



NEWS

**SECURITIES AND
EXCHANGE COMMISSION**

Washington, D. C. 20549

(202) 755-4846

FOR RELEASE

BUSINESS ETHICS AND THE FREE ENTERPRISE SYSTEM

REMARKS BY

A. A. SOMMER, JR.

COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION

NATIONAL ASSOCIATION OF TRUCK STOP
OPERATORS SEMINAR

SAN ANTONIO, TEXAS

FEBRUARY 16, 1976

BUSINESS ETHICS AND THE FREE ENTERPRISE SYSTEM

Remarks by

Commissioner A. A. Sommer, Jr. *

We all know where lay the fame of 1776: this was the year in which the American people, driven to the point of desperation by the petty tyrannies of their fellow Britons, thirty-five hundred miles away, determined to shape their own fate in the future and took the first momentous steps toward the development of the most unique political system in the history of the world, one that has endured uninterruptedly through a civil war, two wars of global scope, numerous other less widespread conflicts, economic recessions, panics and depressions, and innumerable other threats to the viability of the system. Within this political structure ordained almost two hundred years ago, there has developed in this country the richest, most productive and most advanced economy in history. Throughout this history there has always been a delicate, complex, often difficult, interplay between the government that we have and the economic forces in our society that have been principally responsible for providing such benefits to so many

*The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or of my fellow Commissioners.

people. All the while the political structure was the means by which people's liberties were protected, including the freedom to use the resources of the nation in imaginative and fruitful ways. At times, particularly in times of war, those in control of the economic resources of the country have been tightly restrained by government and their energies directed in the manner in which the government chose. At other times, and certainly with considerable frequency during the last forty years, the government, responsive in many instances to the demands of the people that something be done to assure more concern with the public welfare on the part of those controlling economic forces, has reached into the economic mechanism and mandated reform.

After the 1929-1933 debacle the federal government, acting through Congress, determined that the freedom which entrepreneurs, who sometimes were also swindlers, had enjoyed with regard to the marketing of securities could no longer be tolerated and enacted the statutes which the Securities and Exchange Commission now administers requiring full disclosure to investors. Similarly, in more recent years, as our society has become more consumer oriented, government has been the means by which higher standards of safety have been imposed upon the manufacturers of innumerable products, not the least

of which have been automobiles, drugs and children's toys.

The intrusion of government into the affairs of the economy has always been varied - and has always been controversial. The intervention has sometimes been in the form of direct command; in other cases, it has been through the taxing power; sometimes it is done by direct mandate of Congress; often, it is by executive order or independent agency directive. Throughout our history, these interventions have always generated controversy at various levels of sophistication. The response of businessmen to extensions of governmental influence in the economy has been almost universally hostile. Some of this has been the result of self-interest; but in other cases, it has stemmed from genuine conviction, modelled on the judgments of such ancestors as Thomas Jefferson, that the government should be characterized principally by self-restraint and that this self-restraint should keep government from dealing with any but the most urgent public needs. At another level scholars have debated the issues. In our present day many outstanding economists contend that we have stifled the beneficent forces of the marketplace and that if the forces of competition were accorded a freer play we would all be better off. Others have contended that while competitive forces can be of some use in our economy, the growth of

giant corporations and giant unions has resulted in a different kind of competition which ultimately must be controlled with considerable vigor by a strong government.

These debates continue in this the year of our bicentennial. One of the principal issues being discussed during the present presidential campaign is the extent to which the government should regulate the lives of our citizens. Perhaps more surprising than the fact that this argument has gone on for a couple of centuries is the fact that at least verbally, if not spiritually, virtually all of those seeking the presidency are agreed that perhaps government has grown too big, that there is a need for a retrenchment, that government has intruded too much into our individual lives and into the economic life of our country. It is obvious that both liberal and conservative are caught up in this theme and are vying with each other in an effort to convince the electorate that they are the true bearers of this essentially conservative, if you will, eighteenth century idea.

While these ideas are in greater currency, another series of events is if anything creating counter pressures which may be the foundation for even greater government involvement in corporate affairs - unless the leaders of our economic life

grasp the opportunity to meet this new challenge free of governmental mandate.

As 1776 is known as the year in which we commenced the process of putting our political house in order, I would suggest that 1976 may be the year in which business began putting its moral house in order. During the past couple of years, something that started like the proverbial "cloud no bigger than your hand" on the horizon has suddenly become dark and menacing clouds which threaten this country's position in international trade, has resulted in the premature departure of corporate leaders from their offices, has shaken the confidence of the American people in the integrity of business leadership, and has plummeted the ratings of businessmen in public esteem into the teens.

