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NEWS

SECURITIES AND EXCHANGE COMMISSION
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SEC INFLUENCE ON CORPORATE ETHICS AND GOVERNANCE

Address by

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Commissioner

Southwest Assembly on
Corporate Ethics and
Governance
Southern Methodist University
Tanglewood, Texas
June 9, 1978

I consider it an honor to participate in this Assembly on Corporate Ethics and Governance. Our discussion topics during this weekend are not hypothetical issues such as might be encountered in a business or law school examination to test the ability of students to solve problems. Nor will we be dealing with abstract philosophical concepts of ethics or morality. We will be considering principles which I believe are essential to the maintenance of our securities markets and our private enterprise economic system.

All civilized society is built upon the fundamental proposition that individuals and institutions act in accordance with a code of generally accepted socio-ethical standards. Some of these standards are codified into law. But layered around the law are other values and beliefs by which men are restrained and the social interest is protected. These ethical self-disciplinary standards supplementing the law are particularly important in a nation such as ours in which we prize individual freedom of action as one of our most basic rights, and believe that governmental rules and regulations should not exceed those necessary to maintain an environment in which private parties are protected and assured an opportunity to seek their own interests as long as they do not infringe on the rights of others or society generally. If, however, institutions or individuals choose, as they may

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in our free society, not to adhere voluntarily to appropriate standards of conduct despite such influences as the church, the family, and professional organizations--additional laws, rules and regulations will inevitably be imposed by government to protect the public from unacceptable practices. Thus the freedom of action which is enjoyed by individuals and institutions is dependent upon their willingness to exercise that freedom in a way that is considered to be appropriate by our society.

The business corporation is one of our great institutions. It is unsurpassed in our free enterprise system as a vehicle through which capital, labor and other resources can be managed efficiently for the production of desired goods and services and has contributed significantly to a standard of living envied throughout the world. Yet, in recent years, confidence in business leaders has declined dramatically. A recent survey conducted by Yankelovich, Skelly and White, Inc. of more than 500 non-corporate American leaders found that in 1977, public confidence in business stood at only 15 percent. In 1968 it was 70 percent. This decline in confidence is due, at least in part, to changes in what is expected of corporations and corporate management in our society and the view that corporations are not meeting these new expectations. The formerly accepted concept that the sole purpose of corporations is to provide desired goods and services at a profit sufficient to obtain needed capital, is now being

questioned. There has been increasing interest ~~and concern~~ about corporate performance relative to such social goals as the hiring and promotion of women and minorities, preserving the environment, and protecting customers. There is also considerable current concern with the economic and political power corporations exercise, and whether they are properly accountable to investors and the public. To the extent these concerns reflect a perception that business is not acting in accord with today's socio-ethical values, there exists the foundation for increased governmental regulation of business.

Business is not alone in being subject to greater scrutiny and criticism. The loss of confidence and questioning of moral and ethical conduct is pervasive and applies to all segments of our society including government, labor, academia, the professions, and religious institutions. Instances of reprehensible conduct in each of these areas provide reason for concern.

Nevertheless, I believe the widespread lack of trust and confidence, apparently based on the belief that the reported problems are typical of our entire society, is unwarranted and is detrimental not only to business corporations but to the proper operation of our free system. Each of us in this Assembly and throughout the country, whatever our position or occupation, bears a responsibility to help strengthen the ethical and moral fiber of this nation and to help rebuild essential trust and confidence. We can do this in a number of

ways. First, of course, we can be sure that as individuals we set an appropriate example in our own activities. We can also help establish a code of conduct for organizations in which we have a leadership responsibility and for professional organizations to which we belong. And finally, we can participate in private and governmental processes which have an influence on moral and ethical behavior. I will not presume to suggest how each of you should respond. You are in the best position to make that determination. I can, however, on the basis of my experience at the Commission, give you my views as to how the Commission in fulfilling its responsibility to administer the federal securities laws may properly have an effect on corporate ethics and governance.

