environmentalist says, "Go ask the owners. Maybe they would forego some profit for the sake of a clean and healthy lake."

And management says, "We doubt it, but anyway the owners are 100,000 names in the computer. We don't know them. We don't even know the real names of many of them. And they are changing all the time."

The environmentalist, not to be put off so easily, says, "Well, put it to a vote."

And management replies, "It wouldn't do any good, at least unless we got 100% approval, which is impossible. We can't even get 100% of our stockholders to answer their mail or cash their dividend checks."

"Why do you need 100%?"

"Because, the fundamental presumption is that we will operate their business to make a profit for the owners, that is, the stockholders. Our stockholders have invested in the business of making steel, not cleaning up lakes. For us deliberately to engage in a non-profit activity would be inconsistent with that presumption."

"Not everything you do makes money or is even intended to make money."

"Not in itself, that is true, but it is intended to contribute to the overall profitability of the enterprise. Show us that cleaning up the lake will be to the long-range benefit of our stockholders and we will consider it."

"Suppose people stopped buying your steel because you are a dirty pollutor. Or suppose polluting was made illegal and your company would be fined and you would go to jail."

"Either of those eventualities would have a persuasive effect."

My little dialogue illustrates, more or less, two thrusts of reform. Ever since Berle and Means discovered that most of our large corporations are not managed by the owners, there has been a reformist movement toward making the non-owner managers more responsive to the owner-stockholders. The temptation is great for management to operate the business for its own pleasure and profit, and pressures must be applied to encourage management to resist the temptation. The problem is as old as the days of the chief stewards of medieval manors, and wealthy Roman land-owners probably suffered from it as well. It is naturally exacerbated when the owner is not a mighty baron who can descend upon the thieving steward from time-to-time and boil him in oil when appropriate, but is rather an amorphous and ever-changing mass of unknown people.

But there is this counter-thrust to modern reform. Protecting the financial interests of owner-stockholders, important as it is, is often directly opposed to changes in business activity that are being pressed upon management. Indeed, most of the changes pressed to achieve environmental or social goals are immediately unprofitable or at least unrelated to profit-making. Corporate resistance to such changes would presumably not be different if the business were owner-operated, except for the curious tendency of our fiduciary laws, so noble in themselves, to make fiduciaries peculiarly greedy and heartless.

Obviously, the Federal securities laws and the efforts of the Securities and Exchange Commission have been devoted to the first reformist effort. We are primarily concerned with fairness of treatment of security holders, present and prospective, and fairness has meant predominantly disclosure. The Investment Company Act and the Public Utility Holding Company Act, as well as the Securities Exchange Act to some extent as you know, have substantive provisions designed to protect investors that go beyond disclosure, but not the Securities Act.

There have been, are, and will be, temptations to use the leverage provided by the disclosure acts to achieve other substantive ends. Those of you with long enough memories will recall that before the present note to Rule 460 was adopted in 1957, it was settled, though unwritten policy, to deny acceleration in a secondary offering unless the selling stockholder was paying the costs of the offering, regardless of disclosures in the prospectus. When the Commission proposed to set out that and certain similar policies in a note to the Rule, the bar took up arms and persuaded the Commission that those policies were beyond the intent of the Act. Hence, the present note and almost 20 years of consistent restraint in this regard in the exercise of our authority to grant or deny acceleration.

The subject is not dead, however. Early last summer, for example, when Citicorp's floating rate notes were in registration, we were urged from sundry quarters to deny acceleration because the offering was regarded as contrary to the public interest in that it would cause further disintermediation and thus further weaken the already severely crippled housing industry. We resisted these importunings as bad policy in the administration of the Securities Act, arguing that "public interest" as used in Section 8 is limited to full and fair disclosure to investors and does not extend to other policies, however desirable. In fact, there was not unanimity in government circles on the question of floating rate notes of the Citicorp type, so the pressure was not what it might have been. But I think we may expect future assaults on the integrity of our policy as we have known it. In my own view, the maintenance of this traditional policy is of great importance. Not only are we not experts on all conceivable matters of public interest, but also there is a dangerous negative implication in our denying acceleration on non-disclosure grounds. It suggests that if we do grant acceleration, we endorse the offering as consistent with the public interest. This is getting too close to the qualitative judgments on investments that we have strived for 40 years to avoid.

In the administration of the Exchange Act, our policy has not been so sharply defined. I believe that it is fair to say that in our formal disclosure requirements of Section 12 registrants -- I am not speaking of broker-dealers or national securities exchanges -- we have limited ourselves pretty faithfully to disclosure for its own sake, uncontaminated by other policy objectives. In some other areas, perhaps, we have been forced or tempted to go a bit beyond. Stockholder proposals under Rule 14a-8 are a case in point. Here we have attempted to adhere to a coldly legal approach, trying to remain aloof from the merits of the proposal and our personal views thereon. It is difficult because of the hopeless vagueness of our several corporate laws and even in accepted corporate theory as to what may or may not be a proper subject for stockholder action at the initiative of a stockholder. As we have seen, the intensity of feeling among some groups on various social, environmental and moral issues has put continuous pressure on this device and led some courts to bend, and us along with them.