You're all familiar with the story. As the result of the investigations of the Watergate Prosecutor, it was found that in a number of instances American corporations had, in violation of the Federal Corrupt Practices Act, contributed money, in some cases under considerable pressure, to the Committee to Reelect the President. That fact in itself, of course, would be cause enough for concern. But, these investigations, when extended by the Securities and Exchange Commission, acting to determine whether this conduct and related conduct involved failures to make appropriate disclosure under the

federal securities laws, uncovered much more than enthusiasm, expressed with contributions from corporate coffers, for President Nixon's 1972 campaign. What was found was that in many instances these contributions were small parts of larger and long-standing patterns of corporate conduct involving illegal contributions to many candidates over a period of years, with the totals often reaching very substantial amounts. This raised the level of concern and apprehension and certainly the level of illegality. But we still were only grazing the tip of the iceberg. As the story continued to unfold, we learned that in many instances these political contributions had been made out of much larger pools of money which had been sequestered and secreted outside the normal course of corporate accountability and that these funds were being used not only for political contributions, but also for the purpose of bribing, seducing, suborning, and buying political officials abroad. Where once we had concern about \$50,000 contributions to the Committee to Reelect the President, the numbers were now escalated into the millions and tens of millions. These sums were pulled out of the normal accounting processes by means of false entries on the books of the corporations, the creation of phony subsidiaries, and all the other devices that we had previously thought were only the tools of the international manipulator. While initially some expressed questions concerning the materiality from the standpoint of investors of political

contributions to a presidential candidate, which in terms of the resources and income of a corporation might appear very small, few if any voices suggest that disclosure of the fact that millions of dollars have gone overseas for illegal bribes is not or should not be a matter of concern to investors in those corporations or to prospective investors in them.

The Securities and Exchange Commission's concern with this problem has been in terms of the mandate which Congress gave it - namely, to assure by rules, enforcement actions, and whatever means lie within its powers, that investors are fully informed concerning those matters which bear upon the quality of their investment or the matters upon which they are called to vote. It is neither the function nor the purpose of the Commission to articulate a standard of morality or legal conduct for corporations overseas or in this country, but rather, when a corporation is engaged in a course of conduct that may bear upon investment decisions or a decision to vote one's shares, then the Commission is obliged to see to it that that conduct is disclosed.

However, there is no question that this requirement of disclosure will perceptibly influence courses of conduct. If people know that they will have to report their misconduct under penalty of severe retribution, probably there would be

more compliance with the law. Closer to home, we know that our requirements with regard to the disclosure of transactions between corporate officers and the corporations they serve have resulted in reduction in the number of such transactions and has assured their fairness.

In addition to evidence that we have secured with respect to illegal political contributions and illegal payments overseas we are also uncovering evidences that in many cases companies may have engaged in sordid, illegal and wholly improper practices in carrying on their businesses in this country. This conduct would appear to include bribery of public officials, commercial bribery, that is, payments, for instance, to purchasing agents to secure orders, and other kinds of conduct which, if not explicitly illegal, at least are avoided and condemned by honest, reputable businessmen.

One of the consequences of all this disclosure goes well beyond acquainting investors with the manner in which their money has been used by the management of these companies. Not only have investors focussed upon these matters, but the American public in general has, with the result that we are now, as a nation, engaged in one of the broadest scale reviews of corporate morality and corporate conduct that we have ever

conducted. This examination of corporate conduct is not confined to the SEC or to the Congress or to the Executive Branch of the government. It is being carried on in board-rooms, in universities, in learned journals, in the popular press and in innumerable conversations throughout the nation. Rather basic questions are being asked, questions such as: to what standards of conduct should these giant corporations be held? who should determine what are the appropriate standards to govern corporate conduct? how should they be controlled? is investor concern a sufficient control - that is, if the investors are informed concerning the misconduct of the management, do they have the means, the incentives to undertake the necessary housecleaning? what should government do in this area? is there need for more legislation? or can we depend upon the influence of a concerned citizenry to place restraints on corporate conduct?

These are terribly important questions and they are questions that demand an answer. As exposure after exposure occurs, the disillusionment of the American people with the conduct of many corporate executives increases steadily. However, I think it is totally false to suggest that the conduct of a few companies which has been exposed is typical

of all companies in this country. All of us know of our own knowledge that many of the major companies of this country are conducted with the utmost propriety, legality and concern for ethical standards. However, the public, subjected to this drum fire of exposes, not surprisingly frequently feels that with corrupt conduct so widespread it must be universal. Such a public opinion is a matter of tremendous concern to conscientious executives and they are seeking some means by which the image of American business can be refurbished and future crises of this sort avoided.

That some means be found to do this is tremendously important to you and me. As I mentioned earlier there is abroad in the land a considerable desire on the part of the people to reduce the part that government plays in their lives and in the life of our economy, to restore the primacy of competition as a governing force and discipline and to reduce the costs of compliance with innumerable governmental requirements. However, I would suggest that if the corporate community does not find within itself the means of dealing with this critical problem of illegal overseas and domestic payments, these healthy trends toward less government might very well be reversed and there will be reactivated the

conviction on the part of the American people that business is not to be trusted to run its own affairs and therefore it must be more tightly, rather than less tightly, controlled.