The Commission has significantly less authority over public corporations than it does over participants in the securities industry. We have full regulatory jurisdiction over professional participants in our securities markets such as broker-dealers, depositories, clearing corporations and exchanges and we have the responsibility to assure that our securities markets are honest and equitable. Because honesty and equity are moral and ethical concepts, it can be said that the Commission has a duty to see that appropriate ethical standards are established and maintained in the securities industry. To the extent that other professionals such as accountants and attorneys are involved in securities transactions or the preparation of reports required of public companies, they also

become subject to the securities laws and some Commission authority to set standards and impose remedial sanctions. Although we have broad regulatory jurisdiction over the securities industry it is important to note that the securities laws are structured in such a way as to permit the Commission to regulate primarily through private self-regulatory organizations, an approach which I have always strongly supported because it promotes maximum private decision-making and minimizes government involvement.

The Commission's responsibilities with respect to public corporations are more limited but very significant. The securities laws require public corporations to provide full and fair disclosure of the character and nature of their securities, to facilitate fair corporate suffrage, and to maintain a system of internal controls for safeguarding assets in order to facilitate strong capital markets and protect investors. Investors cannot be expected to entrust their funds to corporate management unless they are assured that the information on which they make investment decisions adequately and appropriately describes the financial condition and operations of the enterprise, that they will be dealt with fairly, and that management is accountable for the use of their money.

Congress has given the Commisssion the responsibility and a number of jurisdictional avenues through which to assure that public corporations fulfill these obligations. Under the Securities Act of 1933 and the Securities Exchange Act of 1934,

the Commission has broad rulemaking authority to prescribe the categories of information which are material to informed investment decision-making.

We also have authority under Section 14(a) of the Securities Exchange Act to promulgate rules and regulations, as necessary or appropriate in the public interest or for the protection of investors, governing the solicitation of any proxy, consent or authorization with respect to any security registered under the Act. The Congress intended Section 14(a) to control the conditions under which proxies are solicited to prevent abuses which had frustrated the free exercise of the voting rights of shareholders. These proxy powers convey the authority not only to require the disclosure necessary to make informed corporate voting decisions, but also to provide comprehensive regulation of the proxy voting process. The Supreme Court has found this to "clearly [reflect] an intrusion of federal law into the internal affairs of corporations . . . ."

A third avenue by which the Commission may have an impact on corporate affairs is through a number of provisions of the Securities Act and the Exchange Act which grant the Commission broad rulemaking authority with regard to the form, content, method of preparation, and certification by independent accountants of financial statements to be filed with the Commission. Another relevant statutory provision is the newly enacted Section 13(b)(2) of the Exchange Act which requires public corporations to make and keep books and

records which accurately reflect the transactions in and dispositions of assets and to devise and maintain a system of internal controls for safeguarding assets and assuring the reliability of financial records. ~~This section authorizes~~ The Commission is authorized to make certain that such systems are in place and operating in the manner intended. A final method to affect corporate practices is through our relationships with and ability to influence securities exchanges, the accounting, academic and legal professions and the business community.

The use by the Commission of these various grants of authority to further the purposes of the securities laws effects corporate ethics and governance both directly and indirectly, sometimes intentionally and sometimes only as a consequence of our efforts to achieve other goals. As I describe the use of our authority in the context of ethical and governance considerations, I would ask you to give particular attention to the uniqueness of the Commission's approach in solving problems and achieving desired results primarily through the private sector rather than through direct governmental intervention in corporate affairs.

Pursuant to our disclosure authority, the Commission has required disclosure of the use of corporate funds for illegal and questionable payments. This has resulted in more than 400 U. S. corporations publicly reporting foreign and domestic payments ranging from rather miniscule amounts intended to assure the performance or receipt of normal governmental services, to the payments of

millions of dollars in order to obtain sales contracts. In a related area, we have taken enforcement actions and issued interpretative releases concerning the disclosure of management perquisites.