From the beginning, the Commission has been of the view that the annual meeting of stockholders is not a proper forum for debating social issues unrelated to the profit-making activities of the corporation or the rights and interests of the stockholders with respect to the corporation. Passions aroused by such recent or current issues as napalm in Vietnam, the condition of blacks in South Africa, women's lib, and so on, are constantly pressing to demolish this barrier. When you feel strongly enough, apparently, you are inclined to regard any possible forum as a proper forum.

It may be, also, in our administration of Rule 10b-5, that non-disclosure considerations have been material in persuading us to sue, even though we have never sued without what we believed to be a prima facie case under the rule. If we encounter activities that we regard as grossly unfair, we will look for a basis for suit under 10b-5, and usually have little trouble finding it, even though the unfairness and not the lack of disclosure is the primary reason for suing. Under the present state of the law I have no apology for these actions. I think this is the way we ought to behave. We are still concerned with investor protection.

Should we go further, beyond investor protection? To pick a relatively non-inflammatory example, the President has announced that there will be a new energy conservation program. Suppose we encounter a company that is clearly wasting energy contrary to the national policy but to the enhanced profit of the enterprise. Should we proceed against such a company under Rule 10b-5 on the ground that there was no disclosure of the wastage and that it is material to investors to know that the management of the company is the kind that would do such a thing? Does it matter whether the wastage would subject the company to penalties and whether the penalties would be material in dollar amount? Do we help the stockholders by bringing a public action that virtually guarantees the assessment of penalties?

I do not pose this hypothetical case as a mental exercise. Last week I attended the summit conference on inflation. It was a grand spectacle and revealing in many ways. While the formal topic was the causes and cures of inflation, especially the latter, special interest groups of all kinds could not resist the opportunity to tell the President and all the world the importance of their interests and why, whatever was done to curb inflation, their own programs needed more money and more protection, not less. A collateral message from all this special pleading was the deep distrust, if not worse, held in many quarters toward business in general, and especially big business. There was some talk of the desirability of tax, and possibly other, measures to encourage savings, and the President included that goal in his summing up; but, except for the brief report of the banking and finance panel, nobody showed any interest in the desperate state of our capital markets and the inability of our companies to raise new capital to increase productivity.

Only the housing industry attracted any sympathy for its capital needs. There was much talk about increasing our domestic sources of energy, but the persons who were not representatives of business and finance would apparently encourage this by penalizing the oil and gas industry. There was some recognition that the future production of electric energy is a problem, but rates should not go up, anti-pollution measures should be increased, and so on. Investors were totally ignored, their existence not even mentioned. Stockbrokers had been mentioned at a pre-summit conference, and they wish they hadn't. When Alan Greenspan observed that all groups were adversely affected by inflation and, as a matter of fact, proportionately the worst hit class was the stockbrokers, he was met with hoots and catcalls. Even at the summit this was referred to snidely, and quite unfairly, as conclusive evidence of the President's advisors' insensitivity to the sufferings of the poor. In general, it was not a good day and a half for business or investors.

What, if anything, does all of this have to do with business ethics and business advisors? Even if spokesmen for consumer and conservationist and welfare groups displayed little knowledge of, and less interest in, the operations of our capital markets, investor protection and the importance of investor attractions, we care. We continue to believe in private enterprise as the best means of economic organization, and we believe that the attraction of investors back into industrial securities is by far the best, if not the only, way to provide the capital for modernization and expansion so badly needed. Fairness of treatment, and confidence in fairness, are obviously essential ingredients. But so is a friendly environment.

You will spend the next day and a half worrying about whether and when you might be sued and by whom, and for what, under the present law. I have nothing to contribute to that general subject. Instead, I have gone into these other matters because modern American business has a broader and deeper problem than fairness to investors, important though that clearly is. The bigger problem is the widespread discontent with the way business is performing, combined with abysmal ignorance not only of how business operates but of elementary economics and, in some noisy quarters, an unqualified hostility toward business and business leaders.

This, I believe, has clear implications for business ethics and policy. Profit maximization as the central concern of management policy I still regard as sound economics but it is not properly understood in many quarters and its assertion may be bad politics. It may be that short-run profit maximization has long-range dangers, because long-range profits depend upon preservation of private enterprise, and that may well depend upon business serving the social and environmental demands of our people as well as their material desires. Returning to my earlier dialogue, the response of company management may be sound economically and consistent with the traditional demands of our corporate law, but it may be increasingly perilous politics. And, as Dr. Gabriel Hauge observed at our pre-summit conference on finance, when economic problems get serious enough, they become political.

Business advisors must, I believe, become increasingly alert to these considerations. I realize this is not the first time this urging has been expressed. Perhaps my personal greening is a bit belated. But the renewal of this idea with added urgency is one of the lessons I drew from the summitry. All of us concerned with private enterprise and our capitalistic system have an enormous task of education before us, plus the need to demonstrate concern for the needs and desires of our people. Business advisors must play a central role in this endeavor.