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OF BOYCOTTS AND BRIBERY, AND CORPORATE ACCOUNTABILITY

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Headlines about the activities of domestic and international corporations have become commonplace in our news media. Often, these accounts explain that the newsworthy information was first disclosed publicly in a report filed with, or in a lawsuit filed by, the Securities and Exchange Commission. During the past two years, these disclosures have had a major impact on some of the world's most prestigious corporations and on the governments of several foreign countries. Our relatively small agency with a budget of approximately $53 million and 2,000 employees has been both praised and criticized for its actions and its inactions.

There is an on-going debate among well-respected, well-intentioned individuals regarding whether the Commission has done too much or too little, and whether its actions have been beneficial or detrimental to the interests of investors, the business community, our free enterprise system and our relationships with other countries. Some have argued that the Commission has exceeded its jurisdiction and does not have legal authority for certain of its actions with respect to accounting practices and corporate accountability. On the other hand, we have been sued by a public interest group and have been criticized by some members of Congress for not using our extensive authority more aggressively.

The most recent example of such criticism was in the Federal Regulation and Regulatory Reform Report released just last Sunday, October 3rd, by the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce. Although the report ranked the SEC's performance as first among those agencies studied with respect to "fidelity to public protection mandate defined by Congress; quantity and quality of agency activity; effectiveness of agency enforcement programs; and quality of public participation," the report is very critical of our performance in the areas of accounting practices and corporate accountability. In the business community, views also differ widely with respect to SEC actions. Some businessmen claim that our activities are jeopardizing the ability of U.S. firms to compete effectively in international markets; others claim it is a good business practice to do more than what the Commission has suggested.

I will not presume to suggest that I can resolve all of the questions pertaining to our actions but I hope that my remarks, focusing on certain international business practices, and our subsequent discussion will contribute to a better understanding of the Commission's past activities and possible future activities.

Recently, there has been increased publicity and discussion regarding the Arab boycott and the nature and

extent of our country's response thereto. Current government reports indicate that over 90 percent of the companies providing confidential data to the Commerce Department comply with at least some aspect of the boycott. Editorials abound on whether the Tax Reform Act of 1976 is an appropriate vehicle for dealing with what many people believe to be blatant and reprehensible discrimination by those elements of the American business community which, willingly or unwillingly, participate in the primary or secondary boycott of Israel.

Notwithstanding the growing moral, social and political debates on the propriety of the Arab boycott, little recognition has been given to the legal obligations of corporations under the federal securities laws to disclose their participation in economic boycotts. Perhaps this lack of recognition is due to the fact that the Commission's disclosure requirements do not explicitly refer to boycotts. In fact, in the context of a rulemaking proceeding regarding disclosure of environmental and other socially significant matters, the Commission declined last year to adopt an explicit disclosure requirement relating to participation in the Arab boycott. That determination should not be interpreted, however, as being the Commission's acquiescence to the strained view that public companies are never required to disclose such so-called "social" information to investors.

Quite to the contrary, the protection of investors and the public interest requires full and fair disclosure of boycott participation whenever such information would be material to an informed investment decision.

The very first item of the Form 10-K annual report calls for a meaningful description of a registrant's business with special emphasis on competitive factors; significant customers; and foreign operations. Moreover, the Commission's rules state that "[i]n addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be needed to make the required statements, in light of the circumstances under which they are made, not misleading." Thus, disclosure is necessary under the federal securities laws whenever a publicly-owned company is participating in a boycott and the cessation or disclosure of such participation might have an adverse material impact on the assets, revenues or earnings of the company.

Apparently in compliance with these rules, Santa Fe International Corporation filed a registration statement earlier this year which disclosed that, since the 1950's, it has been required, as a condition of doing business in a number of Arab countries to comply with "local legal requirements imposed pursuant to the Arab Boycott of Israel." The company further stated that its business in such countries

would be materially adversely affected if Congress enacted legislation precluding compliance with such local legal requirements. Generally, however, the Commission has not received many filings disclosing boycott participation.

To date, the boycott issue has arisen in only one suit against a public company. In that case the Commission alleged that a company failed to disclose it had paid bribes and had maintained false books and records in connection with the company's efforts to be removed from a boycott blacklist that had effectively precluded it from doing business in Arab countries.

I do not think the boycott disclosure issue has received the attention it deserves and I question whether all multinational corporations are cognizant of, and in compliance with, their disclosure obligations. Therefore, I believe that it is important for our staff to continue to pursue informal enforcement inquiries in this area and for the Commission to take appropriate action based on the results of those inquiries.