Critics have suggested that in most cases the dollar amounts involved in these matters are too small to be material to investors. This view has given rise to the charge that the Commission requires disclosure because the conduct is unethical or immoral and that we have set ourselves up as the arbiters of good corporate conduct. Ethical and moral considerations may well be involved in the events underlying these disclosures, and the disclosure may have ethical consequences, but this is not the basis on which the Commission requires disclosure.

Disclosure of questionable payments and perquisites is material to investors for a number of reasons entirely unrelated to corporate ethics. Illegal and questionable payments are material because they reflect on the ability of the corporation to compete effectively on the basis of price, service, and quality of goods sold. They also create potential liabilities. Such conduct can result in expropriation, extortion, loss of market, and civil and criminal legal actions. Disclosure of perquisites is grounded in Section A of the Securities Act of 1933 which specifically identifies the remuneration of officers and directors as a category of information the Congress believed to be material to investors.

Both perquisite and payment disclosures bear on the effectiveness of the company's system of internal controls. One of the most basic concepts of our securities laws is that corporate books and records must adequately account for the receipt and disbursement of corporate funds. In the absence of appropriate disclosure based on such records, informed investment and corporate suffrage decision-making cannot occur and corporate management cannot be held accountable to shareholders and the public.

In some instances, illegal and questionable payments and management perquisites are also material because they reflect on the integrity of management. I recognize that there are those who may believe that this is a new materiality criterion being used by the Commission. However, fourteen years ago in the Franchard Corporation opinion, the Commission said, "Of cardinal importance in any business is the quality of its management." In that opinion the Commission defined integrity of management to mean management's "willingness to place its duty to public shareholders over personal interest." In a number of cases which have come before the Commission in recent years, this willingness to place duty to public shareholders over personal interest has been singularly lacking. In the most egregious cases, perquisites and questionable payments have been used to disguise managerial defalcations.

Much of the controversy surrounding some of the Commission's recent actions can be traced to uncertainty about

the concept of materiality. The Supreme Court has defined a fact as material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote his shares. Presumably the same standard is applicable to investment decision-making. There is nothing in this definition or in the securities laws that would limit disclosure that should be required by the Commission to information that bears a certain dollar and cents relationship to corporate sales or assets. In order to apply the Supreme Court's definition of materiality, the Commission must be sensitive to the information needs of the investing public. When those needs change and are not met through voluntary disclosure by management, the Commission has a responsibility to adopt disclosure requirements to secure the necessary information.

The question, of course, is if investor information needs are dynamic so that the materiality concept is an evolving one, how does the Commission determine what information should be disclosed? The Commission's Advisory Committee on Corporate Disclosure wrestled with this problem and suggested that the Commission look (1) to articulated sentiments of investors; (2) to investment decision-making literature and research; and (3) to its own judgment to make these determinations. This formulation is helpful but the problem in these decisions is to determine what information is of such value to shareholders and the public to outweigh the cost of providing it. There must be a rule of reason, but at some point, if a sufficient

number of investors desire certain information from a corporation, it is required by the federal securities laws.

The disclosure concept is the genius of the statutes which the Commission administers. Disclosure permits the marketplace to make the judgment as to what kinds of conduct are appropriate. If disclosure reveals corporate conduct which shareholders find unacceptable, efforts can be made to influence the corporation either through management, through the board of directors, through political means or through the purchase and sale of securities. I feel strongly about full and fair disclosure because I believe it can greatly assist the business community to regain the confidence which it has lost.

Openness and communication are of basic importance in building trust and confidence. In the Commission's own experience, although there are some problems, the Freedom of Information Act which allows the public to obtain increased information from federal government agencies and the Government-in-the-Sunshine Act which requires federal agencies to hold many of their meetings in public, are very positive forces. They are positive not only because public knowledge about the activities of government officials dispels improper notions but also because being more accountable to the public tends to make government officials more responsible. The same concept applies to corporate officials. The fact that one expects his actions to be the subject of independent review and public scrutiny usually has the remarkable effect of stimulating behavior that is in conformance with currently accepted standards.

