

FINANCIAL FRAUDS AND RELATED PARTY TRANSACTIONS --  
THE SEC RESPONSE \*

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## INTRODUCTION AND SCOPE OF OUTLINE

The Federal securities laws are premised upon the disclosure of full and accurate information. Such disclosure is essential to informed decision making by public investors and the integrity of the securities markets. The Commission has devoted a substantial amount of its enforcement capacity to the enforcement of the disclosure obligations by public companies.

The disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 are structured and designed to ensure that the revenues and earnings of public companies be fairly and accurately presented to investors.

The Federal securities laws are also designed to provide a mechanism by which public investors may evaluate the manner in which management of publicly held companies fulfills its fiduciary duties with respect to the management of public funds. The securities laws provide such a mechanism through the disclosure requirements of the proxy and periodic reporting provisions of the Exchange Act. Because of the potential for abuse and personal enrichment, the Commission, through its existence, has utilized these provisions to emphasize the disclosure obligations upon public companies with respect to transactions between the corporation and its officers and directors.

Set forth in this outline is a discussion of the provisions of the Federal securities laws which concern financial disclosure and related party transactions and a description of Commission enforcement actions in this area of the securities laws.

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## PART A

### FINANCIAL DISCLOSURE PROBLEMS

#### I. INTRODUCTION

##### A. Financial Disclosure Problems

1. Problems with respect to financial disclosure have existed since interests in corporations and other entities were first offered to the public and continue to the present day. Failures concerning disclosure of financial information by publicly-held companies include the failure to timely disclose any information concerning the financial condition of the entity, the omission of financial information necessary to make the disclosures made not misleading and the disclosure of false and misleading financial information. For example, the Philadelphia Business Journal recently reported that Computer Input Services, Inc., a company engaged in data entry services and the operation of a data processing school, ". . . shocked Wall Street and stunned stockholders as a twisted tale of alleged deception and numbers manipulation. . ." unfolded. The article further reported that shortly after accusations concerning CISI were made the accounting firm of Laventhol & Horwath withdrew its opinion on the financial statements of CISI for its most recent fiscal year.

2. Disclosure failures by public companies have occurred during both favorable and unfavorable economic periods. The motivation for failure to disclose accurate and complete financial information is varied. In many instances a publicly-held company may disclose misleading information to indicate a stable and profitable position in order to conceal deteriorating conditions; to indicate increasing profits and favorable results of operations in order to maintain or increase the price of the company's stock; to conceal diversion of funds to their own use by officers and directors; and to prevent and avoid conditions that would jeopardize proposed business transactions or result in defaults on lending arrangements.

3. In order to present apparent stability and profitability and to prevent detection of the true financial condition from auditors public companies engage in creative accounting. Recently such activity has been described as "cooking the books." False and deceptive accounting practices have included: inflating revenues, overstating sales, inflating inventories, recognizing income prematurely, adjusting accrual accounts, adjusting reserves, understating accounts payable, deferring or capitalizing expenses. In order to accomplish such practices corporate books and records have been falsified; documents have been altered and fictitious accounts have been created to conceal off-the-book payments.

4. In order to offer, sell and maintain market interest in securities, corporations require the assistance of various professionals. The primary participants include investment bankers, accountants, auditors and attorneys. The failure to disclose financial information or the disclosure of false and misleading financial information often requires either the assistance of such professionals or a failure on their part to conduct the type and scope of inquiries concerning the company which their professional positions and responsibilities require.

## II. THE FEDERAL SECURITIES LAWS

### A. Prelude

1. The absence of adequate provisions requiring timely, complete and accurate disclosures concerning companies which offered and sold securities to the public and the rampant speculation in securities on margin lead to the Great Crash of October 1929.

### B. Enactment of the Federal Securities Laws

1. The collapse of the stock market and the severe financial losses suffered by public investors of all income groups required a response by the Federal government. An important decision confronting the Congress was the approach and nature of the federal involvement in the regulation of securities offered and sold to the public.

2. The draftsmen of the Federal securities laws, after lengthy consideration and deliberation, determined that the Federal regulation of the offer and sale of securities and securities markets should be premised upon disclosure. The effects of disclosure were noted by Louis Brandeis in 1914, 19 years prior to the enactment of the Federal securities laws when he wrote: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." Brandeis, L., Other People's Money (1914).

3. President Roosevelt concurred in Brandeis assessment of the importance and utility of disclosure; with respect to the proposed Federal securities laws he stated:

I recommended to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce.

In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.

This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.

S.Rep. No. 47 at 6-7 and H.R. Rep. No. 85 at 1-2, 73d Cong., 1st Sess. (1933).

