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THE SEC AND THE NEW DISCLOSURE*

Russell B. Stevenson, Jr. †

INTRODUCTION

The American polity has for the better part of this century carried on a vigorous romance with the idea that the free flow of information is a potent remedy for social and political ills. It is difficult to say exactly why this notion is so popular—perhaps it is because it seems to work; perhaps, because it meshes so comfortably with the principle of individual choice that permeates our conventional social philosophy. In the last decade alone we have seen the passage of the Freedom of Information Act,¹ the Truth in Lending Act,² the Interstate Land Sales Full Disclosure Act,³ and the Consumer Credit Protection Act.⁴ Moreover, disclosure requirements play an important role in the Real Estate Settlement Procedures Act,⁵ the Fair Credit Reporting Act,⁶ and the Employee Retirement Income Security Act (Pension Reform Act),⁷ to name only a few. Until recently, the thrust of such disclosure statutes has been directed largely at putting in the hands of various private groups, most often consumers, sufficient information that they may fend for themselves in dealing with large business. Where such acts have been successful, they have usually also had some influence, albeit indirect, on the conduct of the businesses affected by them. Within the last few years, however, it has been suggested with increasing frequency that the “disclosure principle” be used

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¹ 5 U.S.C. § 552 (1970 & Supp. IV, 1974).

² 15 U.S.C. §§ 1601-13, 1631-44, 1661-65, 1671-77 (1970 & Supp. IV, 1974).

³ 15 U.S.C. §§ 1701-20 (1970).

⁴ Pub. L. No. 93-495, §§ 302-05, 307, 401-15, 503, 88 Stat. 1511 (1974) (codified in scattered sections of 15 U.S.C.).

⁵ 12 U.S.C. §§ 1730f, 1831b, 2601-16 (Supp. IV, 1974).

⁶ 15 U.S.C. §§ 1681-81t (1970).

⁷ Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified in scattered sections of 5, 18, 26, 29, 31, 42 U.S.C.).

more directly as a tool for altering the behavior of large corporations.⁸ It is this relatively new use of an old mechanism by an old agency that is the subject of this Article.

The federal agency that wears its "disclosure principle" badge most proudly is probably the Securities and Exchange Commission (SEC). The creature of a conscious rejection of direct regulation in favor of disclosure as a preferable means of preventing securities fraud, the SEC administers a series of statutes whose single most important underlying theme is that the way to a healthy securities industry is to provide investors with adequate information. The Commission is often cited as one of the most effective of all federal regulatory bodies—one that has generally avoided being "captured" by those it regulates. To the extent that this is true, it is probably attributable in large measure to the fact that the SEC's principal mission has been the oversight of its disclosure responsibilities. It has thus been able to avoid to some degree the entanglements and political struggles that are inevitably associated with direct substantive regulation of the conduct of business.

It is somewhat ironic, therefore, that the Commission's response to pressures to wield its disclosure implement more imaginatively—in particular to scribe its mark on the institutional machinery that shapes the social behavior of large corporations—has been traditionally one of extreme reluctance, and that in those areas in which it has moved, the Commission has backed into action after the manner of a reluctant Don Quixote.⁹

When the Securities Act of 1933¹⁰ and the Securities Exchange Act of 1934¹¹ were enacted, Congress' attention was focused on "securities fraud" in the normal and obvious sense of that term. The principal thrust of these two statutes, as envisioned by their draftsmen, was to provide investors with sufficient accurate and timely information about publicly-traded securities to permit informed purchase and sale decisions and to prohibit fraudulent practices related to securities transactions, particularly those which

⁸ E.g., Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 419 (1962); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 646-48 (1964); Schoenbaum, *The Relationship Between Corporate Disclosure and Corporate Responsibility*, 40 FORDHAM L. REV. 565, 587-94 (1972).

⁹ As former SEC Chairman Garrett observed: "We may be forced to conclude that something more [in the way of disclosure] is necessary, at least in the environmental area." Address by Ray Garrett, Jr., to the National Investor Relations Institute, SEC News Release at 8, Sept. 30, 1975 (emphasis added) (on file at *Cornell Law Review*).

¹⁰ 15 U.S.C. § 77a *et seq.* (1970 & Supps.).

¹¹ 15 U.S.C. § 78a *et seq.* (1970 & Supps.).

involve misleading the investing public by misstatements, half-truths, or the withholding of significant facts.¹² Aside from prohibiting fraudulent practices "in connection with the purchase or sale of any security,"¹³ as variously expressed in the two statutes, no effort was made to protect investors by the direct regulation of what might be called the "primary conduct" of corporations, their promoters, and their managers. It was clear at the outset, however, that the effect of requiring disclosure of shady practices would be that many of them would cease—"sunlight," in Justice Brandeis' famous words, being "the best of disinfectants."¹⁴ As Professor William Cary, then Chairman of the Commission, put it:

It is the disclosure principle upon which a rational evolution of a theory of control over management must be premised. . . . [E]thical behavior—and wise counselling—results from estimating the public reaction to a full knowledge of a planned course of conduct. The requirement of disclosure in certain instances, and its possibility always, is thus a most important regulatory force in our society.¹⁵

The challenge with which the SEC has been recently confronted is to make use of the disclosure principle to influence varieties of corporate behavior that the Commission has heretofore tended to treat as outside its jurisdiction. Within the past few years it has faced this challenge in two entirely separate contexts. In one instance the Commission has responded quite deliberately to a petition requesting it to use its disclosure powers for the express purpose of influencing the behavior of reporting companies with respect to the environment and equal employment opportunity. In the second, it has suddenly, and apparently inadvertently, found itself in the center of a raging controversy over the use of the disclosure principle to strike at illegal or improper corporate political contributions and commercial bribery. As diverse and unrelated as these two problems might initially appear to be, they both raise important and difficult questions about the extent to which disclosure can be used as a tool for effectively modifying socially undesirable corporate behavior, and the proper role of the SEC in

¹² Heller, "Integration" of the Dissemination of Information Under the Securities Act of 1933 and the Securities Exchange Act of 1934, 29 LAW & CONTEMP. PROB. 749, 768 (1964); James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 632 (1934); Message of President Franklin D. Roosevelt to Congress, Mar. 29, 1933, 77 CONG. REC. 937 (1933).

¹³ Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970).

¹⁴ L. BRANDEIS, *OTHER PEOPLE'S MONEY* 92 (Frederick A. Stokes Co. 1932).

¹⁵ Cary, *supra* note 8, at 408-09.

doing so. In both instances the Commission has flirted with, then backed off from, experiments in indirectly influencing primary corporate conduct that is essentially unrelated to investor protection or securities fraud. What follows is an effort to explore in some depth the ramifications of these experiments in the "new disclosure."

I

DISCLOSURE OF "SOCIALY SIGNIFICANT MATTERS"

A. *History of the Proposals*

In 1971 the Natural Resources Defense Council (NRDC)¹⁶ and the Project and the Center on Corporate Responsibility,¹⁷ filed a rulemaking petition with the SEC requesting that the Commission amend its reporting rules to require that registrants disclose more information about the environmental impact of their activities and their progress in achieving equal employment opportunity.¹⁸ More specifically, the petitioners sought to have the forms for registering new securities and for filing annual, quarterly, and interim reports amended to include, with respect to each major activity or product, descriptions of the registrant's environmental activities, including "(1) the nature and extent (quantified to the extent feasible) of the resulting pollution or injury to natural areas and resources, and (2) the feasibility of, and plans for, correcting the same."¹⁹ In the area of equal employment, the petition requested that any company making public claims about its employment of women or minorities be required to file with the SEC statistical information sufficient to permit testing of such claims.²⁰ The information required would essentially have been no more than that already required by the Equal Employment Opportunities Commission on its form EEO-I. In addition, the petition sought a rule requiring

¹⁶ NRDC is a nonprofit membership organization dedicated to environmental protection; it devotes much of its effort to environmental litigation.

¹⁷ The Project and Center are an affiliated pair of organizations dedicated to fostering a greater degree of social accountability by large corporations. The Project is best known for its efforts in sponsoring various "corporate responsibility" shareholder resolution efforts, most notably "Campaign GM."

¹⁸ See *Natural Resources Defense Council, Inc. v. SEC*, 389 F. Supp. 689 (D.D.C. 1974) [hereinafter cited as *NRDC v. SEC*]. The requested rule changes are printed in the appendix to this Article, *infra*.

¹⁹ *Id.* at 694.

²⁰ *Id.*

the reporting of all proceedings against a company under Title VII of the Civil Rights Act of 1964.²¹

The SEC's initial response was to publish a release pointing out that

[t]he Commission's requirements for describing a registrant's business on the forms and rules under the Securities and Exchange Act [*sic*] call for disclosure, if material, when compliance with statutory requirements with respect to environmental quality; e.g., various air, water and other anti-pollution laws, may necessitate significant capital outlays, may materially affect the earning power of the business, or cause material changes in registrant's business done or intended to be done.²²

Some seven months after the petition was filed, the Commission issued an order indicating that it "declined to take the action requested."²³ The Commission did, however, indicate that it was considering some form of amendment to its reporting forms along the lines suggested by the petitioners.²⁴

The Commission labored sixteen months and brought forth a mouse. In April 1973, it promulgated a release amending Forms S-1 and S-9 (for registration of new issues under the 1933 Act) and Forms 10 (for registration under the 1934 Act), 10-K (for annual reports under the 1934 Act), and 8-K (for interim reports under the 1934 Act).²⁵ The additions to these forms require registrants to report

[t]he material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries.²⁶

Companies must also disclose any material legal proceedings against them involving environmental matters; "material" is de-

²¹ *Id.*

²² SEC Securities Act Release No. 5170 (July 19, 1971), [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,150, at 80,487 (footnotes omitted).

²³ NRDC v. SEC, 389 F. Supp. 689, 694 (D.D.C. 1974).

²⁴ *Id.*

²⁵ SEC Securities Act Release No. 5386 (Apr. 20, 1973), [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,342, at 83,029.

²⁶ SEC Form 10-K, Item 1(b)(7), 3 CCH FED. SEC. L. REP. ¶ 31,103, at 22,053-3 (1976). The changes to the other forms are substantially the same.

fined to include any private action for damages in excess of ten percent of the consolidated current assets of the firm and its subsidiaries and any proceeding by a government agency.²⁷

These amendments fell far short of the substantial alterations in environmental disclosure obligations sought by the petitioners. Indeed, with the possible exception of the requirement that *all* government proceedings of an environmental nature be disclosed, they made virtually no change at all. Reporting firms were already required to disclose all material features of their business and investment plans, as well as all material litigation in which they were, or were likely to become, involved. And as the Commission had pointed out in its earlier release, these requirements made no exception for environmental matters.²⁸ It is probably fair to say that the changes in the forms were motivated in part by a desire to placate the environmental activists who had been pressing for far more drastic measures. In addition, they were obviously intended to comply with the obligations imposed on the Commission by the National Environmental Policy Act (NEPA)²⁹ and Executive Order No. 11514, which requires all federal agencies to "initiate measures needed to direct their policies, plans and programs so as to meet national environmental goals."³⁰ The Commission took no action with regard to the proposed amendments dealing with equal employment opportunity.

Unsatisfied with the changes wrought by this series of releases, the petitioners filed suit against the Commission. They sought an order requiring the SEC to modify its regulations to encompass the reporting of more information regarding the environmental and equal employment opportunity practices of registrants.

In December 1974, Judge Richey of the United States District Court for the District of Columbia held, in *Natural Resources Defense Council, Inc. v. SEC*³¹ [hereinafter *NRDC v. SEC*], that the SEC's response to the plaintiffs' rulemaking petition had violated the Administrative Procedure Act (APA).³² First, the court held, the

²⁷ *Id.*, Item 5, Instruction 4, 3 CCH FED. SEC. L. REP. ¶ 31,103, at 22,058 (1976).

²⁸ SEC Securities Act Release No. 5170, *supra* note 22, ¶ 78,150, at 80,487.