A few months ago, I suggested that perhaps American business should try to develop a common code of conduct which would govern the affairs of American business. I suggested that means should be worked out so that transgressions of this code could in some manner be punished - by adverse publicity, by denying erring businesses membership in business organizations, by publicly declaring, through business organizations, that a corporation or business violating the code was an outcast from good business society. This idea was articulated by others, including W. Michael Blumenthal, the chief executive officer of Bendix Corporation. I still think there is merit in this sort of approach. I understand that work is going forward, quietly, undramatically, but nonetheless positively, looking toward the articulation of such a code. I would hope that engaged in it are not only businessmen, but clergymen, academics, lawyers, and others who may in some particular fashion have been exposed to the problems of corporate conduct and corporate morality, as well

as broader conceptions of ethics. The broader the representation in any such group, the more likely that the code, if one is developed, will reach the profound level it should.

There are moral problems as well as legal problems that go far beyond simply the question of illegal payoffs to foreign officials. There are questions concerning the role of multinational corporations, the extent to which they have obligations to the countries in which they conduct their business, the extent to which they should seek to raise the standards of conduct there, the respect which they should show the laws of other countries. Indicative of the complexity of this problem was the suggestion by one clergyman stated in a New York Times article that perhaps the gravest sin of a company which had been exposed as making a multimillion dollar payment to the head of a Central American country to secure a reduction in tax level was the harm inflicted upon the people of that country by channeling money into the hands of the ruler at the expense of tax revenues which would hopefully have been expended to alleviate the terrible poverty in that country. This is surely a dimension that most people have not considered, and yet, I think is a most important one for it may well involve an ethical consideration that is perhaps more

meaningful and more important than the legal problems associated with the bribe itself.

But, while continuing to endorse this notion of an industry-wide or perhaps even businesswide code of conduct, I am afraid the elaboration of such a code might take an inordinate amount of time and unquestionably the problems of enforcing it would be considerable. I am afraid American business simply doesn't have that kind of time in which to reestablish itself in the esteem of the American people. Something which can be more quickly accomplished and which can go far to address these problems is at hand - and some corporations have availed themselves of this tool. What I refer to is the development by companies individually of codes of conduct to govern their employees and their activities throughout the world, including this country. Caterpillar Tractor is an outstanding example of a company with worldwide activities that has carefully articulated such a program. While Caterpillar has been one of the pioneers in this effort, it is not alone and increasingly companies are developing standards to guide their employees in formal codes of conduct.

Obviously, some of the elements of such a code are easy to formulate: bribes of government officials anywhere in the

world, abroad and at home, should be forbidden; standards should be set with regard to permissible promotional activity; practices with regard to commercial bribery should be stated. Obviously a good deal more could be included in any code of conduct.

Any company opting for such a code should not in my estimation seek perfection or all-inclusiveness immediately. I was recently at a meeting where this problem was discussed. I was distressed that the representative of one large corporation denigrated the establishment of such a code on the grounds that to do so would take several years. I would suggest that with the example of so many companies which have adopted such codes it should not be difficult for a company to at least make a beginning in defining the conduct which it will regard as intolerable on the part of its employees. There is no need for a code as first adopted to be refined, honed and polished to perfection with no need for further elaboration or definition or modification. I would see no reason why a corporation could not in relatively short order adopt such a code and begin its enforcement.

For some time now, the Commission has been deeply concerned with the manner in which outside directors have carried out their responsibilities. In many instances, the failures of

outside directors to carry out their duties have violated not only state law, but have also resulted in violations of the federal law. In several instances, courts have determined that directors, by their inattention to their duties, had become either participants in, or aiders and abettors of, violations of the federal securities laws committed by the corporations which they served. In the Penn Central case, the Commission named three outside directors in its injunction action charging that they had, by failing to do what they should have done, violated the federal securities laws. In the case of Stirling-Homex, while the Commission did not sue the outside directors, nonetheless, as a part of the settlement with them, the Commission published a statement setting forth with particularity the ways in which their performance had fallen short of required standards. In addition to these formal actions various Commissioners, myself included, have repeatedly urged that directors, and particularly outside directors, perform their duties in accordance with a higher standard than has been customary.

