Reprinted from Report (The Los Angeles Daily Journal) December 15, 1978 No. 78-24

Management Fraud — What are the Standards

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I have chosen to speak to you this afternoon on a topic which has been discussed frequently at Commission meetings since I became a Commissioner—the materiality of management integrity to decision making by investors and stockholders. This topic can be discussed in a variety of contexts. For example, management integrity has been a relevant consideration in some recent enforcement cases as well as a topic of discussion in the Commission's Corporate Governance Hearings held during the past year and the rulemaking proceedings which have evolved from those hearings.

Integrity, like other ethical qualities, is difficult to define or legislate into existence. Further, the federal securities laws do not generally regulate the relations between officers, directors and stockholders. Accordingly, I have placed the topic of management integrity in its securities law obverse — namely, management fraud. Regulation is often better, from both a legal and a policy perspective, if standards are established by stating what is prohibited. Nevertheless, it is always desirable to engage in such standard setting with reference to basic principles.

In the case of management integrity, it seems to me that the basic principle involved is the proper resolution of conflicts of interest between a manager of capital and the investor who has turned over that capital for management. The essential legal principles by which a manager of capital is judged and held accountable pre-date the federal securities laws. In the case of **Meinhard v. Salmon**,[1] the highest court of the State of New York was presented with the following facts:

In 1902, Mr. Salmon, a real estate operator, and Mr. Meinhard, a woolen merchant, formed a joint venture to lease, alter and operate the old Bristol Hotel in New York City. They agreed that Mr. Salmon would manage the property. Twenty years later, when the lease was about to expire, the landlord proposed that Mr. Salmon, the manager, renew the lease on the property, demolish the hotel and build a new, larger building on that land and several adjoining parcels.

Shortly, thereafter, Mr. Salmon, who had not told Mr. Meinhard anything about the proposal, signed the new lease only on his own behalf. About three weeks later, Mr. Meinhard learned of the agreement and—as is the wont of disappointed investors—took the matter to court.

Chief Judge Benjamin N. Cardozo analyzed the duty which the managing partner owed to his partner, who was a passive investor, in words which have frequently been cited in securities law cases under the statutes which the SEC administers:

"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone; but the punctilio of an honor the sensitive, is then the statdard of behavior."[2]

In his thoughful book considering the overlap between legal questions in American

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1) 249 N.Y. 458, 164 N.E. 545 (1928).
2) Id. at 546.

law, **The Moral Decision**, Edmond Cahn analyzes the **Meinhard v. Salmon** case as a demonstration of the moral and legal value of loyaly. He states that:

Loyalty - *even on the level of commercial* affairs - bears a special beauty of its own to which men are irresistibly drawn. For the example of a faithful trustee reminds us that rapaciousness *and insensibility do not* necessarily make up the final sum of human character."[3]

On a less optimistic note, Cash, writés that:

"The problem of assessing loyalties is therefore one of the most acute in modern economic life, and very few power managers seem to meet it with wisdom."[4]

In the post-industrial society in which we live there is some question as to whether management hires capital or capital hires management. The corporate world like the rest of society suffers from a dehumanization which encourages rapaciousness and insensibility rather than faithfuless. Judges and lawmakers therefore find the struggle to test legal standards by moral principles difficult. And, there is some question whether a regulatory agency should attempt to impose moral standards on business enterprises.

One trenchent critic of the SEC has criticized the Commissions's efforts to prevent and suppress management fraud as an invocation of moral rather than legal materiality.[5] While I believe that moral standards are an important guide for regulators, I also believe that government regulation of business conduct must be based on objective legal statdards. Accordingly, the Commission's policies and programs concerning management integrity and management fraud must be defended by standards of materiality contained in the federal securities laws—or they are indefensible.