²⁹ 42 U.S.C. §§ 4321, 4331-35, 4341-47 (1970 & Supp. IV, 1974). NEPA requires that, "to the fullest extent possible: (1) the policies, regulations, and public laws of the United States shall be interpreted and administered in accordance with the policies set forth in this chapter . . ." *Id.* § 4332. The Commission apparently felt that the changes fully discharged its duties under NEPA. See *NRDC v. SEC*, 389 F. Supp. 689, 695 (D.D.C. 1974).

³⁰ 3 C.F.R. § 104 (1970 Compilation).

³¹ 389 F. Supp. 689 (D.D.C. 1974).

³² 5 U.S.C. §§ 551-59, 701-06 (1970 & Supp. IV, 1974).

Commission had failed to give adequate notice of the proceeding to

legal scholars, public interest groups, foundations, colleges, universities, and other institutions and individuals who participate in the nation's capital markets and who may want to comment about what the SEC legally could and should do to fulfill NEPA.³³

Second, the rather spare rationale given by the Commission to justify the changes fell short of the APA requirement that "the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose."³⁴ And finally, the Commission had given no reason for the denial of that part of the petition dealing with statistics on equal employment practices; this was contrary to the APA requirement of a "brief statement of the grounds for denial."³⁵ Consequently, the court "remanded" the matter to the SEC for a full-dress rulemaking proceeding.

The Commission declined to appeal Judge Richey's decision (the decision not to appeal was itself attacked in some of the submissions in the subsequent hearings) and, pursuant to the court's order, published a notice soliciting public comment on the desirability of amending its rules to require the reporting of information concerning "environmental and other matters of primarily social rather than financial concern, including equal employment matters."³⁶

After hearing nineteen days of oral testimony and receiving over 10,000 pages of written submissions, the SEC issued proposed rule changes that would have required firms registered under the 1934 Act to submit as part of their annual reports

[a] list of the registrant's most recently filed environmental compliance reports which indicate that the registrant has not met, at any time within the past 12 months, any applicable environmental standard established pursuant to any Federal statute³⁷

The proposed rules would also have required firms that solicit proxies to include in the proxy statement or annual report an

³³ 389 F. Supp. at 700.

³⁴ 5 U.S.C. § 553(c) (1970).

³⁵ *Id.* § 555(e).

³⁶ SEC Securities Act Release No. 5569 (Feb. 11, 1975), [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,110, at 85,109.

³⁷ SEC Securities Act Release No. 5627 (Oct. 14, 1975), 40 Fed. Reg. 51656, 51669-70 (1975).

undertaking by the company to furnish compliance reports to interested shareholders upon the payment of a reasonable copying fee.³⁸ The same requirement would have applied to companies engaging in a registered public offering.³⁹ Finally, the proposals called for registrants under the 1933 and 1934 Acts to disclose any "material estimated capital expenditures for environmental control facilities."⁴⁰

The proposed rules came under vigorous attack from both sides. The petitioners claimed that, "[b]y any standard, the Commission's proposed disclosure rule is so trivial as to border on being ludicrous."⁴¹ Various representatives of industry, on the other hand, maintained that the proposals would impose unnecessary burdens on registrants and argued that no disclosure requirements could be designed that would serve the desired end without intolerable costs to industry.⁴²

Eventually, after several trips to the district court to seek extensions of the court's deadline, the Commission announced its final position on May 6, 1976.⁴³ It retreated from even its own modest proposals, withdrawing all of the proposed changes except for the requirement that material environmentally-related capital expenditures be disclosed. And that amounts essentially to no change at all, for as the Commission pointed out in the initial proposal: "To the extent they are material, [such capital expenditures] are already required to be disclosed"⁴⁴

Although the end product is a disappointment to those who advocate that the SEC use its disclosure powers for social ends, it is instructive to examine the process by which the Commission arrived at its final position, for that process represents a slight but distinct departure from the SEC's traditional approach to its disclosure mandate.

³⁸ *Id.* at 51669, [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,310 at 85,726.

³⁹ *Id.*

⁴⁰ *Id.* at 51667, CCH ¶ 80,310, at 85,726.

⁴¹ NRDC, Inc., Project on Corporate Responsibility, Inc., & Center on Corporate Responsibility, Inc., Comments Submitted to the SEC at 7 (Jan. 12, 1976) on file at *Cornell Law Review*. [Hereinafter cited as NRDC et al. Comments.]

⁴² See SEC Securities Act Release No. 5704 (May 6, 1976), [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,495, at 86,291. See generally SEC File No. S7-593.

⁴³ SEC Securities Act Release No. 5704, *supra* note 42.

⁴⁴ SEC Securities Act Release No. 5627 (Oct. 14, 1975), [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,310, at 85,719.

B. *The SEC's Authority*

The principal sources of the SEC's disclosure authority are the several sections of the 1933 and 1934 Acts that call, in the most general terms, for the reporting of such information as the Commission finds to be "necessary or appropriate in the public interest or for the protection of investors."⁴⁵ In the past, the Commission has tended to view the "public interest" portion of that mandate rather restrictively. For the most part it has concerned itself with only those matters of public interest that are associated with the protection of investors and the maintenance of a healthy securities market. As a result, registrants have generally been required to report only information that is economically relevant and significant enough to be considered material. The Commission reaffirmed this interpretation of its disclosure authority in the release containing the proposed rule changes:

The Acts and the relevant legislative history also suggest that a prime expectation of the Congress was that the Commission's disclosure authority would be used to require the dissemination of information which is or may be economically significant.⁴⁶

Nevertheless, information about a corporation's socially significant activities may in fact be relevant to an economic appraisal of the firm in one or more ways. The relation between corporate social behavior and economic materiality will be discussed at greater length in the second part of this Article,⁴⁷ but it is useful to summarize briefly some of the ways that information about socially significant activities might be of interest to an investor motivated exclusively by the pursuit of the dollar. First, corporate misconduct can lead to substantial direct costs to the corporate treasury in the form of civil damages or criminal penalties and the ancillary expenses of litigation.⁴⁸ The present disclosure rules already require

⁴⁵ Securities Act of 1933, §§ 7, 10(c), 15 U.S.C. §§ 77g, 77j(c) (1970); Securities Exchange Act of 1934, §§ 10(b), 12(b)(1), 14(a), 15 U.S.C. §§ 78j(b), 78l(b)(1), 78n(a) (1970). Section 19(a) of the 1933 Act authorizes the Commission to promulgate such rules "as may be necessary to carry out the provisions of this [title]." 15 U.S.C. § 77s(a) (1970). Section 23(a) of the 1934 Act authorizes such rules "as may be necessary or appropriate to implement the provisions of this [title] for which [the Commission is] responsible . . ." 15 U.S.C. § 78w(a)(1) (Supp. V, 1975).

⁴⁶ SEC Securities Act Release No. 5627, *supra* note 44, ¶ 80,310, at 85,710.

⁴⁷ See text accompanying notes 104-33 *infra*.

⁴⁸ See, e.g., N.Y. Times, May 31, 1974, at 1, col. 3 (\$30 million settlement by AT&T of employment discrimination suit).

that investors be informed of any pending litigation that might have material economic effects on the corporation.⁴⁹

But the direct impact on the corporate fisc of fines, civil damages, and lawyers' fees does not exhaust the ways in which social misbehavior can be economically relevant. Many of the institutional investors that testified in favor of some additional disclosure requirements indicated their belief that the socially significant activities of corporations are relevant in assessing the quality of management and in evaluating the long-term political and regulatory climate in which a firm will operate.⁵⁰ Even the more pragmatic investment managers indicated that such factors might affect investment decisions.⁵¹

Judge Richey specifically recognized this argument in his opinion in *NRDC v. SEC*; he wrote:

[T]his Court is not prepared to say that a corporation's adverse impact on the environment or its equal employment practices may not directly lead to an unfortunate financial condition in the near future. There is substantial risk that failure to adjust corporate behavior to federal standards will result in severe monetary sanctions.⁵²

⁴⁹ SEC Securities Act Release No. 5170, *supra* note 22, ¶ 78,150, at 80,487-88.

⁵⁰ The submission of the Rockefeller Family Fund is fairly representative:

We support mandatory disclosure of socially significant matters . . . not because we view ourselves as a special kind of "ethical" investor nor because we have a policy of pursuing (or feel an obligation to pursue) all avenues of action available to us as an investor to eliminate corporate practices considered inimicable to the environment or to equal employment opportunity. We support such disclosure because we consider it to be material to us as a reasonable, prudent investor and also as an investor with a policy of avoiding investments in corporations whose activities are contrary to its programmatic goals.

. . . .

We submit, further, that in many cases, socially significant matters *are* material in the economic sense to the reasonable, prudent investor. Any genuine long-term investor must be concerned about a corporation's societal impact as well as its short-term economic success.

Statement submitted on behalf of the Rockefeller Family Fund at 7, 12, SEC File No. S7-551 (1975) (on file at *Cornell Law Review*).

⁵¹ For example, the statement submitted on behalf of the Financial Analysts Federation reported: "It is our experience that socially-significant matters have a way of becoming economically significant." Statement on behalf of the Financial Analysts Federation at 5, SEC File No. S7-551 (1975).

⁵² 389 F. Supp. at 700. *See also* NAACP v. Federal Power Comm'n, 520 F.2d 432 (D.C. Cir. 1975), *aff'd*, 425 U.S. 622 (1976). There the court stated:

In the long run, after all, the most efficient, lowest-cost production and distribution of electricity and natural gas will be that which is conducted in compliance with the laws, employment discrimination laws and other laws alike.

Id. at 444.

C. *Disclosure and the "Ethical Investor"*

Were economic relevance the only standard for measuring disclosure proposals, it would be tempting to abandon the discussion at this point and retreat—as the SEC has apparently done in the past—to rules that look only to the direct economic impact of corporate activity. But the interests of investors are not limited to the purely economic realm. There are an increasing number of “ethical investors” who, because of personal preference or institutional commitment to certain social and political values, are reluctant to hold securities of firms whose activities tend to conflict with their ideals. Many of this newly aware group of investors also desire to influence the policies of firms in which they invest, either by direct contact with management or by the exercise of the corporate franchise at shareholders’ meetings.⁵³ It would seem that the informational needs of this group of SEC constituents are entitled to no less solicitude from the SEC than are those of investors whose interests run to more crass concerns.⁵⁴ Commenting on these “ethical investors,” the district court in *NRDC v. SEC* declared that it was “not prepared to say that they are not rational investors and that the information they seek is not material information within the meaning of the securities laws.”⁵⁵

But however reasonable the interests of this class of investors may be, it is obvious that the disclosure system would break down were the SEC to require the disclosure of all significant corporate activities that touch on every area that might be of concern to some “ethical investor.” There are costs as well as benefits from increased disclosure. Not only does disclosure impose burdens on reporting firms, but there is obviously a limit to the amount of information that can be included in reports and disclosure statements before they become so unwieldy that they go unread and unused by most of the investors for whose benefit they are intended.

D. *Disclosure and Corporate Behavior*

The analysis of the proper role of the SEC in the exercise of its disclosure powers has thus far followed a familiar path. It is no

⁵³ See, e.g., B. LONGSTRETH & H. ROSENBLOOM, *CORPORATE SOCIAL RESPONSIBILITY AND THE INSTITUTIONAL INVESTOR: A REPORT TO THE FORD FOUNDATION* (1973); J. SIMON, C. POWERS & J. GUNNEMANN, *THE ETHICAL INVESTOR—UNIVERSITIES AND CORPORATE RESPONSIBILITY* (1972).

⁵⁴ Cf. *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972).