Yesterday Schlitz case
first time a court upheld
our action to require
disclosure on a litigated
case

Today
Founded

I characterized our disclosure efforts regarding corporate payments and perquisites as affecting ethics and goveranance indirectly because we did not prohibit such payments or expenditures, we only required them to be disclosed. To the extent the conduct which was the basis for these disclosures ceased because it could not withstand exposure, I view that as an incidental, positive result. I would note that as a result of the Foreign Corrupt Practices Act, foreign corrupt payments are now illegal. ~~But it was not the Commission's goal.~~

The use of the Commission's authority under Section 14(a) to improve corporate governance is a direct policy goal of the Commission. In Securities Act Release No. 13482, issued on April 28, 1977, the Commission announced its intention to conduct a broad re-examination of its rules relating to shareholder communications, shareholder participation in the corporate electoral process, and corporate governance generally. The decision to undertake this review was based, in part, on the fact that recent events, such as the disclosures of questionable and illegal payments, had focused public attention on the subject of corporate accountability and raised questions about the adequacy of existing checks and balances on management. The Commission held almost six weeks of public hearings around the country and solicited written comments. The response was overwhelming. More than three hundred persons and organizations, including corporations, business associations, government officials, public interest and religious groups, law firms, bar

associations, financial analysts, academics, accountants, and individuals testified or submitted comments as to (1) whether existing avenues of communication between shareholders and corporations are adequate; (2) whether the shareholder proposal rule should be amended to further facilitate the presentation of shareholder views in the corporate proxy materials; (3) whether the Commission should amend its proxy rules to enhance the ability of shareholders to participate in the corporate electoral process; and (4) whether additional disclosure relevant to an assessment of the quality and integrity of management should be required. The hearings also considered the need for federal minimum standards or federal chartering legislation, the role of self-regulatory organizations in improving corporate governance, and the costs and benefits associated with various regulatory approaches.

On Wednesday of this week, at a Commission meeting open to public observation pursuant to the Government-in-the-Sunshine Act, we considered preliminary staff recommendations growing out of our corporate governance reexamination. From the staff's recommendations the Commission identified and authorized the staff to proceed with those important matters which it was believed could be developed, proposed for comment and considered for final adoption in time to be effective for next year's proxy season. These included rules requiring disclosure in proxy and information statements regarding the functions, composition and responsibilities of all committees of the board of directors,

affiliations of board members, directors' fees, the number of board and committee meetings held and attendance at those meetings, and director resignations for certain reasons.

The Commission also authorized the staff to prepare for publication a report containing a detailed summary and analysis of the comments received in connection with this reexamination of corporate governance and to give further thought to the broader questions raised, including the adequacy of existing checks on corporate decision-makers, the proper role of [redacted] self-regulatory organizations in improving corporate governance and the desirability of new federal legislation.

I support these recommendations because governance information improves the ability of investors to make investment decisions as well as to exercise their corporate franchise rights by providing valuable insights into how well the corporation is run and how the board of directors exercises its function of monitoring management action and assuring that management is properly accountable. In our hearings Robert Conant, of the TIAA-CREF Teachers Pension Fund, expressed investor interest in this kind of information by saying:

> [w]hen corporate governance breaks down, our experience has shown that the result frequently is poor investment return. When management of a corporation is innovative, progressive and when it demonstrates socially responsible attitudes toward its business activities, that corporation more likely than not will be a good long-term investment.

An added benefit of this disclosure is that it will tend to raise the level of corporate director performance.

The Commission has also fostered effective corporate governance through the involvement of independent monitors in the corporate governance process. The Chairman of the Commission and individual commissioners have spoken about the importance of having at least a majority of independent [redacted] members of the board of directors and we have secured the appointment of independent directors in the disposition of enforcement actions. Moreover, I believe the disclosure of director affiliations in proxy material will encourage an increase in the number of independent directors on corporate boards.

