NEWS

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TURNING THE TIDE

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During the past two years, disclosures that corporations have used their funds for illegal or questionable purposes have attracted national and international attention, and such terms as bribe, slush fund, kick-back, extortion, "mordita" and "grease" have become part of everyday conversation. It is well known that in many instances, including two injunctive actions filed earlier this week, the Securities and Exchange Commission has been instrumental in bringing about the disclosure of such payments.

There seem to be, however, some rather significant misunderstandings regarding our actions. For example, there is the belief that our actions are the product of rubber-stamped recommendations made by an over-zealous enforcement staff and are not careful deliberations by the Commission. There is also an impression that the Commission has been badly split in its decisions. More substantively, there are those who apparently believe that the Commission has ventured into an area in which it has no expertise; that our actions have been naive and have jeopardized the ability of U.S. corporations to compete in foreign markets; that the Commission has misinterpreted and exceeded its statutory authority; that we are utilizing our authority to establish standards of business ethics and morality;

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and that our actions have compromised the Commission's credibility and imperiled the unique reputation and high respect that the SEC has enjoyed over the past 42 years. I hope my remarks today will help clarify some of these issues.

Our program with respect to disclosure of illegal or questionable corporate payments began in January 1974 when our Division of Corporation Finance recommended that the Commission publish a release expressing the staff's views on the disclosure of illegal political campaign contributions by public corporations. While this issue was pending before the Commission, we also received a recommendation to authorize the filing of a complaint charging the American Ship Building Company and its chief executive officer with violating the proxy and periodic reporting requirements of the securities laws by failing to disclose that corporate funds had been used for political contributions and that false and fictitious entries had been made in the company's books and records to conceal the purpose for which these funds were used.

These two staff recommendations were considered together and the issues involved were the subject of careful and deliberate Commission consideration in several meetings spanning a period of three months. Among the issues discussed were whether the decision to disclose the fact that corporate funds had been knowingly used for purposes other than those

recorded on the company's books should be based on economic materiality standards or whether the amounts involved were irrelevant because such activities reflected directly on the integrity of management. At the same Commission meeting, and without a dissenting vote, the Commission approved the issuance of the release and instructed the staff the lines along which to draft a complaint against the American Ship Building Company for our review.

I mention this fact because it has been suggested that the complaint which was filed on April 15, 1974, along with a consent settlement, was a clear contradiction with the release issued on March 8, 1974, and indicated that during the interim the Commission must have changed its mind. I do not find such a contradiction between the two Commission actions. The release focused on and required disclosure in all specific situations in which there was a conviction, guilty plea, or pending indictment alleging that the federal election laws had been violated. It stated further that in other instances management was in the best position to judge whether disclosure was necessary. The Commission could not then, nor in my opinion should it now, suggest such an absolute disclosure requirement for all illegal or questionable payments. We have given further specific disclosure advice to registrants and brought enforcement actions only after considering the facts in each case. Without such a consideration, management is still in the best position to judge whether disclosure is appropriate as we stated in the release.

The American Ship Building complaint was based on allegations that the company had filed reports which were false and misleading with the SEC and that false and fictitious entries were made on the books of the company to conceal the purposes for which corporate funds had been used. The fact that the amount of corporate funds involved was just over $120,000 during a period beginning in September 1970 until the complaint was filed in April 1974, or an average total annual amount equal to 4/100 of one percent of the company's average annual revenues, should have indicated the Commission's decision that the standard for disclosure in such a case was not traditional economic materiality, but that such payments reflected on the integrity of management.

The relief obtained in the consent decree and court-ordered undertaking prohibited the alleged violations and established a review committee, including a chairman not affiliated with the company, and at least two independent members of the company's board of directors, to examine all books and records beginning with September 1970. The examination was to focus upon the expenses or payments entered on the company's books for purposes other than those indicated. The Committee was also ordered to prepare a report of its findings and to submit it to the court, the Commission, and the company's board of directors which in turn was directed to review it and take whatever action was necessary and proper

to implement the recommendations of the report. This settlement was accepted by the Commission without a dissenting vote.

Before making the decision to file the complaint, and before voting to accept the settlement, various members of the Commission expressed concern, and there was considerable discussion that this application of the securities laws and enforcement approach would lead to undesirable results. Although there was some speculation at the time, we could not have known, of course, that our program would result in the disclosure of illegal or questionable payments by many corporations to recipients throughout the world. We could not have known that investigations by independent company committees would bring about the replacement of top management officials of some major corporations. We could not have known that some corporations had made payments which, if disclosed, would result in political crises in foreign countries. We did know, however, and discussed the fact that these results were possible, and, with that knowledge, authorized the filing of the injunctive action and agreed to the settlement.