⁵⁵ 389 F. Supp. at 700.

secret, however, that the principal motive underlying the petitioners' request for changes in the disclosure rules bore very little relationship to the needs of investors; this brings us to territory that has been virtually unexplored.⁵⁶ As a result of the *NRDC v. SEC* court order, the Commission was forced to examine closely, perhaps for the first time, the wisdom of using disclosure as a vehicle for affecting corporate policies that do not immediately touch on areas of traditional investor economic concern. The belief that compulsory disclosure affects primary corporate behavior is one of the foundation stones of securities law. As Justice, then Professor, Frankfurter put it at the time of the passage of the 1933 Act:

There is a shrinking quality to such transactions; to force knowledge of them into the open is largely to restrain their happening. Many practices safely pursued in private lose their justification in public. Thus social standards newly defined gradually establish themselves as new business habits.⁵⁷

In addition, the speeches of SEC Commissioners are replete with tributes to the salutary impact of disclosure on the conduct of corporations and corporate managers.⁵⁸ It is little short of astonishing, therefore, that the SEC maintained, in the district court proceedings in *NRDC v. SEC*, that the disclosure rules called for by the plaintiffs would not in fact affect corporate behavior. Judge Richey was moved by the Commission's anomalous posture to comment:

This position, of course, appears to fly in the face of the premise upon which both Congress, in enacting the securities acts and NEPA, and the SEC, in administering the securities acts from day to day, operate: "that appropriate publicity tends to deter questionable practices and to elevate standards of business conduct."⁵⁹

⁵⁶ *But see* Sonde & Pitt, *Utilizing the Federal Securities Laws to "Clear the Air! Clean the Sky! Wash the Wind!"* 16 How. L.J. 831 (1971) (discussing use of disclosure to promote public, non-economic interests).

⁵⁷ Frankfurter, *The Federal Securities Act II*, FORTUNE, Aug. 1933, at 53, 55.

⁵⁸ *See, e.g.*, Address by Ray Garrett, Jr., to the American Society of Corporate Secretaries, Inc., SEC News Release at 1-2, June 27, 1975; Address by Ray Garrett, Jr., to the Wharton Graduate Business School Club of New York, Inc., and the Harvard Business School Club of New York, SEC News Release at 6-7, 12-13, Apr. 14, 1975; Remarks by A.A. Sommer, Jr., to the Wharton-AICPA Advanced Management Program for CPA Firm Partners, SEC News Release at 6-7, 11-13, June 24, 1975 (all on file at *Cornell Law Review*).

⁵⁹ 389 F. Supp. at 701 n.10, quoting SECURITIES AND EXCHANGE COMMISSION, DIS-

Thus chastened, the Commission retreated from this surprising position after the hearings on the proposed rule changes. In its subsequent release it conceded that

disclosure to investors of information reflecting corporate compliance with existing environmental standards might have some indirect effect on corporate practices to the benefit of the environment.⁶⁰

Nevertheless, the Commission continued to maintain that "it is generally not authorized to consider the promotion of social goals unrelated to the objectives of the federal securities laws"⁶¹ This conclusion was based on the Commission's fear of overburdening the disclosure process, thereby imposing unwarranted costs on reporting corporations, and on a fairly well-established line of judicial interpretations of other statutes containing similar authority for an agency to require disclosure "in the public interest." These cases have typically read such grants of authority to be restricted to that area of the public interest which lies within the agency's overall mission.⁶² As the Court of Appeals for the District of Columbia recently said in *NAACP v. Federal Power Commission*:

Congress has not charged the Commission with advancing *all* public interests, but only the public's interest in having the particular mandates of the Commission carried out, its interest, in other words, in the conservation of natural resources and the enjoyment of cheap and plentiful electricity and natural gas.⁶³

Applying this line of decisions to the proposal that it require the reporting of equal employment opportunity data, the SEC found that it was not at liberty to use the disclosure process solely to further that particular social concern and could therefore not justify additional disclosure on the ground that it would serve the public interest. Moreover, although the information in question might be of some economic relevance, and might be useful to "ethical investors" seeking to influence management policy on employment discrimination, the Commission felt itself unable to draw

CLOSURE TO INVESTORS, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICY UNDER THE '33 AND '34 ACTS 10 (1969) (the "WHEAT REPORT").

⁶⁰ SEC Securities Act Release No. 5627, *supra* note 44, ¶ 80, 310, at 85,722.

⁶¹ *Id.* at 85,706.

⁶² *See, e.g.*, *New York Cent. Sec. Co. v. United States*, 287 U.S. 12, 24 (1932).

⁶³ 520 F.2d 432, 441 (D.C. Cir. 1975), *aff'd*, 425 U.S. 622 (1976) (emphasis in original).

a satisfactory distinction between the goal of equal employment opportunity and other social goals that might also be served by disclosure, and equally unable to justify the burdens of attempting to require disclosure in all such areas. It therefore denied that portion of the petition.⁶⁴

Initially, it might appear that environmental protection should have fared no better. In the Commission's view, however, environmental goals have been elevated above the mass of other social concerns by NEPA, which directs that "to the fullest extent possible . . . the policies, regulations, and public laws of the United States . . . be interpreted and administered in accordance with the policies set forth in this chapter . . ." ⁶⁵ Where corporate environmental activities are not economically material but nevertheless have some interest for investors, either economic or "ethical," the Commission proposed to balance the benefits to be achieved by disclosure against the costs to the corporation and the disclosure process. Because of NEPA's unique nature, the Commission felt itself permitted, and perhaps required, to add to the scales the impact that disclosure might have on the advancement of environmental protection, even though it was unwilling to do so for other social goals.⁶⁶ Thus, for the first time in its history, the Commission proposed a disclosure rule part of the avowed justification for which was "the promotion of social goals unrelated to the objectives of the federal securities laws."⁶⁷

E. *Disclosure Rules and the New Disclosure*

The proposed rules, to be certain, represented only a modest increase in the environmental information required of registrants. And the rules as finally promulgated reduce even that minor alteration to the merest shadow of a change. But the rationale specifically adopted in the release announcing the proposed rule changes is, nonetheless, a significant departure from the Commission's prior administration of the disclosure process. And in withdrawing

⁶⁴ SEC Securities Act Release No. 5627, *supra* note 44, ¶ 80,310, at 85,723-25.

⁶⁵ 42 U.S.C. § 4332 (1970). *See generally* Sonde & Pitt, *supra* note 56.

⁶⁶ The release sums up the result:

[W]hile the disclosure of nonmaterial information is generally not required . . . adding the promotion of environmental protection to the other factors considered by the Commission in the administration of the disclosure process causes a different balance to be struck here.

SEC Securities Act Release No. 5627, *supra* note 44, ¶ 80,310, at 85,718.

⁶⁷ *Id.* at 85,706.

most of the earlier proposals, the Commission did not retreat from that rationale, but rather seemed to emphasize it. The justification offered for eliminating the requirement that certain reports include "a list of the registrant's most recently filed environmental compliance reports which indicate that the registrant has not met . . . any applicable environmental standard," was simply that the requirement "would not provide additional meaningful information to investors interested in the environmentally significant aspects of the behavior of registrants."⁶⁸

But the Commission did not back off from the position of the earlier release that it has the power, indeed the responsibility, to consider the impact of its disclosure rules on environmental protection. The release promulgating the final rule changes repeated that theme several times:

The Commission has, however, concluded . . . that no disclosure alternative of which it is aware would provide such additional information without costs and burdens grossly disproportionate to any resulting benefits to investors and the environment.

And again:

Such information appears to be that which is of interest to investors and its disclosure to them would appear also to be of some benefit to the environment. The Commission has also extensively considered whether other types of disclosure requirements might provide additional meaningful environmental information of interest to investors and of benefit to the environment . . .⁶⁹

This uncharacteristic reiteration of the Commission's concern for environmental protection marks a sharp departure from its traditionally narrower focus on investor protection and, for the first time, injects some substantive content into the statutory mandate that the disclosure rules be concerned also with the public interest. To be sure, the Commission continues to insist that NEPA "does not . . . authorize the collection of corporate information unrelated to investor protection solely for the purpose of dissemination."⁷⁰ But it would appear that henceforth the Commission may consider itself authorized in designing disclosure rules to consider other areas of the public interest so long as they can be said to bear at least some relationship to investor protection. That

⁶⁸ SEC Securities Act Release No. 5704, *supra* note 42, ¶ 80,495, at 86,292.

⁶⁹ *Id.*

⁷⁰ SEC Securities Act Release No. 5627, *supra* note 44, ¶ 80,310, at 85,715 n.35.

is clearly so where environmental protection is the issue, although in light of the Commission's refusal to require the reporting of equal employment opportunity data, it appears unlikely that the new disclosure will be broadened very quickly.

The remaining question is whether the Commission has been too hesitant in this first cautious expansion of its use of disclosure. The Commission is obviously quite right to be concerned about the burdens imposed on registrants and the disclosure process by its reporting rules. And it is unquestionably difficult to draft rule changes that will advance the interests of environmental protection without requiring too much of registrants. It is unfortunate, therefore, that throughout the rulemaking proceedings there was so remarkably little focus on specific proposals in the environmental area. The suggestions initially advanced by petitioners,⁷¹ although couched as proposed rule changes, were, in fact, extremely broad and would almost certainly have imposed intolerable burdens on reporting firms. And the Commission's rulemaking announcement was even broader and included no specific proposed changes.⁷²

As a result, the public comment tended to be general and unfocused, with industry making frontal attacks on hypothetical proposals, while advocates of the petition were, in general, only slightly more constructive. Surely, however, there must be *some* information about corporate environmental activities that would serve the end of environmental protection without imposing undue burdens on issuers. For example, a proposal supported by a task force of the American Institute of Certified Public Accountants would require the reporting of "[a] registrant's organizational and procedural arrangements for taking environmental matters into account in making important decisions."⁷³ Certainly this sort of information would be useful both to investors and environmentalists and would impose no substantial burden.

In refusing to act on the proposal for the disclosure of equal employment opportunity information—which would clearly not have imposed unwarranted burdens since the data in question are already compiled by most firms in response to the requirements of other federal agencies—the Commission appears to have accepted

⁷¹ The requested rule changes are printed in the appendix to this Article, *infra*.

⁷² SEC Securities Act Release No. 5569, *supra* note 36.

⁷³ Statement of the AICPA at iii, SEC File No. S7-593 (May 8, 1975), *quoted in* NRDC et al. Comments, *supra* note 41, at I3 n.25.

the "slippery slope" argument: if it requires disclosure in this area, it will be unable to draw an acceptable line when faced with similar demands in numerous other areas. It cites a list of "over 100 different 'social matters' . . . in which 'ethical' investors were said to be interested,"⁷⁴ implying that no principled distinction can be drawn among them since there is no statute for these areas imposing on the Commission requirements analogous to those of NEPA.

With all due respect, the Commission's fears are somewhat disingenuous. First, the list of "over 100 different 'social matters'" could easily be condensed to a dozen or so by consolidating items on the list that fall within the same general area of social concern. And even among this reduced list there are a substantial number of social problems for which there is nowhere near the evidence of Congressional commitment to solutions as there is in the areas of civil rights or environmental protection. And are we really to believe that by enacting NEPA Congress intended to set environmental goals in a wholly separate and superior category from other social priorities of the order of civil rights and equal employment opportunity?⁷⁵

Might it not be possible for the Commission to make use of one of the greatest strengths of our legal system, the tradition of the case-by-case approach to the resolution of difficult doctrinal problems? This is not to suggest that the Commission is free to act like a court in the exercise of its rulemaking authority—modifying its rules only in response to petitions from outside. But in feeling its way along this relatively new ground, it would seem entirely appropriate that the Commission proceed one step at a time. At the very least it would be unfortunate to shut the door on this potentially powerful use of disclosure in the public interest because of a generalized fear that once this path is entered, there will be no turning back short of the point at which both the disclosure mechanism and the resources of issuers become unwisely burdened.

II

THE "MANAGEMENT FRAUD" CASES

Although dragged unwillingly to the altar in promulgating rules relating to the disclosure of the socially significant activities of

⁷⁴ SEC Securities Act Release No. 5627, *supra* note 44, ¶ 80,310, at 85,724.

