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SOCIAL AND ETHICAL OBJECTIVES OF REGULATION -

CAN A GOVERNMENT BE NEUTRAL?

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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Introduction

Charles DeGaulle, not always thought to be a friend of America, once observed that "America brings to great affairs elementary feelings and a complicated policy." His statement holds much truth, at least with respect to the complicated policies of the American government which grew out of elementary feelings. Fairness and equality, progress, decency and charity, God and country are inextricably part of the fabric of American society. The concept of free enterprise and minimal or no governmental intervention likewise is part of our social fabric. Yet, in our business community, emotionally committed to free enterprise, capitalism, and competition, we nonetheless frequently encounter a contradictory tendency. Businesses are not hesitant to ask that the federal government set standards, grant de facto monopolies, subsidize certain businesses, and protect businesses against competition. Others in our society, taking the cue of business, do not hesitate to ask that the federal government protect minorities, eliminate all forms of discrimination, regulate abortions and otherwise become involved in social and ethical issues. As a result, our legal system, including the Congress, the federal agencies, and the federal courts, have become arbiters of the conflicting demands of a diverse society, much of which apparently believes that federal regulation is the best means to achieve social, ethical and economic goals.

Today's complicated federal regulations, many with decidedly ethical overtones, have their source in large part in the Stock Market Crash of 1929 and the Depression. Before then, there was no widely perceived need for extensive federal intervention in the marketplace, much less into matters of ethics or conduct. Such federal intervention and regulation can contrary to our fundamental notions of entrepreneurship and independence, in short, our pioneer spirit. Like the King before it, the federal government was not to be trusted.

The industrial revolution radically altered business enterprises by 1929, but no comparable revolution in federal regulation of business had occurred. But in the minds of a majority of Americans, the Crash demonstrated that both business and government had proved inadequate against the unethical and immoral excesses of free enterprise. Pervasive and intense federal regulation was the only answer. That attitude gave birth to a bevy of new laws. Constitutional interpretations thought revolutionary under Coolidge and

Hoover were seized upon during the Depression as the theoretical underpinning of the new legislation. Sixty-four years before the Crash, Lee's surrender at Appomatox had settled the question of national sovereignty far more effectively than any dry Supreme Court decision. The Depression just as forcefully resolved the equally difficult question of federal regulation of private property and the right of contract, working another permanent alteration in our society.

In many respects, we continue to be governed by laws and regulations adopted during the Depression. In that era the people turned to the federal government for fairness, hope, an ethical business world, and a fresh start. But has federal regulation accomplished what the people hoped? Or did the Depression encourage an insidious myth that the federal regulation is the exclusive or most efficient forum in which to resolve social, ethical and policy issues? Even if it is, should federal regulation be so pervasive?

Those of you who would answer both questions affirmatively may be in the minority today. We in Washington hear that you want the federal government out of all social and ethical issues. Others express the same thought by saying that our laws should be simplified and our legal system should deal only with genuine conflict and not provide the ultimate forum in which to resolve all competing social conflicts. We hear that some of you wish the demise of the legendary federal welfare state.

Yet, at the same time we never hear commercial bankers -- perhaps there are some present today -- clamoring that the governmental subsidy of federal deposit insurance should be withdrawn, or that banks should be subjected to to the same regimen of disclosure and market discipline as competing businesses which use other people's money. And so that I do not unfairly single out the bankers as being inconsistent, how many of you wish to deposit your savings in a bank which lacks the governmentally-imposed protection of federal deposit insurance and lose your money in a bank failure?

Our laws governing corporate tender offers and hostile takeovers may seem far too complex to many, improperly involving the government in allocating capital resources favoring bidders or targets. Furthermore, some concepts embodied in the takeover laws may be contrary to a free market spirit. Yet, we hear no calls for the removal of the federal protective presence from the chief executive officers of corporations threatened with hostile takeovers.

Does the federal government encourage shareholders to promote social and ethical causes in a disruptive manner at corporate annual meetings, making it convenient for shareholders to portray management in an unfavorable light? Perhaps you say yes. But consider the fact that under the prevailing scheme shareholders almost never win, and management, complaining all the while, overwhelmingly endorsed the existing shareholder proposal process when its usefulness was reconsidered this year.