Probably none of these actions or speeches has had as much effect upon the development of higher standards of conduct for outside directors as the disclosures with regard to corporate misconduct. In innumerable instances, directors

have been embarrassed and angered when they learned of the way in which the corporations on whose boards they served secured and maintained their business. They have felt they were kept in the dark, denied information that was necessary for them to carry out their duties, and been regarded by the public as unwitting dupes of management. As a consequence, I would suspect that many outside directors will be far more probing with regard to the way in which management is running the business than they have been before. Beyond that, in its settlements and in its arrangements with those who have voluntarily informed the Commission with respect to misconduct, the Commission has insisted that the outside directors play an active role in investigating the extent of misconduct and reporting it to the SEC. The effectiveness of this is evident in the report by the McCloy Committee with regard to misconduct by officials of Gulf Oil Company. Furthermore, in some instances even without the prod of the Commission, companies have set up committees of the board to take steps to assure that the sins of the past are not repeated in the future.

Thus increasingly outside directors are becoming involved in the policing of corporate conduct. I would not be understood to suggest that this is their sole or their principal

responsibility or function. But nonetheless, in the light of events, it now appears as a very important part of their role. I would therefore suggest that the outside directors of a corporation should be actively involved in the development of a corporate code of conduct. They will obviously need the assistance of others, such as lawyers; they may wish to utilize the help of clergymen and scholars; but I would suggest that all this activity should be under the direction of the outside directors and that the code of conduct should finally be approved by the entire board.

But, I would suggest, this should not be the end of their responsibility. I would strongly urge that any corporation which has adopted a code of conduct should establish a committee, somewhat after the fashion of the audit committees which are becoming commonplace - or perhaps the audit committee itself should perform this function - to periodically review the code to determine its adequacy and its currency and also to supervise its enforcement. This committee should, in collaboration with management, establish procedures for ascertaining whether the code is adhered to and it should establish procedures for determining, when it is suspected that it has not been honored, the facts about possible violations.

Obviously, companies which establish such committees and such procedures will want to make them known to their shareholders and to the investing world. It may well be public knowledge that some corporations have adopted this course will nudge others into a similar practice. Initially I would not suggest that the government intervene in any way in this process. However, I think at some point it may be well for the Commission to consider the possibility of requiring corporations to disclose, as they must now do about the existence of audit committees, whether they have established such a code and such a procedure. As I indicated previously, in many instances the necessity of disclosure can have a significant impact upon the conduct. I think such would be the case here.

Obviously, it is going to be difficult to keep government out of this field. Too much has happened, the American people have been too scandalized. As you undoubtedly noted, last week the President indicated that in several ways he expected to bring the forces of the federal government to bear upon those companies which have engaged in illegal practices abroad - closer attention to tax audits, withholding of government contracts and so on. In the Congress, legislation had been

introduced that would develop a means of defining what conduct is permissible for American corporations operating overseas and provide penalties for those companies which transgress the prohibitions.

I doubt whether any voluntary program on the part of business is going to forestall much of the action that is proposed to be taken. However, I think a wide-scale adoption of internal codes of conduct by corporations can have several effects. First of all, I would suggest that if this were to occur on a large scale, many people in this country would find their confidence in American corporations and American businessmen beginning to rebuild instead of steadily deteriorating. I think there is still a great admiration in the American people for the virtue of self-help and I think that this predisposition to honor and respect someone who takes up weapons in the face of trouble would gain admirers for the American business community. Second, I think that such a course by American business would forestall many demands for more aggressive governmental action. As I say, it may be too late to prevent it all, but at least, unduly severe expedients may be avoided.

In this country we honor the notion of "free enterprise". We regard it as the touchstone of our economic life, the ideology which has made possible the comfortable life that so many Americans enjoy; we dread its elimination and we are quick to identify perils to it. But I think it is important that we understand clearly that "free" enterprise does not mean freedom of all restraints, freedom to do as one likes, freedom to bribe and engage in a vast variety of immoral and illegal acts. To me "free enterprise" means freedom to operate as one wishes within the confines of the law and accepted moral concepts and in my estimation the worst danger to the continuation of "free enterprise" in this country rightly conceived is the perpetuation of the practices which have brought so much dishonor and discredit upon American business.

I would suggest further that corporate misconduct cannot help but have a corrosive effect upon our national life. If men feel free in their role as corporate executives to engage in the venal, the illegal or the immoral, how long is it going to be before these traits are carried over into their personal lives? At one meeting I attended concerning this subject, the head of one of the largest multinational companies in this country said that his company had had a strict policy against any sort of misconduct overseas because he knew no way

to shut out those habits when the people engaged in them overseas came back to this country. I would suggest that we cannot tolerate immorality and illegality anywhere in our society and that to do so undermines and endangers every ideal by which we have lived in this country throughout our history.

This country confronts many crises and many problems. We fret about energy, we worry about our political processes, we are troubled by detente, we worry about communistic encroachments. It may well be that our deepest concern should be about the forces which could undermine the ideals that this country has cherished and the morality that we have espoused. I would hope that corporate America will become not a suspect in this national drama, but rather the leader in drawing Americans to a reassertion and reaffirmation of their moral standards.