C. The Disclosure Provisions of the Securities Act of 1933

1. That disclosure is the basic premise underlying the Securities Act is made clear in the description of the Act itself: "An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." A series of provisions implement the disclosure requirements of the Securities Act.

2. Section 5(a) requires that unless a registration statement is in effect as to a security it shall be unlawful to sell such security or to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or delivery after sale.

3. Section 7 provides that the registration statement for securities, other than foreign governmental securities, shall contain the information set forth in Schedule A to the Securities Act. The Commission is authorized by Section 7 to except from the requirement to include the information contained in Schedule A any class of

issuers or securities if it finds that the requirement of such information or document is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement.

4. Section 5(b)(1) makes it unlawful for any person to use the jurisdictional means to utilize a prospectus relating to a security with respect to which a registration statement has been filed unless the prospectus meets the requirements of Section 10. Section 5(b)(2) provides that it shall be unlawful for any person to utilize the jurisdictional means for the purpose of sale or delivery after sale unless accompanied or preceded by a prospectus that meets the requirements of Section 10.

5. Section 10 provides that the prospectus required by Section 5 shall contain items (1) through (28) of Schedule A. The Section further authorizes the Commission to except from this requirement, any statements otherwise required which the Commission by rule or regulation, as not being necessary or appropriate in the public interest or for the protection of investors. The Section further authorizes the Commission to require such additional information as necessary for the protection of investors and in the public interest.

#### D. The Reporting Provisions of the Securities Exchange Act of 1934

1. The Exchange Act requires issuers who meet certain specified criteria to file with the Commission periodic reports containing information concerning the company, its operations, financial condition, the market for its securities and other items.

2. The integral role of these reports in the Federal regulatory scheme was noted by both the Senate and the House of Representatives. The Senate stated that the reporting requirements are "regarded as the minimum which is requisite for the adequate protection of investors" S.Rep. No. 792, 73rd Cong., 2nd Sess. (1934). The House noted: "The reporting provisions of the Securities Exchange Act are a very modest beginning

to afford ". . . long denied aid . . . in the way of securing proper information for the investor." H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 11 (1934). The House further noted the evils which the reporting provisions were designed to impact upon:

the hiding and secreting of important information obstructs the operation of the markets as indices of real value . . . Delays, inaccurate and misleading reports are the tools of the unconscionable market operator and the recreant corporate official . . .

H.R. Rep. No. 1383, 73rd Cong., 2nd Sess. (1934).

3. Sections 12(b) (exchange listed securities) and 12(g)(1) (certain other securities) require corporations whose securities meet certain criteria to register the securities with the Commission.

4. Section 12(b) specifies certain information that must be included in the registration statement and authorizes the Commission to require additional information.

5. Section 13 of the Exchange Act requires every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information and documents in accordance with rules and regulations of the Commission, necessary to keep reasonably current the information required to be included or filed in the application or registration required by Section 12 as described above.

6. Section 13(a)(2) specifically requires issuers of securities registered pursuant to Section 12 to file such annual reports certified by independent public accountants if required by the Commission and such quarterly reports as prescribed by the Commission.

7. Pursuant to this authority the Commission has promulgated Rules 13a-1, 13a-11 and 13a-13 requiring the filing of annual, current and quarterly reports respectively.

8. Section 15(d) of the Exchange Act also requires each issuer which has filed a registration statement pursuant to the Securities Act of 1933, to file such supplementary and periodic reports required pursuant to Section 13 of the Act as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. This requirement remains in effect until such time as the issuer becomes registered pursuant to Section 12 of the Act or if for any fiscal year other than the fiscal year in which the registration statement became effective, if at the beginning of such fiscal year the securities of each class to which the registration statement relates are held of record by less than 300 persons.

#### E. Other Disclosure Requirements

1. In addition to the provisions of the Securities Act and the Exchange Act requiring the disclosure of specific items other provisions of these Acts may impose additional disclosure requirements.

2. Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 promulgated thereunder proscribe fraudulent acts and practices.

3. These provisions, under certain facts and circumstances, may require the disclosure of certain material information and may require the disclosure of information necessary to make other disclosure not misleading.

4. In addition to the specified information required by the Exchange Act to be disclosed in reports and statements Rule 12b-20 provides:

In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.

IV. SELECTED DISCLOSURE ITEMS

A. Description of Business and Property

1. Form 10-K

a. Item 1 - requires information about general development of business over the current fiscal year; plan of operation of business; narrative description of business; financial information about foreign and domestic operations and export sales.

b. Item 2 - requires a description of location and general characteristics of principal plants, mines, and other important physical properties of registrant and its subsidiaries; identification of the industry segment that uses the property; a statement of which properties are encumbered, or not held in fee.

2. Schedule A

a. Item 8 - requires a description of the general character of the business actually transacted or to be transacted by the issuer.