Does the federal government overstep its proper bounds when its agencies, such as the one I represent, act as judge and jury in imposing standards of conduct on lawyers, accountants and corporate directors, or when we overrule a company's independent auditors and require that a company restate its financial statements in the more negative fashion we demand. Perhaps you say yes. On the other hand, how many corporate officers present countenance a competitor's practice of inflating earnings through the use of creative or outright fraudulent accounting practices?

We hear that the federal regulation of payments to foreign officials by U.S. companies as they compete for foreign contracts makes American industry non-competitive. But were you proud last week when the newspapers told us that former Prime Minister Tanaka of Japan had been convicted of accepting a $10 million bribe from Lockheed Aircraft four years before the enactment of the Foreign Corrupt Practices Act?

What about our complicated system of taxation? Does it make any sense? It may have some validity for a favored few. But what would be the financial condition of this Church if the tax laws were totally neutral, concerned only with efficient revenue collection, and did not favor religious organizations through the deductability of contributions?

Does government involvement in industry contravene the American way? Lee Iacocca, no foe of free enterprise, did not think so when the Chrysler loan package was signed. In fact, he claims that the federal government does not go far enough in providing advantages to automakers -- privileges which, of course, would not be provided to other industries.

My objective today is neither to endorse nor criticize our extensive scheme of federal regulation. Instead I propose to focus upon the extent, perhaps surprising, to which social and ethical considerations are ingrained in American law, to ask questions, and to revisit some of the developments which impelled the federal government into its present state of omnipresence and omniscience. I stated earlier that much federal regulation with ethical overtones is the product of the Depression. But are the premises which produced these regulations valid today? Or is it time for a more neutral approach to regulation? As we focus upon specific examples of federal regulation indirectly designed to achieve social or ethical objectives, all the while claiming strict neutrality and no involvement in ethical matters, consider whether federal regulation is being used to achieve ends which are not, cannot or should not be addressed in another forum.

What is the overall effect on our society if social and ethical problems increasingly are resolved in a legal setting, particularly at the federal level? Are there risks? Can federal law achieve the desired ends without stifling progress, innovation, and individuality? Will too much of our energies be siphoned off as we strive to maintain a regulatory and legal structure which deals with more and more non-legal issues? Do we go too far when every special interest group in the country -- from Ralph Nader to Jerry Falwell -- seeks a federal, legal solution?

Neutrality of Taxation

Turning to specifics, I cannot resist starting with everyone's favorite target, the Internal Revenue Code. I vividly remember the Second Presidential Debate during the 1976 campaign. Jimmy Carter, openly contemptuous of the complex system of federal income taxation, described the Internal Revenue Code with its thousands of sections as a 'disgrace,' implying that Gerald Ford was responsible. When Carter left office four years later, the Code was longer, more ponderous, and just as contradictory as it was in 1976, and the issue of "fair" taxation remained a fertile field for rhetoric.

Why is the Code so complex? After all, it only purports to redistribute wealth without impairing capitalism's ability to deliver goods and without unfairly burdening anyone. This typifies the motive of most federal regulation of private property -- achievement of a social good without impairment of the system which produces wealth. But perhaps no federal regulation combines as many ethical and social considerations as the seemingly straightforward concept of a progressive income tax.

The federal income tax deduction for contributions to private charitable organizations is likewise complex. Some claim that the deduction is ineffective in encouraging philanthropy because the Code does not distinguish between gifts that need an official incentive and those which would be made in any event. Moreover, charitable deductions vary in value depending upon the taxpayer's marginal tax rate and primarily benefit the rich, and in some instances charitable contributions may be business expenses, just like advertising. Furthermore, charitable giving may be non-voluntary, coming from a personal conviction that one ought to give to charities. Finally, of two charitably-minded persons, one may be able to make the gift by transferring inherited or accumulated property. The income from the property is devoted to the charity and never shows up on his tax return. The other must make contributions out of current earnings to discharge his moral obligations, perhaps a bit more painful process. The deduction helps equalize their circumstances. Yet, even if the deduction does not encourage philanthropy, most would say that the deduction should continue. In short, the charitable deduction need not stand or fall on its efficiency; hence, the government is not neutral.