⁷⁵ *But see* NAACP v. Federal Power Comm'n, 520 F.2d 432, 441-42 (D.C. Cir. 1975), *aff'd*, 425 U.S. 662 (1976).

its charges, the SEC seems finally to have married—a little bit—the idea that its disclosure powers might properly be used as a means of influencing the social conduct of large corporations as well as for the protection of investors in the more established sense. And there is yet another indication of the SEC's movement in the general direction of expanding the disclosure philosophy to encompass social interests broader than those to which the Commission has in the past insisted its mandate was limited. I refer to what have come to be called, somewhat inaptly, the "management fraud" cases.

A. *History of the "Management Fraud" Cases*

The seed of the vine that bore this series of cases germinated in the Watergate investigation. Informal contacts between the SEC Enforcement Division staff and the Watergate Special Prosecutor's office led the SEC to consider possible securities law implications of illegal campaign contributions made by several major American corporations to the Committee to Re-elect the President (CREP). Most of these companies, it appeared, had concealed their contributions by falsifying the books of account on which the financial statements required by the 1934 Act are ultimately based.⁷⁶ The result was that the companies involved prepared, filed, and distributed to shareholders financial statements that were, in some minor way, false or misleading.

Knowingly filing or disseminating erroneous financial statements is, of course, itself a violation of the securities laws.⁷⁷ But there were other grounds for finding violations in these cases. Concealing illegal contributions could be considered an independent violation of the law, since public disclosure of the illegality creates a possibility, realized in at least some instances,⁷⁸ of costly legal proceedings, criminal penalties, and just plain embarrassment to the corporations involved, with resultant damage to their carefully nurtured public images. On this basis the Enforcement Division asked for, and was granted, authority to investigate the cir-

⁷⁶ See *Hearings on Abuses of Corporate Power Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm., United States Congress, 94th Cong., 2d Sess.* (1976) (statement of Roderick Hills, SEC Chairman) (on file at *Cornell Law Review*).

⁷⁷ Securities Exchange Act of 1934, §§ 14(a), 18(a), 32(a), 15 U.S.C. §§ 78n(a), 78r(a), 78ff(a) (1970).

⁷⁸ See *N.Y. Times*, May 2, 1974, at 42, col. 7; *id.*, Nov. 14, 1973, at 32, col. 6; *id.*, Nov. 13, 1973, at 30, col. 3; *id.*, Oct. 18, 1973, at 1, col. 1.

cumstances surrounding the illegal campaign contributions and to institute enforcement proceedings where appropriate.⁷⁹

The investigation was destined to uncover far more than anyone had suspected. It soon became clear that the corporate contributions to CREEP were but the tip of a very large iceberg. As the investigation progressed, it developed that the money for many of these contributions had been drawn from slush funds maintained by the donor corporation to finance a remarkable variety of questionable or plainly illegal activities. The investigation of an alleged \$100,000 campaign contribution by the Gulf Oil Corporation, for example, brought to light a slush fund that since 1960 had been used to channel over ten million dollars to various questionable causes both in the United States and overseas.⁸⁰ The \$30,000 contribution made by Minnesota Mining and Manufacturing Company to CREEP was paid out of a secret fund that had distributed \$634,000 to various beneficiaries of the corporation's largesse since 1963.⁸¹

As news of these investigations (and of parallel investigations by the IRS and congressional committees) became public, executives of a number of corporations not under investigation began to consult their consciences and their attorneys with the result that several more companies disclosed voluntarily that they had maintained slush funds for a variety of unsavory uses.⁸² The parade of chastened corporate executives to the doors of the Commission is still in progress.⁸³ The resulting disclosures, occupying a substan-

⁷⁹ It was at this stage that the term "management fraud" was first applied to the investigation. It now appears something of a misnomer, but the name seems to have stuck. For a brief history of SEC involvement in these cases, see Testimony of Phillip A. Loomis, Jr., SEC Commissioner, intended to be made to the Subcomm. on International Economic Policy of the House Comm. on International Relations, at 5-6 (June 17, 1975) (on file at *Cornell Law Review*). (This testimony was never delivered; the original draft is available.)

⁸⁰ See Complaint of SEC at 3, *SEC v. Gulf Oil Corp.*, Civil No. 75-0324 (D.D.C., Mar. 11, 1975), reported in *N.Y. Times*, Mar. 12, 1975, at 1, col. 1.

⁸¹ See Complaint of SEC at 2-3, *SEC v. Minnesota Mining & Mfg. Co.*, Civil No. 3-75-29 (D. Minn., Jan. 30, 1975), reported in *Wall St. J.*, Feb. 3, 1975, at 4, col. 1.

⁸² See SECURITIES AND EXCHANGE COMMISSION, REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, SUBMITTED TO THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 94TH CONG., 2D SESS. 38-39 (Comm. Print 1976) [hereinafter cited as REPORT ON ILLEGAL PAYMENTS].

⁸³ At this writing, the SEC has brought enforcement actions in 15 cases in which violations of the disclosure and antifraud provisions of the securities laws by the maintenance of slush funds or the making of secret illegal payments have been charged. Settlements have been reached with all of the corporate, and most of the individual defendants. See REPORT ON ILLEGAL PAYMENTS, *supra* note 82, at 3-4 (reporting 14 such actions); *Wall St. J.*, May 12, 1976, at 2, col. 2 (reporting a 15th). The Commission also reported that as of April

tial amount of the time of the SEC enforcement staff, have led to a series of highly publicized congressional hearings,⁸⁴ and prompted President Ford to order a cabinet-level study of illegal corporate practices.⁸⁵

B. *A Qualitative Difference?*

The SEC's activities have brought howls of outrage from large segments of the corporate community,⁸⁶ hosannas from other quarters,⁸⁷ and some remarkably uncertain public musings from several members of the Commission.⁸⁸ These unusually strong reactions to a relatively mundane series of complaints and consent orders would seem to signal that something is qualitatively different about the nature of these cases. Although part of the clamor is undoubtedly due to the general public furor over the Watergate affair and the disclosures of misdeeds in high places with which the SEC proceedings were initially associated, there is another explanation: that there is, indeed, something different about these cases, a difference that foreshadows a slight but significant alteration in the Commission's traditional use of its disclosure powers, and a difference that may be philosophically linked to the proposed new rules governing the disclosure of socially significant matters discussed above.⁸⁹

It is difficult to postulate any precisely defined qualities that set these cases apart from what might be considered the more

21, 1976, 89 companies had made voluntary disclosures of questionable or illegal payments. REPORTS ON ILLEGAL PAYMENTS 1. And new reports continue to be filed. See, e.g., *Improper Payments are Listed by TWA, Various Other Firms in Reports to SEC*, Wall St. J., May 19, 1976, at 4, col. 2.

⁸⁴ *Hearings on Political Contributions to Foreign Governments Before the Subcomm. on Multinational Corporations of the Senate Comm. on Foreign Relations*, in COMM. ON FOREIGN RELATIONS, UNITED STATES CONGRESS, 94TH CONG., 1ST SESS., MULTINATIONAL CORPORATIONS AND UNITED STATES FOREIGN POLICY, pt. 12 (Comm. Print 1975); *Hearings on S. 3133, S. 3379, and S. 3418 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. (1976).

⁸⁵ See N.Y. Times, Mar. 28, 1976, at 1, col. 4.

⁸⁶ See, e.g., Address by Bruce Allan Mann to the Committee on Federal Regulation of Securities of the American Bar Association, 1975 Annual Convention (Aug. 1975), reported in 1975 BNA SEC. REG. & L. REP. NO. 316, at A-4.

⁸⁷ See, e.g., Editorial, *The Basics of Bribery*, Wall St. J., Feb. 27, 1976, at 8, col. 1; Editorial, *Business and Bakshesh*, Wall St. J., June 2, 1975, at 10, col. 1; Gwirtzman, *Is Bribery Defensible?*, N.Y. Times, Oct. 5, 1975, § 6, at 19.

⁸⁸ See, e.g., Address by Ray Garrett, Jr., to the Society of American Business Writers, SEC News Release, May 6, 1975 (on file at *Cornell Law Review*); Testimony of Phillip A. Loomis, *supra* note 79; Addresses and Remarks cited in note 58 *supra*.

⁸⁹ See notes 50-51 and accompanying text *supra*.

normal SEC enforcement proceeding. There are, however, certain characteristics that may serve as a start: (1) they did not involve the "garden variety"⁹⁰ type of securities fraud; (2) the acts in question were proscribed by a law or ethical canon independent of the securities laws; and (3) those responsible for the acts were acting, or claimed to have been acting, in the service of what they believed at the time to be the best interests of the corporation and its shareholders.

C. *Precedent*

I do not mean to suggest that the "management fraud" cases are entirely without precedent or that, in the more than forty years of the SEC's existence, there have not been other instances of the use of the Commission's disclosure powers that partook of the above three characteristics. There are, however, very few cases genuinely in point.

One of the better-known is *Heit v. Weitzen*,⁹¹ a private action, in which the plaintiff shareholder alleged that the corporation had violated rule 10b-5 by failing to disclose that it had substantially overcharged the federal government in executing a cost-plus government contract. The additional income generated was, of course, reported in the company's financial statements with the result that the company's profits and assets were overstated. The district court held for the defendants on the ground that

the concealment [of the fraud on the government] from the filed statements was for the purpose of further defrauding the Government by not disclosing the original malfeasance and not for the purpose of perpetrating a "misrepresentation or fraudulent practice usually associated with the sale or purchase of securities."⁹²

The Second Circuit reversed, holding that the issuance of false and misleading financial statements might reasonably constitute a fraudulent practice "in connection with the purchase or sale of . . . securit[ies]"⁹³ because of the likelihood that investors would rely on the statements in making investment decisions.⁹⁴

⁹⁰ *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971).

⁹¹ 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

⁹² 260 F. Supp. 598, 602 (S.D.N.Y. 1966), *quoting* *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

⁹³ SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976).

⁹⁴ 402 F.2d at 913.

Although *Heit* was a private action, not involving SEC exercise of its disclosure authority, the Commission filed an *amicus curiae* brief in the court of appeals in support of the plaintiff's position. That brief sheds some light on the Commission's view of the problems of disclosing illegal activities. The defendants had argued that since most acts of corporate mismanagement are bound to have *some* impact on corporate financial statements, the logical extension of the plaintiff's position was that the securities laws required disclosure of all unlawful acts. The defendants argued that Congress could not have intended this result.⁹⁵

The Commission's brief carefully avoided confronting that argument, pointing out that since the defendants had actually published false financial statements, the case did not involve

the troublesome problem of determining when and under what circumstances an act of corporate mismanagement may be converted into a violation of Section 10(b) and Rule 10b-5 implying an obligation to come forward with disclosure of such mismanagement and then holding that a failure to make the disclosure is a violation of those provisions.⁹⁶

By involving (one is tempted to say entangling) itself in the "management fraud" cases, the Commission has leapt with both feet into the murky depths of that "troublesome problem."

SEC v. Frigitemp Corp.,⁹⁷ more clearly foreshadowing the present series of "management fraud" cases, was an obscure enforcement proceeding, settled by consent order, that grew out of an investigation into a case involving the sale of unregistered securities. The complaint alleged that Frigitemp had been paying kickbacks to obtain subcontracts for the performance of certain work.⁹⁸ In its prayer for relief, the SEC asked that Frigitemp's officers be required to pay over to it \$185,000, the total amount of the alleged kickbacks.⁹⁹ The defendants consented to that relief,¹⁰⁰

⁹⁵ Brief for Appellee Tyminski at 11-12 and Brief for Appellee Weitzen at 13-15, 23-25, *cited in* Brief for SEC as Amicus Curiae at 36, *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968).

⁹⁶ Brief for SEC as Amicus Curiae at 34, *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968) (on file at *Cornell Law Review*).

⁹⁷ Civil No. 73-596 (D.D.C., Mar. 28, 1973).

⁹⁸ Complaint of SEC at 6-7, *SEC v. Frigitemp Corp.*, Civil No. 73-596 (D.D.C., Mar. 28, 1973).

⁹⁹ *Id.* at 15-16.