Although the materiality of management integrity under the Federal securities laws recently has been the subject of controvery, the significance of management integrity to investors and stockholders is not new. The Commission in the **Franchard** case, Its first management integrity case, decided almost fifteen years ago, defined that concept as management's "willingness to place its duty to public shareholders over personal interest."[6]

Thus, the moral and legal value of loyalty that was the basis for the analysis of common law partnership duties by Judge Cardozo in **Meinhard v. Salmon**, *also has been the basis* for management integrity, as a term of art under the federal securities laws. In other words, the duty of loyalty that Cardozo found in the two-person partnership has been recognized to apply to the modern corporation.

Although the term "management integrity" is sometimes used more broadly or colloquially, it seems to me that the **Franchard** case definition is a good predicate for establishing a standard prohibiting management fraud.

Accordingly, information relating to a lack of integrity in the resolution of conflicts of interests by an issuer's management is an appropriate subject for disclosure. It is the reasonable expectation of public investors that management will be loyal to their interests. Of course, investors should expect management to prosper **with** the corporation. But, they are entitled to expect that management will not prosper **at the expense** of the corporation.

Where management has materially breached its duty of loyalty—for an extreme example, by misappropriation of corporate funds for personal use—investors have the right to know that their expectations have been disappointed. The disappointment of reasonable investor or shareholder expectations is crucial to an analysis of management integrity under the federal securities laws because of the element of deception required for fraud cases.

I recognize that the fiduciary standards, against which investors' expectations of loyal-

3) Cahn, The Moral Decision 153 (Indiana University Press 1959).

4) **Id.** at 151.

5) Kripke, "Where are We on Securities Disclosure After the Advisory Committee Report?" 6 Sec. Reg. L. J. 99 (1978). Also published at 2 J. Accounting, Auditing & Finance 4 (1978).

6) Franchard Corporation, 42 Sec 163,170 (1964).

ty are measured, do not necessarily arise under the federal securities laws. The United States Supreme Court in **Santa Fe v. Green,**[7] essentially held that at least one critical aspect of the fiduciary relationship between management and shareholders — the duty to deal fairly — is not found in Section 10(B) of the Securities Exchange Act or Rule 10B-5 thereunder.

Nevertheless, the legislative histories of the Securities Act and the Exchange Act are replete with references to trusteeship and fiduciary obligations. For example, one very significant intent of these laws is "that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary."[8]

Santa Fe v. Green probably mandates the conclusion that these standards refer to the requirements of full disclosure, rather than the obligations of fair dealing that are imposed upon the common law fiduciary or upon management by state corporation law.

The **Green** decision does not mean that controlling persons are relieved from disclosing transactions in which they have overreached the minority. For example, the Second Circuit in a case decided after **Green, Goldberg v. Meridor,**[9] held that Rule 10B-5 covers a parent corporation's undisclosed or misleading sale of its overvalued assets for stock of a controlled subsidiary with securities in the hands of the public.

Thus, the securities laws prohibit deceptive failures to disclose material conflicts of interest. But, assuming such disclosure, questions regarding the fairness of transations must be resolved by state law.

Because of this interaction between the anti-fraud provisions of the securities laws and state law, the Commission realistically has the power under its disclosure provisions to indirectly affect corporate conduct. This power exists because the Commission, by requiring disclosure of practices that would result in adverse publicity, can effectively cause those practices to be terminated. Whether and to what extent the Commission should use this power is probably more a question of policy than law.

Although legislative history of the Securities Act does not reflect the regulatory consequences inherent in requiring full disclosure of management's conflicting interests vis-a-vis the corporate issuer, these results were obviously appreciated by that law's sophisticated draftsmen. Felix Frankfurter, the most noted of these draftsmen, wrote shortly after the Securities Act's enactment —

"The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions: to force knowledge of them into the open is largely to restrain their happening. Many practices safely pursued in private lose their justification in public. Thus, social standards newly defined gradually establish themselves as new business habits."[10]

It is not surprising that the framers of the federal securities laws placed such great emphasis on the obligations of full disclosure. Among their ranks were admirers of Justice Louis Brandeis, who believed that informed investors would revolt against overreaching promoters with what he called a "strike of capital" —the public's refusal to purchase their securities. Justice Brandeis, in his classic work, **Other People's Money**, argued that disclosure requirements could have regulatory consequences when he wrote —

"Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[11]

While I believe that Brandeis' analysis was correct, in our modern, complex political economy, the penalties imposed upon the issuer because of disclosed errant behavior may extend beyond a Brandeisian "strike of capital" to far-reaching political and consumer responses.