If we accept the validity of the charitable deduction, is it difficult then to sympathize with those who believe there are valid social and policy considerations for encouraging business investments? Accelerated depreciation and the investment tax credit are subsidies of businesses chosen for favored treatment, just like the Church. What about capital gains taxation? We hear that taxation of capital gains retards investment, discourages risk-taking and interferes with the mobility of capital. But a dollar of gain is still a dollar of gain. Special treatment of capital gains severely complicates the tax law.

I seem to be having little success in rationalizing the Code. If the role of the Code were limited to raising taxes in an efficient and orderly way, perhaps the Code would have only ten to twenty sections. Since the Code has over 9,000 sections, it must be that social, economic and ethical considerations are orchestrating the law, rather than the other way around.

Federal Corporate Regulation

From this example, and perhaps I should not be so critical of the Code, let us move to an area with which I am more familiar, publicly-held companies and banks. As a general proposition, banking and securities regulation aspires to neutrality. But a federal presence in the world of corporate finance, in the first instance, had much to do with simple concepts of fairness and ethics and redressing the grievances of people who felt they had been hoodwinked and swindled. Before the Crash, popular sentiment could be summed up in President Coolidge's famous remark. "This is a business country...and it wants a business government." After the Crash, the people wanted the federal government to provide affirmative investor and depositor protection and to raise the standards of corporate ethics, in short, to be anything but a neutral government. The implications of that attitudinal shift are enormous, for it declares that it is acceptable for the federal government to be involved in corporate ethics and to regulate the corporate world to achieve social and ethical ends.

The abuses leading to this attitudinal change were dramatic. From 1920 to 1928, prices on the New York Stock Exchange doubled. In the eighteen months between March, 1928 and October, 1929, the value of the same shares doubled again. Then came the Crash.

From October, 1929 to July, 1932, these same stocks declined in value by 83%. Blue Chip stocks, including General Electric and U.S. Steel, declined by 90%. From 1923 to 1929, prestigious and ethically minded investment banking houses had sold Americans \$6.3 billion in foreign bonds, at commissions to the underwriters of 14%. By 1931, these bonds were utterly worthless.

During the 1920's, large commercial banks set up securities affiliates, with capital advanced from the bank. These securities affiliates used bank employees to recruit public investors for issues of speculative corporate securities underwritten in effect by the bank itself. The banks' financial stability became linked to the securities issues underwritten by their affiliates. When the Crash came, the affiliates and the banks collapsed like houses of cards, triggering a nationwide run on bank deposits. At the same time, the stock exchanges were either unable or unwilling to police and prevent even the most brazen forms of manipulation in the stock market.

Some causes of the Crash are not that difficult to ascertain: fraudulent sales of speculative securities; a minimum of risk disclosure to investors; inadequate financial statements; high-risk investments by commercial banks using the savings of innocent depositors; and manipulative sales practices by "pool operators" which created an artificial stock market. But behind these specific abuses lay a more fundamental question -- the integrity of corporate managers and their accountability to shareholders and the public.

Many believed a federal solution to this lack of accountability and integrity was inappropriate, perhaps unconstitutional. President Hoover strongly believed that the federal government had to be exceedingly careful not to exceed its constitutionally prescribed limits of power. Franklin Roosevelt's election demonstrated how completely the American people had come to reject Hoover's view that the federal government had a limited role in the marketplace. Within 100 days of Roosevelt's inauguration, the Banking Act of 1933 and the Securities Act of 1933 were in place. Those acts remain the bedrock of today's federal scheme of regulation of publicly-held corporations and banks.

The Banking Act restricted commercial banks to receiving deposits and making commercial loans and prohibited banks from engaging in the securities business. The Securities Act required issuers of securities to disclose extensive data in prospectuses before selling securities to the public, including information about the company's business, need for capital, officers, and costs of the offering. The Securities Act imposed liabilities on the company's officers and directors, independent auditors, engineers or appraisers who certified part of the registration statement, and the investment bankers who acted as underwriters.

Significantly, the Securities Act did not give the federal government the power to pass on the quality of securities, and no attempt was made to direct capital to industries where it was most needed. This was the essence of "neutrality." Interestingly, only a few years before the federal government had attempted to channel the flow of capital toward certain industries. This effort was in the form of the Capital Issues Committee, authorized in 1918 by Congress to investigate, pass upon, and determine whether each securities sale of more than $100,000 was compatible with the national interest. The Committee's authority was voluntary, not compulsory, designed to direct the flow of capital toward "essential uses" by disapproving securities issues that interfered with the government's wartime use of credit, labor, and materials. The Committee functioned for only six months, and its report revealed that it was "unable to deal effectively with many enterprises whose promoters or managers remained deaf to every appeal to their patriotism." The Roosevelt Administration did not take a similar approach.