3. Form S-1

a. Item 11(a) - requires a description of business.

b. Item 11(b) - requires a description of property.

B. Information about Management Remuneration

1. Form 10-K

a. Item 4 - Security Ownership of Management and other Beneficial Owners

(1) Requires disclosure of the name of owner of securities, the amount and nature of ownership, as well as the percentage of securities owned.

b. Item 9 - Directors and Executive Officers of the Registrant

(1) Requires a listing of all directors and executive officers of the registrant, a description of their positions and offices and the terms of such positions and offices, and description of their business experience.

c. Item 10 - Management Remuneration

(1) Requires a list of names of the five most highly compensated executive officers or directors and detail their salaries, commissions, bonuses, securities, insurance benefits, and other forms of compensation. This is also to be done with all officers and directors as a group without specifically naming them all.

2. Schedule A

a. Item 4 - Executive Personnel and Promoters - Requires a list of the names and addresses of the directors, and executive officers if a corporation; of all the partners if a partnership, of all the promoters if the business is to be formed.

b. Item 14 - Executive Salaries - Requires disclosure of salaries paid in the last year to directors and officers.

c. Item 22 - Officers, Stockholders or Directors' Interests in Property Acquired - Requires a description of the nature and extent of stock ownership of officers, directors, and stockholders of more than 10% of outstanding securities.

3. Form S-1

a. Item 11(j) - Directors and Executive Officers - Requires a list of all directors and executive officers of the registrant, a description of their positions and offices and the terms of such positions and offices, describe their business experience.

b. Item 11(k) - Management Remuneration and Transactions - Requires a list of names of each of the 5 most highly compensated executive officers or directors and detail their salaries,

commissions, bonuses, securities, insurance benefits and other forms of compensation. Disclosure of all officers and directors as a group - without specifically naming each officer or director.

C. Financial Information Required

1. Form 10-K

a. Item 6 - Selected Financial Data - Requires a summary of selected data for the last 5 years of operation. Data includes net sales or operating revenues, income (loss) from continuing operations, income (loss) from continuing operations per common share, total assets, long term obligations and redeemable preferred stock, cash dividends/common share.

b. Item 8 - Financial Statements and Supplementary Data - Requires financial statements meeting the requirements of Form S-X and Item 302 of Form S-K (selected quarterly financial data, disagreements on accounting and financial disclosure matters, information on effects of changing price).

2. Schedule A

a. Item 25 - Balance Sheets - Requires the inclusion of the assets of the issuer and liabilities of the issuer.

b. Item 26 - Profit and Loss Statements - Requires disclosure of the issuers' earnings and income, its nature and source, the expenses and fixed charges for the latest fiscal year available.

3. Form S-1

a. Item 11(e) - Financial Statements - requires financial statements meeting requirements of Form S-X.

b. Item 11(f) - Selected Financial Data - Requires the information of Item 301 of Form S-K (see 1(a) above)

c. Item 11(g) - Supplementary Financial Information - Requires the information required by Item 302 of Form S-K (see 1(b) above)

D. Information about the Securities of Registrant

1. Form 10-K

a. Item 5 - Market for the Registrants' Common Stock and Related Security Holder Matters - Requires information on the principal markets on which stock is traded, the high and low prices, the number of holders of the common stock, the frequency and amount of dividends in the past two years.

2. Schedule A

a. Item 9 - Capitalization - Requires disclosure of the authorized and outstanding amounts of capital stock, the amount paid up, the number and classes of shares in which the capital stock is divided, the par value, and a description of the rights attached to each class of stock.

b. Item 10 - Options In Connection with Securities to be Offered - Requires the disclosure of all securities covered by options, disclosure is also required of all person who own more than 10% of all options.

c. Item 11 - Amount of Stock Issued or to be Offered.

d. Item 13 - Use of Proceeds from Securities.

e. Item 15 - Estimated Amount of Proceeds from Securities.

f. Item 16 - Offering Price to the Public - Requires the disclosure to the public of the offering price, or how such price will be computed, any variation in such offering price and name of persons getting such an offering price.

### 3. Form S-1

a. Item 4 - Use of Proceeds - Requires a description of the principal purposes for the proceeds and the approximate amounts to be used for each purpose.

b. Item 5 - Determination of Offering Price - Requires disclosure of how a price was reached when there is no established public trading market.

c. Item 6 - Requires disclosure of the net tangible book value per share before and after the distribution, amount of increase in book value attributable to cash payments of purchases, and the amount of immediate dilution from the public offering price which is absorbed by such purchases.

d. Item 8 - Plan of Distribution Requires disclosure of underwriters or other plans of distribution

e. Item 9 - Description of Securities to be Registered - Requires a description of the securities.