As important as the boycott disclosure issue is, it pales in contrast to the seriousness of the illegal or questionable payments made by public companies both domestically and abroad. The Commission's enforcement program and voluntary disclosure program dealing with this problem are described in our May 12th Report to the Senate Committee on

Banking, Housing and Urban Affairs. That report also includes the public disclosures of illegal or questionable payments made by about 100 reporting companies.

The most common transactions reported were payments to foreign officials in order to secure or retain government contracts, to obtain favorable legislation or advantageous application of tax, currency, customs or other statutes, or to insure that government officials perform their responsibilities in a regular manner. Next in number of occurrences were commercial payments such as excessive sales commissions, over-compensation of agents or consultants and inflated invoicing combined with kick-backs to purchasing agents. In some instances portions of these payments were also channeled to government officials. About half of the reports indicate that corporate management had knowledge of, approved, or participated in the activities reported and most of the instances of abuse also involved inadequate or falsified corporate records.

The number of corporations that have made such disclosures has now increased to approximately 220, and the types of activities reported have remained basically the same as set forth in our May report. It should be understood that the payments made vary greatly in their significance. While terms such as bribes, slush funds, laundering, kick-backs, extortion, grease, mordita, rebates, and influence

While there have been and still are differences of opinion with respect to appropriate disclosure, there is a clear consensus that materiality, which is the basis for disclosure under the securities laws, depends on the facts and circumstances of each particular case. Thus, there is no dollar amount or percentage of assets or income which automatically permits non-disclosure or requires disclosure. In each case, before giving informal advice to a company with respect to its disclosure obligations, there is careful consideration of the factors enumerated in our May 12th Senate report such as the accuracy of the books and records relating to the payment, legality of transactions under applicable law, and the knowledge or participation of management. The over-riding factor has been, and will continue to be, whether such information would be material to an investor in his investment decision-making process.

Nevertheless, our critics are quite vocal in charging that the Commission is mandating disclosure of insignificant transactions. I disagree. In fact, there have been instances in which the Commission has not required disclosure when I believe disclosure was warranted. As an economist, I favor an economic system in which the allocation of productive resources is determined by the demand for those resources and in which economic rewards are based on quality and price. The widespread utilization of illegal payments

could represent the most serious challenge ever to confront our competitive free enterprise system.

We are not dealing with a theoretical question at business school. We are not facing a hypothetical situation designed to permit law students to define the almost metaphysical term "materiality" in the abstract and to apply the concept to a controlled environment. We are not dealing with a discussion topic in situation ethics or moral theology. We are, in fact, grappling with a very real attack on the fundamental building blocks of the free enterprise system.

Disclosures of illegal or questionable payments in connection with business transactions raise serious questions as to the degree of competition with respect to price and quality because significant amounts of business appear to be awarded not to the most efficient competitor, but to the one willing to provide the greatest personal economic rewards to decision makers. Such disclosures, indicating widespread maintenance of incomplete or falsified corporate accounting records ranging from inaccurate descriptions of disbursements to the use of off-book accounts, also raise questions regarding the quality and integrity of professional corporate managers and whether they are fulfilling their obligations to their boards of directors, shareholders, and the general public.

Our securities markets are the arena in which equity and long term debt capital are priced and allocated among competitors. Decisions by investors to provide and allocate capital to corporations are based on the disclosure of corporate information in the marketplace. The integrity of the disclosure system, which is the heart of our securities laws administered by the Securities and Exchange Commission, depends on the maintenance of accurate books and records and a proper accounting for the use of corporate funds. Actions taken by the Commission have had the purpose of restoring the integrity of the disclosure system in order to assure that investors receive material facts necessary to assess the quality of management and make informed investment decisions, and to assure that corporate management officials are fully accountable to shareholders and their boards of directors. The Commission's message to public companies is clear: examine your operations; make appropriate disclosure of illegal and questionable payments; indicate whether such practices will be continued; and, assure that your books and records are accurately maintained.

Some critics argue that the SEC's performance in this area has been too lenient. They point out that the Commission has filed only 20 lawsuits and that the "voluntary disclosure program" is a farce since it does not generally require the identity of the recipients of payments or of

individuals in management positions who approved or were aware of such payments. In my opinion, the Commission has exercised good judgment in its enforcement activities and has acted in a reasonable and responsible manner in establishing the voluntary disclosure program. Perhaps, if our staff and budget had been larger, we may have had additional investigations and enforcement actions. Moreover, the voluntary disclosure program had to have some incentives or it would not have been used and investors and the general public would not have been provided with the information that has been voluntarily disclosed.