¹⁰⁰ *SEC v. Frigitemp Corp.*, Civil No. 73-596 (D.D.C., Mar. 28, 1973) at 1.

although, following the standard practice, they admitted no wrongdoing.

In *Cooke v. Teleprompter Corp.*¹⁰¹ the District Court for the Southern District of New York was confronted with a shareholder dispute relating to the continued participation of Irving Kahn in the management of Teleprompter. Kahn had been convicted of bribery in one case and named as a co-conspirator in another bribery case. Both involved attempts to obtain franchises for Teleprompter to operate cable television systems.¹⁰² The court awarded an injunction delaying the corporation's annual meeting to allow plaintiffs to solicit proxies. In doing so, the court held that Kahn's continued association with Teleprompter following his bribery conviction was a material fact that shareholders were entitled to know before casting their votes for directors.

There may be other cases in which defendants who thought they were acting in the best interests of a corporation have been charged with failing to disclose some corporate wrongdoing that was itself unrelated to a violation of the securities laws. The SEC's brief in *Heit*, for example, cited several cases in which it was apparently alleged that the disclosure provisions of the securities laws were violated by the failure of the defendants to disclose a tax fraud.¹⁰³ Such cases are relatively rare, and none of them has generated the uproar that has surrounded the "management fraud" cases. Certainly none of the prior cases has forced the SEC to deal so directly with the "troublesome problem" of the extent to which the failure to disclose an unlawful act may itself be a separate violation of the securities laws. The conscious, consistent application of SEC disclosure requirements in this area raises difficult problems of authority and policy.

D. *The New Materiality*

Central to these problems is the familiar concept of materiality. The disclosure requirements of the securities laws do not, of course, call for the disclosure of *every* fact about a registrant. Statutory liability attaches only for the omission of potentially mis-

¹⁰¹ 334 F. Supp. 467 (S.D.N.Y. 1971).

¹⁰² *Id.* at 468.

¹⁰³ Brief for SEC as Amicus Curiae, *supra* note 96, at 36, citing *United States v. Guterma*, 281 F.2d 742, 746 (2d Cir.), *cert. denied*, 364 U.S. 871 (1960), *United States v. Pope*, 189 F. Supp. 12, 24-25 (S.D.N.Y. 1960), and *In re Londontown Mfg. Co.*, 41 S.E.C. 676 (1963).

leading material facts.¹⁰⁴ Although statutes or SEC rules occasionally require disclosure of specific information the materiality of which could be questioned,¹⁰⁵ the more general disclosure rules limit the information required to that which is material.¹⁰⁶

Similarly, just as there are penalties attached only to material sins of omission, sins of commission are punishable only if the false or misleading statements that *were* made are material. *Heit* did not raise the "troublesome problem" because the overstatements of profits and assets contained in the financial statements filed with the SEC were relatively large in relation to the size of the business and were therefore unquestionably material. But is a \$120,000 campaign contribution¹⁰⁷ by the American Ship Building Company, a corporation with \$69 million in assets and \$95 million in sales in the year of the expenditure,¹⁰⁸ material? Does a \$634,000 slush fund accumulated over a period of ten years have a material impact on the Minnesota Mining and Manufacturing Company, which had \$1.7 billion in assets and \$1.8 billion in sales at the end of that period?¹⁰⁹ Is \$10 million siphoned into a Gulf Oil Corporation fund over fifteen years material to an evaluation of the corporate health of the seventh largest industrial corporation in the United States, a corporation with \$12.5 billion in assets and \$16.5 billion in sales in 1974?¹¹⁰

Under the classic definition of materiality: "The basic test . . . is whether a *reasonable* man would attach importance . . . in determining his choice of action in the transaction in question."¹¹¹

¹⁰⁴ E.g., Securities Act of 1933, §§ 11, 12, 17, 15 U.S.C. §§ 77k, 77l, 77q (1970); SEC Rules 10b-5, 14a-9, 17 C.F.R. §§ 240.10b-5, 240.14a-9 (1976).

¹⁰⁵ For example, Schedule A of the 1933 Act requires disclosure of the state of incorporation, the addresses of the directors, the remuneration paid directors, and other information that, in many cases at least, would not be truly material to an investment decision. 15 U.S.C. § 77aa (1970).

¹⁰⁶ Rule 10b-5, for example, makes it unlawful "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . ." 17 C.F.R. § 240.10b-5(b) (1976). See also Form 10-K, Items 1(b), 1(b)(6)(c), 1(b)(7), 3 CCH FED. SEC. L. REP. ¶ 31,103, at 22,053-3 (1976).

¹⁰⁷ See Complaint of SEC at 3-4, SEC v. American Ship Bldg. Co., Civil No. 74-588 (D.D.C. Oct. 4, 1974).

¹⁰⁸ *The Fortune Directory of the Second 500 Largest Industrial Corporations*, FORTUNE, June 1972, at 118.

¹⁰⁹ *The Fortune Directory of the 500 Largest Industrial Corporations*, FORTUNE, May 1972, at 192.

¹¹⁰ *Id.*, May 1975, at 210.

¹¹¹ SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971), quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*,

The Commission's rules define materiality as comprehending only "those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered."¹¹² Until very recently, the "average prudent investor" was treated by the SEC as motivated exclusively by the unadorned desire to make a profit; with the result that, without any evident analysis of the matter, the Commission has imported into the concept of materiality a notion of economic relevance. As William J. Casey, then Chairman of the Commission, stated in congressional testimony:

The test of the propriety of specified disclosures has been and . . . must be, whether the proposed disclosures are or would be deemed *material* by . . . public investors.

In determining the necessity of certain disclosures, the Commission and the courts have adhered to a standard of economic relevance to investors; that is, whether the proposed disclosures would be considered by an investor in determining his course of action in a proposed transaction in securities.¹¹³

The "new disclosure," if the thesis of this Article is correct, involves either an expansion of the concept of materiality beyond the narrow traditional concept of economic materiality, or a broadening of what is henceforth to be considered economically relevant, or both.

1. *The Context of Disclosure*

In what ways can the "management fraud" payments be considered material? First, whether a particular item of corporate information is material may depend on the nature of the question asked. For example, information that is material to a stockholder considering how to cast his proxy may not be of interest to the same shareholder considering whether to sell his stock.¹¹⁴

Closer to home, the disclosure of a bribe paid to officials of a

382 U.S. 811 (1965) (emphasis in original). *Accord*, TSC Industries, Inc. v. Northway, Inc., 96 S. Ct. 2126 (1976).

¹¹² SEC Rule 405, 17 C.F.R. § 230.405 (1976). *See also* SEC Rule 12b-2, 17 C.F.R. § 240.12b-2 (1976).

¹¹³ *Hearings on Administration of the National Environmental Policy Act: NEPA Oversight, Before the Subcomm. on Fisheries and Wildlife Conservation of the House Comm. on Merchant Marine and Fisheries*, 92d Cong., 2d Sess., ser. 92-24, at 3 (1972) (emphasis added).

¹¹⁴ *Cf.* Address by Ray Garrett, Jr., *supra* note 9. Garrett said: "It is one thing to provide disclosures to facilitate economic investment decisions. The emphasis is somewhat different when disclosures are provided to facilitate the stockholder's franchise." *Id.* at 6.

foreign government may be of less significance in a proxy statement than in a 1933 Act registration statement for an issue of securities, the proceeds of which are to be used in the development of a concession in the foreign country. This issue disappears, however, once a public disclosure is made, and in determining when an affirmative duty to disclose arises, the distinction is at best a blurry one.

One must also recognize that the interests of investors are not monolithic. An item that stirs substantial interest among the speculators and chartists of Wall and Bay Streets¹¹⁵ may be ignored by bank trust managers. Moreover, there are interests besides the strictly economic that merit the protection of the securities laws.

2. *Economic Materiality*

Improper expenditures of corporate funds may affect the economic welfare of a corporation in several ways. First, such expenditures may distort the profit and loss statement. Unlawful payments are normally treated as expense items; hence, there is no question of the *overstatement* of income on published financial statements, as in *Heit*. However, shareholders are entitled to know that material amounts are being spent for non-business purposes.

In the "management fraud" cases the amounts spent for illegal purposes would not seem to have materially affected operating statements. The largest figure uncovered so far has been Gulf Oil's \$10 million slush fund. Although most reasonable men would agree that this is indeed a very large amount of money, the total, which was paid out over some fifteen years, amounts to less than one percent of the company's 1974 earnings, and less than .06 percent of 1974 revenues.¹¹⁶ During the same period Gulf made charitable contributions of over \$56 million.¹¹⁷ No one would contend that Gulf should report as a separate item on its earnings statement a \$10 million expenditure to drill a new oil well or build a new refining tower. It is not immediately apparent why \$10 million expended to curry political favor should receive different treatment. We must look elsewhere for the materiality of the costs of maintaining the slush fund. As the special committee of Gulf's board of directors appointed to investigate the matter noted:

¹¹⁵ See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971).

¹¹⁶ Report of the Special Review Committee of the Board of Directors of Gulf Oil Corporation, at 2 (1975) (the "McCloy Report") (on file at *Cornell Law Review*).

¹¹⁷ *Id.*

"[T]he character of certain of the contributions and payments is of greater portent than the sums involved."¹¹⁸

A second direct economic impact is that a corporation may sustain further outlays of corporate funds for criminal penalties, civil damages, and legal fees as a result of improper expenditures. Here again these expenses will usually be relatively small, at least for large firms. The maximum fine under the Corrupt Practices Act for corporate campaign contribution is \$25,000.¹¹⁹ The cost of legal representation would vary substantially, but this, too, would seldom significantly affect corporate profits.

Third, illegal payments overseas may expose the firm to risks of expropriation, sabotage, or other loss of assets in the foreign country. Where a major contract or foreign concession agreement depends on under-the-table payments to government officials, public disclosure of those payments might activate political forces that could cause the loss of the contract or concession, or worse.¹²⁰ The risks in such circumstances are not different in principle from the sort of contingent liability that the SEC has always insisted must be disclosed when the risk and the amount at stake are together significant enough to be of interest to an investor.

One particularly apt example of this risk is the United Brands affair.¹²¹ The company paid a \$1.3 million bribe to high officials of the Honduras government,¹²² and the disclosure of the bribe has generated fears that United Brands will lose its concessions in the country.¹²³ It is significant that the illegal activity first came to light in the *Wall Street Journal*, not in reports required by the SEC.¹²⁴

¹¹⁸ *Id.*

¹¹⁹ 18 U.S.C. § 610 (Supp. IV, 1974).

¹²⁰ See Remarks by A.A. Sommer, Jr., to the Wharton-AICPA Advanced Management Program for CPA Firm Partners, *supra* note 58.

¹²¹ See Wall St. J., Aug. 19, 1975, at 7, col. 1.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ The reporter who wrote the article apparently obtained from within the company a leaked report that an SEC investigation was underway.

Cf. Wall St. J., Aug. 6, 1975, at 6, col. 2. In this article Lockheed Aircraft was quoted as stating that disclosure of its overseas bribes "could have a serious adverse impact on several hundred million dollars of the company's present backlog." Lockheed was apparently addressing its comment to the SEC. Ironically, the firm inadvertently delivered documents containing details of the seamier side of its overseas sales practices to the Senate Subcommittee on Multinational Corporations and may have been the source of its own injury. The inadvertent disclosure created a serious risk of "leakage" to the press. See *id.*, Sept. 15, 1975, at 3, col. 6. This latter incident is further evidence that embarrassing information can indeed surface to public view, to the detriment of the company trying to conceal it, quite without the assistance of disclosure required by the SEC. See also *id.*, May

Fourth, being caught *in flagrante delicto*, in some activities, is likely to do substantial damage to a corporation's carefully cultivated public image. Corporate reputation is an asset of considerable economic importance, and harm to that reputation may have considerable impact on the corporation's economic position. The harm to a corporation's reputation caused by the exposure of its peccadilloes will depend on the nature of the crime. Public esteem is not likely to suffer from the imposition of a small penalty for an inadvertent violation of a safety regulation. But the willful breach of a statute embodying values as important as those protected by the ban on corporate political contributions is a more serious matter. Conviction of such a crime would do substantial harm to a corporation's goodwill, however difficult it might be to measure.