Since those first important decisions in early 1974, the Commission has brought a total of 15 enforcement actions which differ in factual content, but which have the same basic allegations of false and misleading reports and false and ficticious entries on the corporate books and records.

And we have obtained settlements with court-ordered relief, similar to that obtained in American Ship Building, in all but one case which has not been resolved. To supplement our enforcement actions, we have also encouraged corporations to examine voluntarily their operations for such payments, and, if problems are found, to consider whether disclosure is necessary.

There have been times when we seemed to be waging a lonely battle, but I believe that the tide is turning as other government agencies have become involved, as international groups have begun to seek solutions to these problems, and as top business executives have expressed their views in opposition to illegal and questionable corporate payments. Instead of jeopardizing respect for the Commission and its outstanding reputation, as has been argued, I believe that this chapter of the Commission's history will be considered as one of its finest hours.

Given the fact that by April 21, 1976, 89 companies, 55 of which are among the top 500 U. S. industrial corporations, have filed documents with the Commission containing various degrees of disclosure with respect to illegal or questionable payments, and the fact that there are more than 7,500 companies subject to reporting requirements under the securities laws, it may be somewhat surprising to know the relatively few cases in which the Commission has made either a specific disclosure or enforcement determination.

In addition to our 15 enforcement actions, the Commission has considered disclosure questions with respect to illegal and questionable payments for only 25 companies. There have, of course, been additional cases in which the staff and the company agreed on disclosure without Commission consideration. In eight of the 25 cases in which companies raised disclosure questions, the Commission, after reviewing the facts presented, expressed no view regarding appropriate disclosure because either the company had not completed its own investigation, or our staff was already investigating the company, or further investigation or enforcement action appeared likely. In these situations, the Commission generally deems it best not to provide any comfort until such inquiries have been completed.

Thus, the number of instances in which the Commission has expressed its views regarding disclosure, other than in an enforcement context, is reduced to 17. Of these 17 cases, without being too specific, it can be said that the Commission generally agreed with the degree of disclosure proposed by the registrants in 12 cases and requested additional disclosure in five cases. In three cases, the Commission determined that no disclosure would be requested, and, in one of these cases, we directed the staff to indicate that, although we did not believe it was necessary, we would encourage disclosure as a good business practice.

Incidentally, in some of these 17 cases, the Commission disagreed with the staff, and, in a few, there was a split in

the Commission vote as to the degree of disclosure that should be provided. Thus, the Commission realizes from first-hand experience that there are some cases in which improper or illegal payments may present difficult disclosure decisions for business firms and for professionals such as accountants and attorneys who advise companies concerning disclosure responsibilities and acceptable accounting standards, and we have seriously considered the possibility and desirability of providing additional guidance in this area.

There are several ways in which this could be done. Court opinions could be helpful, but in their absence our consent decrees may provide some guidance, and, of course, under the voluntary program, our staff will provide specific assistance if requested to do so. In addition, we have just completed a report which we submitted to the Senate Committee on Banking, Housing and Urban Affairs yesterday discussing our activities, the nature of the corporate disclosures that have been made, and our recommendations for congressional action.

The report sets forth by company name, in tabular form, various categories of information which companies have provided in filed documents with the Commission, including the amounts of domestic and foreign political contributions, foreign sales-type commissions, payments to foreign officials, books and records problems, U.S. tax liability, knowledge of top management, and whether cessation of the payments has occurred. It is important to understand, however, that the

Commission advised only 14 of the 89 companies that made disclosures and that many companies disclosed payments for reasons other than a determination that the payments were material, and thus, the fact that the disclosures are made does not necessarily indicate materiality decisions either by the SEC or the companies. However, some guidance may be derived from the information disclosed by the 14 companies that sought and received Commission advice favoring disclosure.

In addition to the disclosure information provided, in an effort to be as helpful as possible, the Commission also included a discussion of the factors which we have considered in making our decisions. In many instances, the determination that disclosure was necessary depended on a combination of several considerations. Our decisions were strongly influenced by the fact that most of the illegal or questionable payment cases involved false and fictitious entries on the corporate books and records and the filing of false and misleading reports with the Commission. These two issues were weighed heavily in our decisions because the disclosure system of the securities laws is based largely on the principle that all corporate funds belong to the shareholders and must be accurately accounted for by the corporation's system of financial accountability. Any diversion of funds outside the corporate system, or any deception with respect to corporate books and records, cannot be permitted without undermining the purposes of the securities laws.