A concern over these continuing signifi-

7) 430 U.S. 462 (1977).
8) H.R. Rep. 85, 73rd Cong., 1st Sess. 5 (1933).
9) 567 F.2d 209 (2d Cir. 1977).

10) Frankfurter, The Federal Securities Act:II, Fortune (August, 1933) 53, 55.
11) Brandeis, "Other People's Money" 92 (1932 ed.)

cant regulatory consequences of disclosure policy was addressed by the Commission's distinguished Advisory Committee on Corporate Disclosure. It reported that —

"The prevention of fraud and the altering of corporate conduct are necessary consequences of 'disclosure' as a regulatory technique. This effect of the disclosure concept is one reason it was chosen as the means to protect investors. Certainly disclosure still has this effect and purpose, and the Committee believes it desirable.

"Nonetheless, the Committee does not believe that disclosure requirements should be imposed, regardless of the materiality of the information to be elicited, because of the effect they will have on corporate conduct. If the Commission sees the need to directly regulate corporate conduct, it should request Congress to authorize it to do so and should not do so through requiring disclosure of immaterial information."[12]

The Committee recommended that the Commission consider a statement of objectives which, in part, would provide that the Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct. The Commission carefully considered the recommendation, but announced that it does not believe that the benefits to be derived from such a statement would, on balance, outweigh the difficulties which it might create.

The Commission was concerned that it could become involved in unfruitful arguments, and even litigation, as to whether its response to a particular situation was consistent with the statement of objectives. It noted that —

"The basic objective of the disclosure requirements is to increase investor confidence and to make the securities markets more efficient and as fair and honest as possible. Any endeavor to define these objectives more precisely would not be beneficial since the disclosure requirements necessarily must be dynamic to meet the ever changing environment in which the securities markets operate."[13]

Of course, any discussion of whether the Commission should limit its requriements to the disclosure of material information cannot be divorced from an analysis of the concept of materiality, itself. Two decisions involving Commission enforcement actions charging the failure to disclose material information regarding management's integrity are instructive.

The **Kalvex** decision stemmed from cross-motions for summary judgment and resulted in an injunction against a defendant, Robert Ingis, who had contemporaneously served as Kalvex's Director, Executive Vice-President and Chief Operational Officer. The court found that a proxy statement did not disclose certain facts which, in the court's words, "might have led a reasonable stockholder to question the integrity of Ingis and his ability to discharge his fiduciary obligations."[14]

These undisclosed facts were that Ingis engaged in a scheme to secretly funnel kickback money to him from a Kalvex supplier through a dummy corporation; and that he siphoned off corporate funds to his personal use by submitting expense vouchers unrelated to any corporate purpose.

The court found this omitted information material, noting that "(o)ne does not elect as a director an individual who is using the corporation he represents for personal gain."[15]

In the **Schlitz** case,[16] defendant's motion to dismiss the Commission's action, which alleged non-disclosure of potentially criminal marketing practices, was denied. In part, the Commission's case was based on a management integrity theory, although the complaint made no reference to individual directors. The Court agreed with the Commission that "the question of the integrity of management gives materiality to the matters the Commission claims should have been disclosed."[17]

In neither of these decisions was any test

12) Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 318-19 (1977).

13) Securities Act Release 5906 (February 15, 1978).