There are also a number of indirect ways in which information about corporate misbehavior might be relevant to an investor's evaluation of a firm. First, some investors perceive a correlation between the ethical and social performance of corporate managers and the economic performance of the companies they manage. One does not have to be a naive idealist or a radical social activist to believe that ethical executives are more likely to provide vigorous, forward-looking management. At the very least, investors may quite reasonably feel that illegal or unethical behavior by corporate managers is a relevant criterion for making investment decisions or for voting at shareholder meetings. The Commission relied heavily on this view in a recent release directing that companies must disclose to their shareholders the fact that they or their officers have been charged with, or convicted of, making illegal campaign contributions. The Commission found this information relevant to "an evaluation of the integrity of the management."¹²⁵

This is not a new position for the SEC. In an opinion in *In re Franchard Corp.*,¹²⁶ involving the failure to disclose questionable transactions between a publicly-held corporation and one of its officers, then Chairman William Cary wrote:

15, 1975, at 1, col. 6 (reporting Peruvian expropriation of Gulf Oil marketing facilities because of Gulf's "notorious immoral conduct").

¹²⁵ SEC Securities Act Release No. 5466 (Mar. 8, 1974), [1973-74 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,699, at 83,874. *But see* Address by A.A. Sommer, Jr., to the Ohio Legal Center Institute Securities Law Seminar (Apr. 2, 1976), reported in 1976 BNA SEC. REG. & L. REP. No. 347, at A-1:

This integrity test is a perilous and dangerous one and I would hope that in the application of it the Commission would proceed prudently and cautiously, lest we find our disclosure documents heavily burdened with masses of personal data far removed from the economic life of a corporation.

¹²⁶ 42 S.E.C. 163 (1964).

Of cardinal importance in any business is the quality of its management. Disclosures relevant to an evaluation of management are particularly pertinent where . . . securities are sold largely on the personal reputation of a company's controlling person. . . .

. . . [T]hese disclosures were highly material to an evaluation of the competence and reliability of registrant's management

Evaluation of the quality of management—to whatever extent it is possible—is an essential ingredient of informed investment decision. A need so important cannot be ignored

. . . *Registrant's argument that the withdrawals were not material because [the officer's] undisclosed indebtedness to registrant never exceeded 1.5 percent of the gross book value of registrant's assets . . . ignores the significance to prospective investors of information concerning [the officer's] managerial ability and personal integrity.*¹²⁷

The management misconduct in *Franchard* involved self-dealing and might be distinguishable from the "management fraud" cases, in which there have been few proven allegations that corporate executives were lining their own pockets at the expense of their corporations. In *Teleprompter*,¹²⁸ however, the misconduct consisted of bribes paid to municipal officials to secure a benefit for the firm. The court held:

The independent shareholders may well conclude that it is inappropriate for a publicly held corporation, which must deal on an almost daily basis with municipal officials in connection with the awarding and administration of franchises for cable television to be controlled directly or indirectly by a person whom a jury has found guilty of bribing such officials.¹²⁹

The scant case law pertaining to corporate bribery indicates that the SEC and the courts have found that the involvement of corporate executives in blatantly illegal activity is itself a material fact because of what it says about the quality of management. Indeed, one of the most troublesome aspects of the "management fraud" cases is the climate of immorality created by repeated and deliberate wrongful acts sanctioned by, and in many cases directed by, executives at the highest levels of the firms involved.¹³⁰

¹²⁷ *Id.* at 169-71 (emphasis added). See also *SEC v. Kalvex, Inc.*, [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,226 (S.D.N.Y. 1975).

¹²⁸ 334 F. Supp. 467 (S.D.N.Y. 1971). See note 101 and accompanying text *supra*.

¹²⁹ 334 F. Supp. at 470-71.

¹³⁰ If any evidence is needed of the spillover effect of corporate misdeeds, the saga of

In many of these cases, corporate executives carried on like characters in a B-grade spy novel, toting about suitcases full of cash, shuffling funds through numbered Swiss bank accounts, and utilizing the services of agents and "consultants" whose reputations would make a robber-baron blush. There is suspicion in at least some instances that substantial sums of "laundered" cash stuck to the fingers of the couriers, or otherwise wound up in unintended hands.¹³¹ Such a pattern of behavior must, if continued, ultimately infect the entire corporate structure. Is it any wonder that the executives of Gulf Oil, many of whom worked during the formative period of their careers in the Middle East where *baksheesh* is a way of life, found it natural to make illegal political contributions in the United States?

Not only does this sort of conduct tend to spread throughout the corporate structure, but the process of generating the illegal funds often involves the falsification of corporate accounts, an invasion of the financial records that lie at the heart of the SEC disclosure requirements. Even where the amounts involved are relatively small, any intentional falsification of accounting figures has long been considered particularly reprehensible by the Commission. It is, in fact, this aspect of the whole shabby affair that seems to be of primary concern to certain members of the Commission.¹³²

the Northrop Corporation provides a persuasive example. In the last two years Northrop has been convicted of making illegal campaign contributions (*see* N.Y. Times, May 2, 1974, at 42, col. 7); admitted paying large bribes to foreign government officials (*see* N.Y. Times, Apr. 17, 1975, at 1, col. 1; Wall St. J., July 18, 1975, at 19, col. 2); and, most recently, admitted entertaining Pentagon officials at an Eastern Shore hunting lodge in apparent violation of government conflict of interest regulations (*see* Wall St. J., Apr. 25, 1975, at 1, col. 5).

¹³¹ In a 10-K report recently filed with the SEC, Lockheed Aircraft reported that it had uncovered evidence that \$100,000 to \$130,000 of "commissions" paid had been "kicked back" to Lockheed employees. *See* Wall St. J., May 5, 1976, at 10, col. 2.

¹³² *See, e.g.*, Address by Ray Garrett, Jr., to the American Society of Corporate Secretaries, Inc., *supra* note 58; Remarks by A.A. Sommer, Jr., to the Wharton-AICPA Advanced Management Program for CPA Firm Partners, *supra* note 58. Sommer said:

It becomes a matter of great concern therefore when we find that significant amounts of money float around outside this system of corporate accountability and are used by one or two or a very small coterie of officers without any necessity to account for that use through normal corporate channels. When such is done, when significant amounts of money are extracted from the system and the uses of the money disguised by false bookkeeping entries, mislabeling, phony subsidiaries and Swiss bank accounts, I think that fact is material to shareholders and should be disclosed. . . . If we tolerate in *any* measure erosion of the standards of financial responsibility and accounting that we have so laboriously developed in this country, then I think we will be imperiling the integrity of our financial mar-

One of the principal purposes of the securities laws is to foster investor confidence in the securities markets. Ultimately this can only mean confidence in the entire business system that underlies the securities markets. It is difficult to measure the impact of the kind of shady dealings at issue here on a quality as elusive as "investor confidence," but one is confident that it is not a salutary one. The spores thrown off from illicit behavior at the top can spread their rot throughout. One crime begets another until the organization and eventually the entire system are corrupt.¹³³

3. *The Cumulative View*

Although in many instances no single item on this list of economic effects may be significant enough to rise to the level of traditional materiality, the items are to some extent additive. It is quite conceivable, therefore, that a reasonable investor might be influenced by their cumulative import. Although not without certain etiological difficulties, this cumulative approach to the materiality problem has a good deal of common-sense appeal to it. If nothing else, it may help to explain why there seem to be such strong feelings on both sides of the argument. And, although not wholly satisfying, it also provides a rational basis for concluding that the Commission is within the bounds of its authority in determining that these corporate misdeeds are economically material and that their concealment is therefore a violation of the securities laws.

E. *Administering the New Disclosure*

Although this rationale may explain and justify the SEC's approach to the "management fraud" cases, it raises a number of problems of administering and interpreting the securities laws—problems not present in the more traditional cases where it is

kets, and needless to say, when that is imperiled, our entire economy takes on a different appearance.

Id. at 8 (emphasis in original).

¹³³ Cf. Address by J.R. Evans to the Securities Cooperative Enforcement Conference, SEC News Release, May 15, 1975 (on file at *Cornell Law Review*). In his address, Evans argued:

[T]o the extent business decisions are made on the basis of a kickback, payoff or bribe, and not on the fundamental economic forces of price and quality of goods and services, graft and dishonesty are rewarded, and the very essence of a competitive free system, which is to promote efficiency, fair dealing, low prices, and quality goods and services, is frustrated and destroyed.

Id. at 11.

possible to identify a single material economic effect. Two further questions present themselves. Is economic relevance a *sine qua non* of materiality? Might a corporate action whose *economic* consequences are concededly immaterial nevertheless be of material significance to investors? Some investors are motivated by considerations other than purely economic ones. "Ethical investors" would seem as worthy of the SEC's solicitude as those less altruistically inclined. Although the SEC has never squarely faced this question, the Commission did concede during the *NRDC* litigation that the "'economic relevance' concept is not found in express terms in the securities laws or rules thereunder," but is only a "loose rule of thumb."¹³⁴ At the least, the fact that some investors might be genuinely influenced in their investment decisions by information about corporate misconduct ought to influence the way in which the Commission interprets economic materiality.

In any event, one may comfortably predict that the SEC will not back off from its present position that concealment of illegal political contributions is a violation of existing disclosure requirements. While the meat of that prediction is carved from the flesh of the securities laws, the dish is liberally seasoned with the spice of politics. The SEC does not operate in a political vacuum. Absent a radical shift in the public mood, it is highly unlikely that the Commission will retreat from the stand it has taken in the numerous enforcement actions recently brought against corporations charged with or convicted of violating the Corrupt Practices Act or of engaging in commercial bribery. To justify this position the Commission will have to insist on the materiality of relatively small corporate expenditures. This, in turn, will lead to a new definition of materiality. But this new definition, departing from the good old-fashioned economic definition, will raise an array of new questions.

1. *What Crimes Are Material?*

The most obvious question, the one giving rise to the largest volume of public soul-searching by various Commission members,¹³⁵ is where to draw the line. At what point must misconduct

¹³⁴ Memorandum for SEC in Opposition to Plaintiffs' Motion for Summary Judgment, at 8 n.12, *NRDC v. SEC*, 389 F. Supp. 689 (D.D.C. 1974).

¹³⁵ See, e.g., Address by Ray Garrett, Jr., *supra* note 9. Garrett noted:

What is needed, of course, is some perceived standard of materiality in the area of corrupt practices. In the rush of events, this is not easy to achieve. Nor is it easy to discern the point, if there is one, where marginal materiality should give way to anticipated harm.

by corporate management be disclosed? Certainly the test cannot be simply whether the improper behavior violates a criminal statute. One does not have to be irredeemably cynical to recognize the virtual impossibility of operating any large American corporation within the enormously complex, confusing, and occasionally contradictory body of legal rules to which its activities are subject, without continually being at least in technical violation of a few of them, however conscientious the management may be in its efforts to comply with the law. Surely a minor violation, even a knowing one, of the requirements of a health standard, or a pollution control regulation, or an occupational safety rule is not of material importance to an investor—at least not in the economic sense.

Nor would it be wise to hold that every instance of illegal conduct must be disclosed solely because of its possible interest to an "ethical investor." Such a result would lead to the conclusion that all violations must be reported provided that the law in question protects a constituency owning securities. Environmentalists, for example, would be interested in pollution control violations, labor unions in occupational safety violations, consumer advocates in health standards infractions, and so on.