We have also recommended that questionable or illegal payments of a significant size, or related to a significant amount of business, should be disclosed irrespective of whether they are properly recorded on the company's books and records because of the effect such payments may have on the economic viability of the company. Moreover, smaller payments which may not individually require disclosure, but which have been part of the company's business pattern for a period of time, whereas other competing companies have not made such payments, may indicate that the company would not be competitive in the absence of such payments and thus disclosure would be appropriate.

The Commission has been inclined to request disclosure of illegal or questionable payments in relation to the degree of management's knowledge or approval of such payments. This factor is important because investors have a right to be informed regarding the integrity of management in connection with the administration of corporate affairs and assets. If management specifically approved payments, or if they were aware, or should have been aware, of such payments through an effective corporate accountability system, then disclosure is usually necessary.

In some circumstances, the recipient of a payment may be important in determining whether disclosure should be made. However, the identity of recipients has thus far not

been required under the Commission's voluntary disclosure program. A direct payment to a high governmental official in return for a decision in his governmental capacity bestowing unjustified benefits, such as tax changes or awarding a government contract to the corporation most likely should be disclosed. Political contributions and similar payments that are designed to assure the performance of services which the recipient is legally obligated to perform may call for disclosure depending on the applicable laws and the amounts involved.

Of course, legitimate payments to consultants and commission agents usually need not be disclosed, but if such payments are abnormal in amount, are made in cash, are deposited in a foreign bank account, or if the agent has an affiliation or close relationship with the foreign contracting party, disclosure of the payments may be appropriate.

Where public disclosure has already been made in a report filed with the SEC or circulated to shareholders, the Commission has generally not objected to non-disclosure in proxy statements, although there are situations in which disclosure is appropriate. When one or more members of top management authorized, or were aware of improper payments, the Commission has required generic disclosure of the payments, and the fact that management knew or authorized them but, generally, disclosure of the name or names of those involved

has not been required. Cessation of undisclosed illegal or questionable payments has been one of the primary aims of the Commission and in some cases, the fact that the payments have ceased has made the difference between disclosure and non-disclosure.

Guidance of the type I have discussed, and which we have provided in our report to the Senate Committee, represents the extent to which the Commission is able to offer general assistance to the business community and professionals at this time. Although we may be criticized for not providing more specific guidance, in my opinion, greater precision cannot be provided except in a factual context, because many factors must be considered and weighed. Moreover, even if it were possible, it might not be desirable to establish guidelines as to how far one may go in utilizing corporate funds for illegal or improper purposes without accurately recording such expenditures on corporate books or disclosing the existence and effect of such payments. In a real sense, whether we like it or not, this type of activity does reflect personal and business standards of ethics and morality, and I do not believe that a public service is performed by the SEC, or anyone else, in condoning any degree of such activity.

I realize that such a statement may fan the flames of criticism that the Commission is improperly attempting to set standards of business ethics and morality. However, in my

opinion, there is no basis for this criticism. In each case brought before us, we have considered and weighed the relevant facts and have made a good faith decision regarding disclosure obligations. If that process has improved ethics and morality in the business community, it is because businessmen must desire to meet the standard they perceive their family, associates, or the public expect of them, or which will be in their own interest or in the corporation's interest, and I am certainly not ashamed of that result. It will be a sad day for this country and its people if we reach a situation in which government officials must apologize for taking action that improves business practices, or in which public servants must assure that their actions do not have a positive effect on ethics or morality.

Moreover, the basic purpose of the securities laws is to promote and maintain securities markets that are fair and honest. I do not understand how fair and honest markets can be promoted and maintained without requiring corporate issuers whose securities are traded in those markets to be honest and fair in describing their activities and accounting for the use of corporate funds which belong to shareholders. It is also difficult for me to find any basis for suggesting that fairness and honesty are not related to ethics and morality.

On the other hand, I am somewhat concerned that the issue of illegal and questionable corporate payments is being considered by some in a context that is too narrow, legalistic, and short-sighted. In view of the objectives of the securities laws, such as investor protection and fair and honest markets, compliance with the spirit of the law may be more meaningful and prudent than quibbling about meeting the bare minimum legal requirements. I would suggest that many companies and their professional accounting and legal advisers would serve their own and the public interest by being less concerned with just avoiding possible enforcement action by the SEC or litigation with private parties and more concerned with providing disclosure consistent with the present social climate. Such a course of conduct should promote the company's public image, its shareholder relations, its customer relations, and its business prospects. If a company has engaged in conduct involving substantial improper or illegal payments, then it is not difficult to determine that disclosure is necessary. If there are no problems or only minimal payments, then it would seem to be a good business practice to inform investors and the public of those facts and many responsible corporate executives are choosing that course of action.