## V. INTEGRATION

1. Both the Securities Act and the Exchange Act require the disclosure of information concerning a corporation whose securities are offered and sold to the public and traded in the public markets. As can be seen from the above description of certain selected disclosure items the registration process and the periodic reporting provisions require the disclosure of similar information.

The two acts operated independently and information was furnished to purchasers of registered offerings although that information was available in the market place through the periodic reporting provisions and thereby reflected in the price of the securities traded. With respect to the apparent tension between the two acts the Commission observed that:

[w]hile both statutes were designed to provide disclosure to investors and the market place, the framework of the Securities Act was transaction oriented, i.e., the focus was upon the public offering of securities by any company. The framework of the Exchange Act was status oriented, i.e., the focus was upon issuers with a class of securities listed and traded on an exchange.

Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6325, Sept. 2, 1980

The Commission has acted to alleviate this tension through the concept of integration. The integration concept is based upon the premise of equivalency between transactional (Securities Act) and periodic (Exchange Act) reporting. The theory is that if the "subject matter is material . . . then it will be material both in the distribution of securities and to the trading markets."

Securities Act Release No. 33-6325.

The Commission revised the structure and content of periodic reporting under the Exchange Act and adopted new registration forms under the Securities Act in order to increase uniformity in mandated disclosure. Integration is accomplished by incorporating by reference information from relevant periodic reports into the registration statements.

## VI. OTHER DISCLOSURE OBLIGATIONS

A corporation which makes a public statement concerning material corporate events subjects itself to a duty to make the statement complete so as not to be misleading. SEC v. Texas Gulf Sulphur Co. 401 F.2d 833 (2d Cir. 1968) cert. denied, 394 U.S. 976 (1969).

In the absence of trading in its own securities the federal securities laws do not generally impose an obligation on an issuer to disclose material information in its possession.

Staffin v. Greenberg, 672 F.2d 1197 (3d Cir. 1982). An issuer in the absence of other facts is also not under a duty to correct statements made by others that are not attributable to it. Elkind v. Liggett & Myers Inc., 635 F.2d 156 (2d Cir. 1980).

In an effort to circumvent this general rule, plaintiffs have argued that an issuer that becomes aware of rumors in the marketplace becomes subject to a duty to make such disclosures as necessary to correct or verify the rumors or to request a halt in trading. The court in State Teachers Retirement Board v. Fluor Corp., 654 F.2d 843 (2d Cir. 1981) rejected this argument holding that a company has no duty to correct or verify marketplace rumors unless these rumors can be attributed to the company.

The Liggett court did recognize that an issuer by activity such as making corrections in statements by others may so entangle itself in the statements that the statements are attributable to it. The court premised this conclusion on the theory that by having commented on the statements the issuer makes an implied representation that the information is correct or at least in accord with its views.

The Liggett court also stated: "Liability may follow where management intentionally fosters a mistaken belief concerning a material fact, such as a company's progress and the earnings prospects in the current year." 635 F.2d at 164.

Prompt disclosure of material information to the marketplace has always been a prime concern of the Commission. On those occasions when a company's stock is actively traded and the company has reason to believe that persons may have access to material inside information and may be acting upon that information, prompt disclosure of material facts is particularly important. The Commission in a report issued pursuant to Section 21(a), Report of Investigation In the Matter of Sharon Steel Corporation As It Relates to Prompt Corporate Disclosure, Securities Exchange Act Release No. 34-18271 (Nov. 19, 1981) stated:

"The disclosure obligations of public companies are a matter of great importance to shareholders and the securities markets. In the past, the Commission has regularly emphasized the responsibilities of public corporations promptly to disclose material developments. In those instances such as described (herein), where there are indications that information may have become selectively available to certain persons who are trading in a corporation's securities, disclosure is especially significant in order to apprise the marketplace of the material information and substantially reduce the opportunity for such persons to profit from such trading . . ."

The listing agreements between an issuer and an exchange generally contain provisions which require the issuer to make prompt disclosure. See e.g., New York Stock Exchange Manual section A-23 and the American Stock Exchange Company Guide § 402(3). See also, Intercontinental Industries Inc. v. American Stock Exchange, 452 F.2d 935 (5th Cir. 1971) cert. denied, 409 U.S. 842 (1972).

## VII. ENFORCEMENT PROVISIONS

The Securities Act and the Exchange Act provide various means to enforce the disclosure provisions.

### A. Stop Order Proceedings

Section 8(d) of the Securities Act provides that if it appears that any registration statement contains any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading the Commission may, after notice and opportunity for hearing, issue a stop order suspending the effectiveness of the registration statement.

Section 8(e) provides that the Commission is empowered to make an examination in any case in order to determine whether a stop order should issue under Section 8(d). Section 8(e) further authorizes the Commission or its officers to