Clearly, the distinction between corporate misbehavior that is material enough to require disclosure under the securities laws and that which is not, must rest on the relative gravity of the criminal activity in question. Although the test is hardly a precise one, I suggest that a crime is material when it is serious enough that it would subject the corporation and corporate officers to substantial public censure. To state the proposition differently: the crime must involve moral turpitude or the corruption of important systemic values, and the criminal act must have been committed deliberately and with knowledge of its criminality.¹³⁶

The relationship of this standard to the various aspects of materiality is evident. First, the direct economic costs to the corporation in the way of fines and legal fees are more likely to be sub-

One outstanding feature in all of this has been the lack of public and helpful responses from the business community. We get some private expressions of alarm from persons who have quickly leaped from the suits that we have filed to the *per se* extreme and deplored the results, but no indication has been shown of a desire to share the burden of developing reasonable standards, either of materiality or, what is vastly more important, of business conduct.

Id. at 12.

¹³⁶ Commissioner Irving Pollack has argued that "[t]he bribery of a foreign official is *per se* a material fact." *The Corporate Rush to Confess All*, BUSINESS WEEK, Feb. 23, 1976, at 22.

stantial in the case of criminal activity of this degree of seriousness. The risks of prosecution are higher, the fines are likely to be heavier, and more money and effort are likely to be required by a defense. Second, the injury sustained by a corporation's public image will naturally be greater where the conduct in question is generally considered more deserving of censure. Third, in committing crimes of such gravity, management has consciously transgressed the community's prevailing moral standards. This insensitivity to community standards raises serious doubts about management's judgment. Fourth, to the extent that the protection of investors requires safeguarding the health of the economic system as a whole, serious criminal activity threatens systemic values that might be properly protected by the disclosure process. Finally, "ethical investors" are obviously more likely to be influenced by grave misconduct than by petty misdeeds.

2. SEC Enforcement Remedies

The line-drawing problem is not the only one created by the "new materiality." The SEC must shape remedies that provide an antidote to the harm. One of the most familiar remedies for breach of the securities laws is an SEC enforcement action in the federal courts, normally to seek an injunction against future violations. An injunction, however, adds little to the penalties already exacted by the criminal process. Moreover, the threat of an injunction by the SEC is not likely to deter executives from committing illegal acts if those executives are not deterred by criminal sanctions. Why should we not simply rely on the criminal justice system to handle corporate illegality?

The answer to this question is found in the ingenuity shown by the SEC in recent years in the creative use of its enforcement powers. For example, in *SEC v. Mattel, Inc.*,¹³⁷ the Commission negotiated a consent decree that required the appointment of two new outside directors and the establishment of audit and litigation committees on the board of directors. It later procured the appointment of a board composed of a majority of outside directors subject to the approval of the SEC and the court.

¹³⁷ [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶¶ 94,754, 94,807. See generally Caplin, *Outside Directors and Their Responsibilities: A Program for the Exercise of Due Care*, 1 J. CORP. L. 57, 69-71 (1975); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188 (1975). But see Malley, *Far-Reaching Equitable Remedies Under the Securities Acts and the Growth of Federal Corporate Law*, 17 WM. & MARY L. REV. 47 (1975).

In *SEC v. Eastern Freight Ways, Inc.*,¹³⁸ the SEC procured a consent judgment against two corporate defendants that provided for the appointment of new outside directors subject to SEC and court approval, the election of a new chief executive, the creation of an executive committee at least one of whose members would be one of the new outside directors, the appointment of a special counsel to conduct a full investigation of the SEC allegations of fraud and to institute such lawsuits as might be appropriate to remedy prior misdeeds, and the appointment of new trustees for the pension funds involved in the alleged fraudulent activities.

Even more apposite is the settlement in a shareholders' action brought by the Center for Law in the Public Interest against the Northrop Corporation and several of its officers and directors.¹³⁹ The suit, which grew out of the firm's bribes and political contributions here and abroad, resulted in an extraordinary consent order, partially based on the securities laws and including the following provisions: (1) the president and chairman of the board was ordered to relinquish the presidency within eighteen months; (2) the board was increased from twelve to fifteen members, sixty percent of whom were to be outside directors; (3) a new executive committee of six was formed, at least five of whom were to be outside directors, and at least three of whom were to be new directors; this committee was instructed to investigate the use of corporate funds for political purposes; (4) outside legal counsel was required to resign from the board and was prohibited from serving on the board in the future; (5) in the future, the audit committee was to be composed exclusively of outside directors and was granted new powers; and (6) a new nominating committee composed exclusively of outside directors was to be appointed; it was to make all management nominations for the board, include their names in the corporate proxy solicitations, and expend corporate funds to support their election.¹⁴⁰ Although the reorganization resulted from a settlement negotiated by two private parties, a federal court, exercising its remedial powers under the securities laws, was to supervise and enforce the agreement.

The SEC has clearly considered the *Mattel* and *Eastern Freight Ways* precedents in designing the ancillary relief sought in the "management fraud" cases. The consent decrees negotiated in

¹³⁸ Civil No. 75-1934 (D.D.C. Nov. 19, 1975).

¹³⁹ *Springer v. Jones*, Civil No. 74-1955-f (C.D. Cal., Jan. 20, 1975). See Caplin, *supra* note 137, at 69-71.

¹⁴⁰ This summary is adapted from Caplin, *supra* note 137, at 70.

those cases have typically included not only the usual injunctions against future violations of the securities laws, but have also required the establishment of special committees of the boards of the companies concerned to investigate the improper payments in question and report to the boards and the Commission. The orders have generally required that the board adopt a statement of policies and procedures with respect to foreign bribes and political contributions and that any future material payments be approved by the board and disclosed in a report filed with the SEC on Form 8-K.¹⁴¹ SEC Chairman, Roderick Hills, has described this approach as being designed to affect the “ ‘governance of the corporations’ by requiring that the boards of directors be provided with adequate information so that appropriate action can be taken to protect the interests of public investors.”¹⁴²

With respect to events that were already history at the time the *affaire* Watergate and its aftermath brought to the surface the problem of corporate impropriety, this relatively temperate approach to the fashioning of ancillary remedies appears to be reasonably effective and, under the circumstances, a good deal more equitable than a more aggressive stance. It is certainly a marked advance over the usual consent judgment in which the defendant admits to no wrongdoing and promises not to do it again.

To the extent that the Commission can continue this creative use of ancillary remedies, the securities laws offer a powerful tool for dealing with future corporate misbehavior. With respect to the difficult and amorphous problem of foreign bribery, the Commission's approach is far superior to the alternatives that come readily to mind. To the extent that bribes or political payments are in fact an inescapable condition of doing business in some countries, the requirement that questionable expenditures be brought to the attention of the board and publicly disclosed in some form leaves corporations some latitude to “do as the Romans do,” while providing safeguards against ill-considered or fraudulently motivated activities that might redound to the detriment of the shareholders and the system as a whole. It also avoids the appearance of interference in the affairs of a foreign nation that would arise out of attempts by the United States to prohibit such payments.

¹⁴¹ See, e.g., SEC v. United Brands, [1975-76 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,420 (D.D.C. 1976).

¹⁴² *Hearings* (statement of Roderick Hills), *supra* note 76, at ____.

However, the matter is not a simple one. Firms may not always be willing to enter into such settlements, and it is far from clear that a federal court would award this sort of relief in a contested proceeding.

Moreover, SEC use of its injunctive power to restructure the decision-making apparatus of large corporations is not without conceptual problems.¹⁴³ The SEC was established principally to administer laws regulating trading in securities, not to supplant state law governing the structures of publicly held corporations. If the SEC presses frequently for institutional changes as major as those in the *Northrop* and *Mattel* cases, it is likely to find itself abandoning the ad hoc approach and establishing general guidelines for institutional modifications. The Commission would then rapidly begin to invade a territory that has heretofore been left exclusively to the law of the chartering state.

But would this result really be so undesirable? The chorus of criticism of the role of the states vis-a-vis large corporations justifiably continues to grow. Although large business has found itself in public disrepute before, we face today a real crisis in the legitimacy of these giant institutions. The abdication by the states of virtually all responsibility for establishing norms for institutional structure and conduct to protect the public interest from abuses of corporate power has generated enormous pressures on any agency with the potential and the inclination to fill this perceived void. The SEC is the nearest thing we have to a rescuing hero. It has not leapt at its opportunity. Nevertheless, the Commission is playing a wider role in dealing with institutional problems presented by the modern corporation. With considerable hesitation, this observer finds himself drawn to the conclusion that the Commission should continue carefully down the path on which it has started.

The SEC's actions are having an effect. Companies are reviewing their policies and procedures with respect to shady activities that had previously been hidden from all but a few directors and top officers. Many corporations are disclosing past peccadilloes and establishing new policies for the future as a result of the widespread publicity given the Commission's activities.¹⁴⁴

¹⁴³ See Malley, *supra* note 137, at 52-59.

¹⁴⁴ Typical is the policy established by one repentant company, filed as part of an 8-K Report with the SEC:

(1) The use of corporate or subsidiary funds or assets for any unlawful or improper purpose is strictly prohibited.

As the special committee of Gulf Oil's board of directors stated, the effectiveness of these new policies "will depend on the spirit in which they are carried out within the organization."¹⁴⁵ But the fact that large corporations are examining their policies and promulgating orders directing the cessation of illegal payments in the future is highly encouraging.

3. *Private Actions*

Since *Kardon v. National Gypsum Co.*,¹⁴⁶ the federal courts have been entertaining private actions for violations of the securities laws. If failure to disclose illegal political contributions and bribes is a violation of the securities laws, the question arises whether private parties may sue the violators. There seems little question that a shareholder could sue for injunctive relief,¹⁴⁷ but a suit for damages, presumably against the officers and directors responsible for the improper payments, is another matter.

The most troublesome form of private action would be a suit by corporate shareholders under Rule 10b-5, claiming that harm resulted from the failure to disclose improper expenditures. Since the Supreme Court has established that the plaintiff must have purchased or sold securities to have standing to bring a 10b-5 damage action,¹⁴⁸ we are concerned here only with actions by pur-

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- (2) No undisclosed or unrecorded fund or asset of the corporation or any subsidiary shall be established for any purpose.
 - (3) No false or artificial entries shall be made in the books and records of the corporation or its subsidiaries for any reason, and no employee shall engage in any arrangement that results in such prohibited act.
 - (4) No payment on behalf of the corporation or any of its subsidiaries shall be approved or made with the intention or understanding that any part of such payment is to be used for a purpose other than that described by the documents supporting the payment.
 - (5) Any employee having information or knowledge of any unrecorded fund or asset or any prohibited act shall promptly report such matter to the auditor general of the company.
 - (6) All managers shall be responsible for the enforcement of, and compliance with, this policy including necessary distribution to ensure employee knowledge and compliance.
 - (7) Appropriate employees will periodically be required to certify compliance with this policy.
 - (8) This policy is applicable to the corporation and all its domestic and foreign subsidiaries.

Quoted in *Hearings* (statement of Roderick Hills), *supra* note 76, at ____-_____.

¹⁴⁵ The "McCloy Report," *supra* note 116, at 291.

¹⁴⁶ 73 F. Supp. 798, *modified*, 83 F. Supp. 613 (E.D. Pa. 1947).

¹⁴⁷ See notes 138-39 and accompanying text *supra*.

¹⁴⁸ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

chasers of securities who claim that they were misled by the corporation's failure to disclose its shady activities.

*Affiliated Ute Citizens v. United States*¹⁴⁹ apparently eliminated any requirement that the plaintiff allege and prove reliance on the omission in making his purchase, so long as the concealed facts are material. This does not mean that a plaintiff who purchased stock in a corporation after it had made, but not disclosed, an illegal political contribution that is material (in the "new materiality" sense) is entitled to damages. Economic materiality should not be abandoned in this context. In an action for damages based on a failure to disclose, the plaintiff should be required to show that the facts in question are sufficiently related to an *economic* appraisal of the company that "a reasonable investor might have considered them important in the making of this decision."¹⁵⁰ Because of the small size of the recent illegal political contributions, that burden would appear relatively difficult to meet in most cases.