Furthermore, an effective corporate disclosure system is an integral part, if not the cornerstone, of the foundation underlying our free enterprise capitalistic

system. Investor trust and confidence are based on the belief that corporate books, records, and reports accurately reflect corporate activities. Without investor trust and confidence, our corporations would be unable to obtain the needed capital to develop, expand, and innovate. In addition, knowledge about the operations of business enterprises is necessary for investors to make choices between alternative firms and the choices made allocate capital among alternatives.

Also, whenever business does not meet responsible standards, there is a demand for increased government intervention. And with every increase of government involvement, burdens on business are increased and the amount of freedom that business entities have is reduced. While this may be necessary in order to protect investors and the public, it is not without costs.

It is important to realize that the general SEC regulatory approach is probably the most effective, the least disruptive, and the most supportive of private decision-making that can be taken by government. In the securities industry, where we exercise direct regulatory jurisdiction, there is a unique regulatory structure in which the industry regulates itself subject to Commission oversight. Our jurisdiction over industrial corporate issuers is generally limited to requiring disclosure of the material financial and business operations of such firms. Although we have had authority to establish

accounting procedures and practices for the purposes of disclosure documents, we have relied almost entirely on the private accounting profession to set acceptable accounting principles and standards. We have also relied heavily on the legal profession to assure that registrants are complying with the securities laws.

I believe that the principles and approach that have been so effective in maintaining maximum freedom for private business corporations and professionals should be retained and used as we seek to remedy the illegal, questionable, and corrupting business practices which have been engaged in by some business firms.

Of course, other alternatives have been suggested. One of these is for the Commission or some other governmental body to set substantive standards in this area and to perform routine audits or examinations of companies. This course of action would require a substantial increase in government activities and government intervention in private business operations, and would seem to have little support.

Another alternative, which has been proposed in legislative form is S.3133, a bill requiring registrants to file with the Commission public periodic reports describing any payments of money or value in excess of $1,000 to any person employed by, representing, or affiliated with a foreign government, any political party or candidate, or to any person

rendering advice in connection with obtaining or maintaining foreign business. The proposed legislation would also make unlawful certain foreign payments for the purpose of influencing foreign governmental decisions or which violate the laws of the foreign jurisdiction. In addition, the legislation would authorize the Commission to initiate criminal actions arising under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Specific statutory reporting levels may provide certainty, but such a mandate by law would reduce the Commission's flexibility and effectiveness to tailor its requirements to particular problems. There is also some question whether the disclosure of $1,000 payments, as well as the recipients, is necessary in every instance in order to protect investors.

The Commission is also concerned whether the outright prohibition of certain foreign payments should be considered in conjunction with matters arising under the federal securities laws. There has never been a serious question that the Commission has adequate authority to deal with this problem in connection with our administration of the securities laws, and, since foreign payments affect issues and problems separate and apart from the federal securities laws, perhaps outright prohibition of such payments should be considered independent of the statutes we administer.

The alternative which I believe to be appropriate, and which has been recommended by the Commission, is to retain and strengthen the professional community's responsibility for assuring that proper standards of corporate conduct are followed. Otherwise, professional expertise and services will be overlooked, and the private sector will have missed an excellent opportunity to demonstrate its good judgment and sensitivity to investor and public interests.

Our legislative proposal is based primarily upon the Commission's confidence and trust in the professional community. Among other things, our draft proposes a requirement that issuers must maintain accurate books supported by an adequate system of internal controls, as called for in the authoratitive accounting literative. These internal controls would assure the accurate preparation of financial statements consistent with generally accepted accounting principles. This requirement would be supplemented by provisions making it unlawful for any person to falsify, directly or indirectly, books and records for an accounting purpose, or for any person to make a false or misleading statement to an accountant in connection with any audit. These provisions should enable the private sector to ensure accurate and meaningful corporate accountability to investors, and we believe strongly that the professional community is equipped and qualified to perform this function.

I hope that this discussion has been helpful in dispelling misunderstandings regarding the Commission's actions. I believe that the Commission's approach is sound and consistent with the securities laws, promotes investor protections and the public interest, and supports the role of private sector participants. The reactions of both the corporate and professional communities have been encouraging, but there is still much to be done, and I hope that the private sector will support our legislative proposal and will accept the challenge and utilize this opportunity to resolve the problems of illegal and questionable corporate payments without further government intervention.