Pursuant to our authority to oversee the setting of financial standards and assure the independence of acountants in the certification of financial statements, the Commission has promoted the institution of independent audit committees of boards of directors. As early as 1940 the Commission, in Accounting Series Release No. 19, advocated the establishment of a committee to be selected from non-officer members of the board to make nominations of auditors and to arrange the details of the auditor's engagement. In 1974 Schedule 14A which prescribes the information to be included in proxy statements was amended to require disclosure of whether or not the board of directors has an audit committee. More recently, the New York Stock Exchange, following a Commission suggestion, proposed a rule change, which the Commission approved, to require listed companies to have an audit committee

"comprised solely of directors independent of management and free from any relationship that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment as a Committee member." Two weeks ago we adopted amendments which require disclosure of whether or not any change in the outside auditing firm was discussed and/or approved by the audit committee and/or the board. The Commission has obtained the establishment of independent audit committees pursuant to the disposition of enforcement actions and we are supporting the AICPA project exploring whether the AICPA should require that companies establish audit committees as a condition of an independent audit.

All of our these actions are predicated on our belief that audit committees are an important and useful feature of corporate goverance because such committees serve as links between independent accountants and the shareholders, and increase auditor independence by providing a decision-making body higher than management with ~~whom~~ the auditors may discuss controversial matters.

Concern has been expressed as to whether certain management services such as executive recruitment, marketing analyses, plant layout, product analysis and actuarial services which public accounting firms currently offer to clients compromise auditor independence. In this connection the Commission last September issued for comment proposed rules which would require companies to disclose in

their proxy soliciting material the range of services provided by auditors and the related fees. It was our thought that this information would assist investors to evaluate the independence of auditors. In this same release we also solicited comment on the nature and amount of services which the profession offers to see whether the scope of those services merits additional Commission action. I expect the Commission to consider the outstanding rule proposals in this area later this month.

The Commission also has been following very closely the AICPA's efforts to develop a self-regulatory mechanism, including an SEC Practice Section with an oversight board and a meaningful peer review program. We will report to Congress on July 1 as to whether the Commission deems the progress made by the private accounting profession toward meeting expected standards of performance to be satisfactory.

The recent amendments of the Exchange Act by the Foreign Corrupt Practices Act of 1977 in part require public corporations to devise and maintain a system of internal controls for safeguarding assets and to maintain complete and accurate books and records. Although the Commission has both rulemaking and enforcement powers with respect to these provisions, the only actions which we have taken in the five months they have been in force is to allege their violation in certain enforcement proceedings. It is clear that the amendments provide the Commission with additional authority

through which to further the goals of management accountability and improved reliability of financial reporting. Wholly apart from any Commission action, the fact that these provisions have been enacted should further these goals because the provisions are self-executing.

I have discussed the Commission's authority and activities and how they relate to corporate ethics and governance. Our primary goals as a Commission are to protect investors, maintain strong, efficient and fair securities markets, and assure corporate accountability. In seeking these goals, we have a direct effect on corporate governance and an indirect effect on corporate ethics. Fortunately the securities laws are so structured that the Commission regulates largely through disclosure, which provides a basis for private sector decision-making with respect to investment, capital formation and allocation, and the setting of corporate ethical and moral standards of behavior.

If private shareholders, independent auditors, corporate boards of directors and the public are able to influence corporate management to act in accordance with public expectations, there will be confidence in business corporations and no need for additional federal laws or regulations. Otherwise we can expect additional legislation and regulation with a concomitant adverse effect on private initiative; a reduction in the role of our private institutions

and professions in responsible decision-making and ~~less~~ less
freedom ~~of~~ for corporations to operate ~~in a~~ flexibly ~~and~~ efficiently
manner. and profitably.

~~This~~, I hope we will be able to avoid these consequences.