14) **S.E.C. v. Kalvex Inc.**, 425 Supp. 310 (S.D.N.Y. 1975)

15) **Id.**

16) **S.E.C. v. Joseph Schlitz Brewing Company**, 452 F.Supp.824 (E.D. Wisc. 1978).

17) **Id** at 830.

made of the economic consequences of the illegal transactions related to the management integrity issue, even though in **Schlitz** these consequences were discussed in connection with other disclosure theories.

As you probably know, in the **Texas Gulf Sulphur** case,[18] which involved the securities marketplace, the Second Circuit held that a material fact is one which is likely to affect the market price of any of the company's securities or is likely to be considered important by reasonable investors, including speculative investors, in determining whether to trade in such securities.

On the other hand, in **TSC Industries,**[19] which involved the solicitation of proxies, the Supreme Court held a fact to be material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. The relation of these two cases is unclear.

The Commission's Advisory Committee on Corporate Disclosure could not agree whether the materiality standard is now the same under the antifraud and the proxy provisions. Interestingly, the Court in the **Schlitz** case cited **both TSC** and **Texas Gulf Sulphur** in determining that a reasonable person would attach importance to the questionable transactions in making investment decisions regarding **Schlitz** securities.

Now I wish to extend this somewhat abstract discussion on management integrity and its materiality to investors and shareholders to the Commission's current work. In particular, I will refer to three of the most significant—and controversial—of the Commission's ongoing programs: corporate governance, management remuneration, and questionable payments.

I believe it is important for the Commission and persons regulated by the Commission to agree on how and under what circumstances management integrity is material under the securities laws because integrity can be an amorphous and moralistic concept. Federal regulation, however, under our constitutional system, must meet objective legal standards to be valid and enforceable.

The Commission has undertaken a comprehensive examination of the issues pertaining to how corporate America is governed. In several areas, the Commission proposed disclosures regarding, among other things, management integrity — that is, as I discussed earlier, management's willingness to place its duty to public shareholders over personal interest.

These areas include the corporate board's composition and independence from mangement, the existence of certain key committees, board and committee attendance, and information that would be required when a director resigns or declines to stand for reelection because of a disagreement concerning the issuer's operations, policies or practices.

While these disclosures would not directly show whether management is satisfying its obligations of loyalty, they could provide structural information upon which investors and shareholders could determine the institutional checks and balances available to monitor management's fidelity to shareholders.

Since these rule proposals are part of an ongoing rulemaking proceeding, it would be inappropriate for me to discuss in any detail their merits today.

However, I would like to draw a distinction between the Commission's authority to require disclosures which relate to management integrity and the efficient functioning of a corporation in the best interests of shareholders and any effort by the Commission to change or mandate corporate board or committee structure.

In my opinion, compelling a particular composition for directors' committees goes beyond disclosure requirements or even the regulatory consequences of disclosure. Rather, I believe that position would represent a **direct** regulation of the corporate sector which would require a specific legislative authorization.

On the other hand, the Commission's pronouncements on management remuneration, including undisclosed management per-

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18) **S.E.C. v. Texas Gulf Sulphur Co.**, 401 F.2d 833 (2nd Cir. 1968), cert. denied sub nom. **Coates v. SEC,** 394 U.S. 976 (1969).

19) **TSC Industries v. Northway, Inc.**, 426 U.S. 438 (1976).

quisites, represent an area squarely within the Commission's jurisdiction. I believe that shareholders reasonably have an expectation that management will deal openly with the corporation.

Inherent in this concept is the idea that management will not act to the disadvantage of public investors by deceitfully extracting personal gains from corporate assets. By deceitfully, I mean without proper disclosure to the persons to whom management has a duty of loyalty.

The relation of questionable corporate payments to management's integrity is a somewhat different matter. The threshold question, in deciding whether management's integrity has been compromised, is determining whether management thereby placed its own interest above its duty to public shareholders in making the payments.