However, the voluntary program has received widespread publicity and the payments issue has been of concern long enough for all companies to have had an opportunity to review their past activities and come forward voluntarily with any information that was discovered. The Commission should now consider whether it would be appropriate to establish a termination date for the voluntary disclosure program, after which more detailed disclosure would be required.

Those company managements choosing not to disclose voluntarily should be aware that the disclosures made thus far have indicated competitive practices in certain industries which constitute a reasonable cause to investigate the activities of others in those industries. Perhaps only

a strong enforcement approach will convince cynics that the voluntary disclosure program is not just a fad to be followed by the weak. If that is true, it may be necessary for the Commission to reallocate its limited resources to broaden our investigation into the area of illegal and questionable corporate payments and practices.

In the meantime, the Commission has determined to improve the corporate accountability system. For example, the Commission recently suggested that the New York Stock Exchange reexamine its listing standards with a view towards requiring each listed company to have an audit committee composed of independent directors who would review accounting and auditing procedures. I believe the New York Stock Exchange responded in a reasonable and forthright manner in proposing that by December 31, 1977, each listed company must have an audit committee dominated by outside directors as a condition of being listed on the exchange. I applaud their efforts.

The Commission also recommended the enactment of legislation which would:

--require every issuer subject to the periodic reporting requirements of the Securities Exchange Act to maintain accurate books and records;

There was general agreement with the intention and thrust of the Commission's proposals, but the American Institute of Certified Public Accountants expressed concern that the legislation would mandate the maintenance of an adequate system of internal controls without defining the term "adequate." The Institute also suggested that the requirement in the legislation "that books and records 'accurately and fairly' reflect transactions, . . . connotes a concept of exactitude that is simply not obtainable . . . ." In addition, the AICPA stated that the prohibition on misstatements to auditors may inhibit communications and that such a prohibition should be limited to written representations.

The Commission did not agree with the positions taken by the Institute. In my judgment, it was unfortunate that this important legislation was not enacted in the closing weeks of the legislative session because of rather minor criticisms, which, I believe, could have been satisfactorily resolved through rulemaking. Now that legislation cannot be expected until some time next year, I think the Commission should use its broad administrative powers to accomplish the substance of our legislative proposals.

In addition, the Commission should consider explicitly requiring that every proxy statement contain disclosure of whether the company has a policy with respect to questionable or illegal corporate payments or transactions

and, if so, a brief description of that policy. It might also be appropriate to require disclosure in the proxy statement regarding the involvement or knowledge of any director, or nominee, or executive officer in any material questionable or illegal payments or transactions that have not been previously disclosed in a document distributed to shareholders.

An explicit, annual disclosure requirement may be very beneficial, but the Commission should also reevaluate all of the proxy regulations to determine whether they promote the "corporate democracy" envisioned by the Securities Exchange Act of 1934. Such a reevaluation may well reveal that the proxy rules rather than making directors more responsive to stockholders have served as an impediment in this intended process.

In conclusion, I believe the SEC must more actively promote both improved disclosure of corporate transactions and more meaningful corporate democracy in order to make directors and executive officers of public companies more responsive to the stockholder owners of those companies. For it is in this context that issues such as the Arab boycott and illegal and questionable corporate payments can best be resolved.

--require such issuers to maintain a system of internal controls capable of meeting certain objectives;

--prohibit any person from falsifying the accounting records of any such issuer; and

--prohibit any person from making a false or misleading statement, or omitting to state a material fact, to an accountant in connection with an audit of such an issuer.

These modest but important provisions were embodied in Section 1 of H.R. 15481 and in Section 1 of S. 3664.

As Chairman Hills testified, the enactment of this legislation would have demonstrated a strong affirmative congressional endorsement of the need for accurate corporate records, effective internal control measures, and the unacceptability of deception or obstruction of auditors. Such endorsement would have effectively ended any uncertainty about the Commission's role and approach to the solution of the problem and would have unquestionably made far easier the criminal prosecution of corporate officials who intentionally violated the mandate of the proposed legislation. Unfortunately, although the Senate bill was approved by a vote of 86 to 0, the House did not complete action on its bill before adjournment and thus our proposals were not enacted into law.