Even if the effects of unlawful payments could be shown to have materially altered a firm's economic prospects, the plaintiff would still have to prove damages—*i.e.*, that the price of his stock did decline as a result of the illegal payments. A plaintiff meeting this burden is entitled to an award. But the possibility of establishing even a *prima facie* case strong enough to withstand a motion for summary judgment is sufficiently remote that there need be little fear of a wave of "strike suits" against corporations and their managers as a result of the SEC's new treatment of illegal campaign contributions.¹⁵¹

4. *Foreign Payments*

Private actions stemming from overseas bribes and political contributions may be dealt with in much the same way as domestic payments. However, since they involve systems of law and ethics that may depart significantly from our own, and because they involve business competition with firms not subject to our securities laws, an insistence by the SEC that improper foreign payments be disclosed poses a number of serious problems of a somewhat different nature than those raised by domestic political contributions.

To the extent that overseas bribes involve large amounts of

¹⁴⁹ 406 U.S. 128 (1972).

¹⁵⁰ *Id.* at 153-54.

¹⁵¹ There may, of course, be private derivative actions under state law for the return of unlawful payments by the executives responsible. *Cf.* Cort v. Ash, 422 U.S. 66 (1975); Schwartz v. Romnes, 495 F.2d 844 (2d Cir. 1974).

money or falsification of corporate books, or create substantial risks of expropriation or loss of important contracts, they will often be material in the traditional economic sense. Applying the disclosure rules then becomes a straightforward affair, involving no departure from the role usually played by the SEC. However, full disclosure of the amounts involved, the recipients, and the purpose of the payments would at least inhibit, and probably prevent, most such payments from ever being made. Anything short of full disclosure would vitiate the purpose of requiring disclosure at all, since it would not provide investors with the information necessary to evaluate the risks involved. Many insist, however, that it is virtually impossible to carry on business in some countries without a liberal sprinkling of bribe money to the well-connected. This is particularly so, it is alleged, where there are foreign competitors not inhibited by requirements that they disclose their under-the-table activities. Moreover, officials of some of the countries in question have raised objections to what they characterize as attempts by the United States to impose its ideas of business morality on other nations.

There is no entirely satisfactory way to resolve the resulting dilemma, but a few observations can be made. First, the reasons advanced for considering foreign payments to be material are often less persuasive in these situations. Judgments about the ethical qualities of corporate managers are not so harsh if they pay bribes in a country where to do so is not a violation of the country's ethical standards. If the funds used for such payments are accounted for in a straightforward manner on the company's books (even though the names of the recipients, and perhaps even the country, are kept secret), the dangers of sticky-fingered managers with access to loose cash are significantly reduced. The argument that the SEC should occupy the void created by the absence of any effective state institutional governance of large corporations is much less persuasive when the alleged misdeeds involve legal and ethical systems remote from our own, with respect to which the SEC has little knowledge. If the payments are handled as openly as possible and if they do not create unusual business risks, their disclosure should not be required.

A different case is presented, however, if the risks are significant enough that the payments are economically material in the traditional sense. In such cases, the SEC's first concern should be the protection of investors. Here the possibility that compulsory disclosure of the details of a foreign bribe might prevent the con-

summation of a deal must yield to the superordinate policy embodied in the securities laws. The right of corporations to do business abroad is not a right to expose investors to undisclosed hazards. Distinguishing between those payments that create material risks and those that do not (a task that could be avoided by requiring all to be disclosed), is not easy. The possibility of private damage actions should, however, cause most companies to err on the side of caution.

The most difficult problem is handling the disclosure of improper foreign payments already made. In some instances, disclosure of such payments might lead to a loss of business or assets in the countries where the payments were made. As a result, the very investors the securities laws seek to protect would suffer harm. Fortunately this particular problem is a transitory one, since multinational firms are now on notice that they must report under-the-table dealings abroad when they rise to the level of materiality. More precise articulation of SEC policy in this area would further lessen this problem. For the time being, the approach the Commission seems to have adopted—that firms voluntarily disclosing their questionable overseas activities of the past will be granted some sort of “amnesty” and will not routinely be required to publish the details¹⁵²—appears to be a fairly sensible compromise.¹⁵³

CONCLUSION

The business community finds itself facing a crisis in confidence. Abuse of the environment and corrupt use of corporate funds are only two of the more important varieties of sin with which large corporations have been charged in recent years. And, although some accusations have been unwarranted and some thoroughly irresponsible, ample evidence indicates that large numbers of the most important players in the economic arena have been conducting themselves in a manner rather far from exemplary.

¹⁵² See REPORT ON ILLEGAL PAYMENTS, *supra* note 82, at 6-23.

¹⁵³ The Commission has recently proposed legislation that would: (1) require that '34 Act registrants “make and keep books, records and accounts, which accurately and fairly reflect the transactions and dispositions of the assets of the issuer”; (2) require registrants to maintain internal accounting controls designed to prevent illegal or unauthorized uses of corporate funds; (3) prohibit the falsification of accounting records; and (4) prohibit the making of false or misleading statement to accountants performing audits of registrants under either the '33 Act or the '34 Act. S. 3664, 94th Cong., 2d Sess. (1976). (The bill was approved by the Senate, but not by the House.) See also REPORT ON ILLEGAL PAYMENTS, *supra* note 82, at 63-66.

Protestations that "it is a jungle out there," and that "everyone does it, you have to do it to survive," have begun to sound a bit feeble. Closer examination shows that everyone does *not* do it, and that among those who do not are found some very successful firms. The problem does not lie so much in the alleged naivete or hypocrisy of the American public as in the supposed unwritten code that allegedly justifies such corporate activities, a code clearly condemned by most codes of individual ethics.

One thing should be manifest: these are in large part institutional problems. They arise out of the microstructure of the internal organization of the firms themselves and the macrostructure of the economic and political systems in which they operate. Although it may be possible to deal with these problems by imposing additional layers of substantive regulation on corporations, a more intelligent approach is to alter these structures to encourage more socially acceptable modes of corporate behavior.

Viewed in this light, the SEC actions on which this Article has focused begin to make sense. The Commission is an agency whose mandate is uniquely concerned with the preservation and improvement of institutions. Although the SEC has been justifiably criticized for building undue complexity and expense into the mechanisms by which we raise capital, its fundamental role has traditionally been the delineation and enforcement of fair and effective rules to govern the playing of the game. The philosophy underlying the disclosure principle is that difficult judgments involving conflicts in values or differing appraisals of a set of facts should be made by individual economic actors, not by a regulatory body. That philosophy is consistently carried out in both the environmental disclosure rules and the enforcement activity regarding improper expenditures of corporate funds. These areas are, it is true, outside the scope of the traditional concerns of the Commission. But, as the Commission has consistently maintained, they are not entirely unrelated to those concerns, indeed they are in some ways closely linked.

What is to be remarked about the Commission's actions is that they appear to be motivated in both instances by a clear intention to use the disclosure process to influence primary corporate conduct whose principal impact is on areas of the public interest only tangentially associated with the protection of investors. To the extent that this is true, the Commission has launched a new experiment in the use of its disclosure powers that holds great potential as a tool for improving the governance of large corporations.

APPENDIX

RULEMAKING PETITION OF THE NATURAL RESOURCES DEFENSE COUNCIL AND THE PROJECT FOR CORPORATE RESPONSIBILITY

PROPOSED NEW PARAGRAPHS (G) AND (H) TO ITEM 9 DESCRIPTION OF BUSINESS IN SEC FORM S-1

(g) If registrant directly or through majority owned subsidiaries is engaged in operations or in the manufacture or sale of consumer products or services which operations or products or services, unless controlled or modified, cause material environmental pollution or material injury to valuable natural areas or resources, describe with respect to each major plant facility, process, activity, product or service or group of products services:

- (1) The nature and extent (quantified to the extent feasible) of the resulting pollution or injury to natural areas and resources;
- (2) The feasibility of curbing such pollution or injury to natural areas and resources under existing technology, including a description of the principal alternative courses to that end and the costs and benefits of each alternative;
- (3) Plans and prospects for improving such technology;
- (4) Existing and projected investment and annual operating expenditures for curbing such pollution or injury to natural areas and resources;
- (6) [sic] Applicable legal environmental protection requirements, including requirements for licenses and permits and outstanding court or administrative orders, and the status and effects of compliance with such requirements; and
- (7) Pending legal or agency proceedings, or threats of such proceedings, challenging or calling into question registrant's compliance with environmental protection standards, criteria or guidelines, including all proceedings initiated by private citizens or governmental bodies or both.

Instructions to paragraph (g)

(1) Environmental pollution includes emissions, discharges or deposits into the air or water or into ground waters or upon land with impact beyond the areas owned or occupied or to be owned or occupied by registrant, of substances which are potentially harmful or injurious to human health and welfare, fish or wildlife resources or natural ecosystems. Substances as used here includes but is not limited to all substances regulated or controlled under the Federal Water Pollution Control Act and related state statutes, the Refuse Act and the permit program initiated thereunder, the Atomic Energy Act, the Federal Clean Air Act and related state statutes; and all solid wastes including paper, plastics, glass, organic material, stone, sand, rubber, metals, and related substances. Environmental pollution from the manufacture or sale of consumer products or services includes indirect effects through disposal by the consumer of used consumer products, packaging and containers including, for example, newspapers, paper and plastic packaging, and cans and jars containing foodstuffs. Environmental pollution also includes the creation of excessive and disturbing noises and disagreeable odors.

(2) Injury to valuable natural areas or resources includes the destruction, depletion, or degradation of wilderness, forests, mountains, seashores, parks, recreation areas, open space in and around major urban areas, wetlands, fish and wildlife habitat, and unique scenic amenities. Such injury includes destruction or degradation both by direct intrusion and by inconsistent nearby land uses, whether or not the land is owned by registrant.

- (3) Registrant's environmental pollution shall be deemed material only when:
- (a) such pollution is or has been within five years subject to legal proceedings brought by a federal, state or other government authority or by private citizens to abate such pollution; or
 - (b) such pollution is in violation of applicable law; or
 - (c) registrant is in the business of generating electrical power for sale; or
 - (d) registrant together with its subsidiaries is among the fifteen largest firms in any of the following industries (or such lesser number as in the aggregate accounts for not less than 80% of the total production of such industry within the United States and Canada according to figures available to registrant as of a time within three months of the filing date): coal mining; other mining; petroleum extraction and refining; chemicals and allied products; primary metals; leather and leather products; rubber and miscellaneous plastic products; paper and allied products; stone, clay and glass products; transportation equipment; all transportation; and wholesale and retail trade.
- (4) Injury to valuable natural areas or resources shall be deemed material only when the injury results from registrant's operations and:
- (a) such injury is or has been within five years subject to legal proceedings brought by a federal, state, or other government authority or by private citizens to abate such pollution; or
 - (b) such injury is or was in violation of applicable law; or
 - (c) registrant together with its subsidiaries owns, controls or otherwise has rights to more than \$5 million dollars in forest resources or \$5 million dollars [*sic*] in mineral resources; or
 - (d) registrant together with its subsidiaries is among the fifteen largest firms in each of the following industries (or such lesser number as in the aggregate accounts for not less than 80% of the total production of such industry within the United States and Canada according to figures available to registrant as of a time within three months of a filing date): coal mining; other mining; petroleum extraction and refining; stone, clay and glass products; lumber and wood products; paper and allied products; primary metals; ground transportation; air transportation; residential housing construction; other construction; banking; insurance; and real estate and land development.
- (h) If registrant is required by paragraph (g) of Item 9 to provide the information requested therein, such information should be accompanied by a general statement of registrant's policy toward environmental issues and concerns, including such specific information as may be helpful and desirable.

Instructions to paragraph (h)

The general statement of environmental policy shall, among other things, state whether, and if so to what extent, registrant (1) has changed or altered company policies, production and distribution methods, products, packaging, investments or advertising in order to further environmental values; (2) pre-tests or screens new products, projects, and production methods to minimize or eliminate injury to the environment; and (3) has appointed environmental or consumer advisory groups or has made representatives of environmental or consumer interests members of registrant's board of directors.

[Footnote omitted].