To cite Professor Walter Werner's example,[20] when Gulf Oil Corporation made payment to representatives of foreign governments, its Chief Executive Officer, who made those payments received no personal benefit therefrom. Rather, he acted in what he thought to be the best interests of the company and its stockholders. And he personally assumed the risks for those payments. Was he acting disloyally to his shareholders?

In 1974 the Commission's Division of Corporate Finance stated its view[21] that the conviction of a corporation and/or its officers or directors for having made certain illegal campaign contributions is a material fact that should be disclosed to the public and specifically to shareholders, particularly in the context of a proxy statement where shareholders are being asked to vote for management. The Division believed that —

"Such a conviction is material to an evaluation of the integrity of the management of the corporation as it relates to the operation of the corporation and the use of corporate funds.

It is hard to argue against a duty to disclose a criminal conviction for a crime committed by an officer or director in the course of a company's business. Nevertheless, I am troubled by the sometimes articulated theory that any illegal act by management is necessarily material to an evaluation of that management's integrity, and therefore the failure to disclose such information violates the anti-fraud provisions.

In particular, I am troubled by the notion that the SEC should be generally investigating suspected violations of federal or state laws other than the securities laws in order to compel disclosure by management of such other violations. Now that, of course, does not constitute an acceptance of corporate crime as a way of business. But corporations are subject to a myriad of federal and state laws, many of which are known to be honored in their breach.

If the SEC could investigate and compel disclosure of any business crime under a management integrity theory, the Commission could well have license to prosecute any public corporation in America. I believe that kind of laxity in the legal standards by which corporate conduct is measured would be very bad government.

I should stress, however, that my reservations about materiality under the anti-fraud provisions of conduct indicating a lack of management integrity, does not mean that I question whether certain forms of illegal behavior should be disclosed under other theories.

For example, a corporation whose vitality is based on surreptitous payments to particular individuals may be experiencing commensurate business risks that must be disclosed. Or, a corporation maintaining substantial undisclosed off-book accounts or subsidiaries to fund these payments may not be presenting its investors with accurate financials.

Further, the enactment of the Foreign Corrupt Practices Act has made more complex the question of whether questionable payments reflect on management's integrity so that failure to disclose such payments is a material omission under the anti-fraud provisions of the securities act.

Moreover, questions about the materiality under the securities laws of illegal management conduct are not easily answered. While I believe that the federal securities laws are in-

20) Werner, Management, Stock Market and Corporate Reform: Berle and Means Reconsidered, 77 Col. L.R. 388 (1977).

21) Securities Act Release No. 5466 (1974).

tended to protect investors against nondisclosed overreaching by corporate management, I am not certain that those laws — or the Commission that administers them — should be used to protect society against general misconduct by corporate management.

Consequently, I would discard the simplest possible management fraud standard: the theory that any knowing illegal action by management constitutes management fraud. In contrast, I believe that defining management integrity in terms of its loyalty to public investors is judicially administerable, effectively protects the interests of those investors, and is squarely within the Commission's statutory mandate.

Although this standard may not be sufficient as an exclusive standard for management fraud, I believe that this standard would encourage the public confidence needed to maintain the vitality of the capital markets.

When the public investor thinks in terms of management integrity he thinks in terms of management loyalty. He wants and expects his hard-earned capital to increase, not to be siphoned off by disloyal managers into a Swiss bank account. He does not want to feel "taken," which is perhaps a colloquial way of expressing the prohibitions of the antifraud provisions of the securities laws. This primary concern of investors and shareholders should also be the Commission's primary concern.

Management integrity is also a national concern. Absent confidence that business management will be loyal to the interests of investors, the capital investment that is needed to keep America competitive in the world marketplace will not be forthcoming. This bottom line reaction —the "strike of capital" which means loss of public confidence —is the investing public's common sense recognition of Frankfurter's principle that —

"In the last analysis business, like government, depends on men."[22]

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22) Frankfurter, supra, at 106.