The immediately following Securities Exchange Act of 1934 continued to expose internal corporate workings to public scrutiny. Although the Exchange Act primarily focused on exchange trading practices, it included many provisions significantly affecting corporate governance, including proxy and insider trading rules dealing with overreaching by corporate insiders.

All this federal regulation was avowedly neutral, but that claimed neutrality conceals the fact that these laws were based on fundamental concepts of honesty, fairness and ethics. I ask whether it is more accurate to say that the aim of federal securities regulation is disclosure of risk, or compelling a company to make a given transaction fair, to require management to say that the transaction is fair, and thus to pressure management to avoid transactions which involve self-dealing? The unavoidable fact is that even neutral-sounding laws may well be founded on concepts of fairness and ethics.

Corporate Takeovers

Consider another specific example of proclaimed neutrality, the regulation of hostile corporate takeovers or "tender offers." The governing Williams Act, adopted in 1968, expressly stated that it was neutral and was not intended to promote or deter hostile takeovers, only to make the process fair and orderly.

The much publicized Bendix-Martin Marietta takeover battle of last year, during which millions of dollars were spent on legal and investment banking fees, which put Bill Agee and Mary Cunningham on the front page, and which made household words out of technical terms such as "shark repellents" and "golden parachutes" has resulted in a rethinking of the rules of this high-stakes corporate game. Last Spring, the Commission appointed a blue ribbon panel composed of internationally recognized business executives, lawyers and others to examine this area. The Advisory Committee published its report in July. Some of the Committee's recommendations require changes; others endorse the present system. Recommendations were submitted on the controversial subject of "shark repellents," provisions in corporate charters or bylaws which erect high barriers to changes of control. The Committee found that these barriers operate unfairly against the interests of shareholders and recommended stringent controls on such defensive tactics. Yet, the Committee recognized that the Commission has insufficient authority to implement such recommendations. They suggested more legislation, all to achieve the Committee's concept of "fairness."

The Advisory Committee also addressed "golden parachutes" and "silver wheelchairs," lucrative termination arrangements for corporate managers made in anticipation of a takeover. The Advisory Committee found that such arrangements had little, if any, impact upon the outcome of tender offers. But the Committee nonetheless recommended that such arrangements be prohibited once a threatened takeover of a company was underway, even though the Commission's authority to prohibit "golden parachutes" and "silver wheelchairs" is questionable. And why did the Committee make this recommendation and in effect ask for more legislation and more regulation? Again, to achieve their notion of "fairness."

All the while, the Advisory Committee stated that the fundamental premise of its reexamination was neutrality, so as not to favor bidders or targets. The motivation behind the Committee's recommendations dealing with shark repellants and golden parachutes is not that these devices have any effect on allocating capital or on the outcome of the takeover. Instead, it is that they have lost their social support; they are contrary to a spirit of fairness. Hence, the prohibitions or restrictions should become embodied in law. If these tactics have no effect on the outcome, can it be said that the Committee was neutral in recommending that they be regulated to satisfy the Committee's sense of fairness?

The Foreign Corrupt Practices Act

In the late 1970's, much attention was focused upon "questionable" payments by U.S. corporations to foreign government officials. The Commission called these "questionable payments" rather than "bribes" because of two factors: frequent uncertainty about what was done with the money in the foreign country and uncertainty whether certain payments were illegal under the laws of the foreign country. Despite all this uncertainty, and despite the widespread beliefs of American businessmen that business abroad required "questionable payments," Congress found that such payments affected the stability of overseas business and had an adverse impact on domestic competition "when domestic firms engage in such practices as a substitute for healthy competition for foreign business." That finding produced the much-criticized Foreign Corrupt Practices Act of 1977.

But that Act dealt only indirectly with these payments by strengthening corporate accounting mechanisms to prevent off-the-books "slush" funds used to make such payments. A provision was added requiring public companies to "make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." The Senate Conference Report stated that the recordkeeping provision was designed to assure that corporate transactions are recorded in "conformity with accepted methods of recording economic events" and that such recordkeeping "should effectively prevent payments of bribes." Another provision required companies "to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that certain specified objectives are met, including recording of transactions "as necessary...to maintain accountability for assets" and the execution of transactions "in accordance with management's general or specific authorization."

Those provisions create a legal mechanism undeniably intended to deter activities which may not be clearly illegal but nonetheless are perceived as unethical, immoral, or simply improper. Moreover, the law does not directly outlaw the payments, but addresses them indirectly by strengthening accounting standards. After all, what could be more neutral than requiring that U.S. companies have accurate books and records? Yet, the result is that a concept of ethical conduct has been injected into the activities of American corporations.

The Shareholder Proposal Rule

A final specific regulation which vividly illustrates the recurrent conflict between neutrality and ethical standard-setting by the government is the Commission's shareholder proposal rule. No matter who I talk to about this rule, shareholder activist or corporate executive, liberal, moderate, or conservative, I sense that blood pressures instantly rise. Adopted in the early 1940's, the rule is intended to allow shareholders to participate in corporate affairs to a limited extent by submitting proposals to be included in the proxy statement and voted on by fellow shareholders.

The Commission concluded that a federal mechanism was needed to provide shareholders that limited access to the Company's proxy statement, a remedy for pre-Crash abuses by managers which kept shareholders in the dark about basic corporate affairs. As a protection against shareholder abuse of the rule, the Commission specified several grounds which permit management to exclude a proposal. The Commission acts as a neutral arbiter of disputes arising under the rule.

We heard little about shareholder proposals during the quiet years of the 1940's and 1950's, but during the late 1960's social activists discovered the corporate proxy statement. In 1970, a committee of shareholders submitted proposals to amend Dow's corporate charter to prohibit sales of napalm unless the buyer gave reasonable assurance that the substance would not be used against human beings. At the time, a company could exclude proposals submitted primarily to promote "general economic, political, racial, religious, social or similar causes." This was part of the claimed "neutrality" of the rule. On that basis, the Commission concurred with Dow's decision to exclude the proposal from the proxy statement.

These shareholders sought judicial review of the Commission's decision. The Court found that management could not exclude proposals by shareholders who wished to see their assets used in a manner which they believed to be more socially responsible, but possibly less profitable, than that dictated by company policy. The Court strongly endorsed shareholder review of corporate decisions with political implications.

Today, the shareholder proposal process is used to require companies to reconsider business activities in South Africa and to raise issues about nuclear disarmament and environmental protection. Modifications in corporate behavior have resulted, even though shareholder proposals almost never receive more than a de minimus number of votes. The shareholder proposal rule, supposedly neutral and administered neutrally, nonetheless still has influenced social change by permitting ethical and social issues to be debated in a corporate setting. If the shareholder proposal rule has resulted in changes of an ethical and social nature, can the rule be called neutral, and can the Commission's actions in requiring that such proposals be included in the company's proxy statement be characterized as neutral?

Conclusion

So what do you make of our complicated policies and the claimed neutrality of regulation? Some believe we have created a highly-sophisticated regulatory system which intrudes no more than is necessary to assure a fair, efficient, and orderly marketplace, and that the government is essentially neutral. Others say the law has has unwisely intruded into ethical and social issues. Considering the specific laws and regulations I have mentioned, what is your opinion? Is our government neutral? Should it be? Or is neutrality like beauty and exists only in the eye of the beholder?

I cannot tell you what your opinion should be, other than to observe that claims of neutrality should be closely examined. Yet, I am not particularly disturbed by the uncertainty that exists. To the contrary, I am more disturbed by the absolutists, of all persuasions, who have quick answers to and inflexible attitudes on difficult issues. Without the presence of doubt, we lack the impetus to reconsider from time to time some of our own, perhaps too-easily acquired convictions. If I were speaking in ecclesiastical terms, I might say that without doubt we never learn how strong our faith may be, and it is only through doubt that faith is confirmed.

The Jeffers Lectures, by bringing together the diverse fields of law, business, theology, and ethics is an apt forum in which to raise doubts and leave questions for future debate. I understand that such an ending is consistent with the rich tradition of this Cathedral.

I am most flattered to have been asked to speak at the Jeffers Lectures. My visit to Houston has been most enjoyable, and I thank the Jeffers family, Dean McGehee, and all the staff of Christ Church Cathedral for their hospitality.

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