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Foreign Bribes and the Securities Acts' Disclosure Requirements

The Securities Act of 1933 and the Securities Exchange Act of 1934 require most major corporations to disclose to investors all material information concerning company operations. Although they were not intended to regulate the conduct of business, these disclosure obligations can have a deterrent effect upon improper corporate activities. The recent revelation that a significant number of corporations have been making bribes and similar payments abroad has created interest in the feasibility of employing the disclo-

3. See text at notes 16-31 infra.
5. Both of the acts were adopted shortly after the stock market crash of 1929. Analyses of the causes of that disaster indicated that half of the securities issued subsequent to World War I had proven to be worthless—a loss to investors of some 25 billion dollars. H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). This speculation in worthless or overpriced securities to the disadvantage of the average, uninformed investor was the principal factor that led President Franklin D. Roosevelt to request the passage of national securities laws. See S. Rep. No. 792, 73d Cong., 2d Sess. 1-2 (1934). Thus, one of the significant evils that Congress set out to rectify was the absence of adequate information in the securities markets upon which the investing public could reliably base its investment decisions. The express purpose of the Securities Act of 1933 was "that there should be full disclosure of every essentially important element attending the issue of a new security." H.R. Rep. No. 85, supra, at 3. Similarly, a principal purpose of the Securities Exchange Act of 1934 was to cope with "the secrecy surrounding the financial conditions of corporations which invite the public to purchase their securities." S. Rep. No. 792, supra, at 5. The deterrent effect of public exposure of information was clearly recognized when the acts were adopted: "The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions; to force knowledge of them into the open is largely to restrain their happening." Frankfurter, The Federal Securities Act: II, FORTUNE, Aug. 1933, at 55. Congress, however, expressly denied that the acts resulted from any purpose on the part of Congress to regulate the conduct of business: "Nor is its purpose or effect to regiment business in any way." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3 (1934); "The principal objection directed against the provisions for corporate reporting is that they constitute a veiled attempt to invest a governmental commission with the power to interfere in the management of corporations. The committee has no such intention . . . ." S. Rep. No. 792, supra, at 10.
7. See, e.g., How Clean Is Business?, NEWSWEEK, Sept. 1, 1975, at 50. It does not seem that such practices are isolated instances of corporate indiscretion. A significant number of corporations are under Internal Revenue Service investigation for
ensure requirements to curtail this practice. This Note will show that, despite recent pressures for change, the Securities and Exchange Commission has continued to view its disclosure requirement as applying primarily to material information of financial, rather than of social or political, concern to investors. Improper payments in foreign countries can, under certain factual conditions, be found material in this traditional sense through ad hoc adjudication. The Note will then demonstrate the difficulty of delineating new tests for materiality that could be made specifically applicable to all improper payments abroad. It will further argue that, even if payments can be brought within the scope of disclosure requirements, the deterrent effect would be insufficient to curb objectionable conduct. The Note concludes that reliance upon the securities laws to control improper corporate conduct abroad is thus inferior to the direct sanctions normally used by society to prevent antisocial behavior and may, in fact, undermine the traditional purposes of federal securities legislation.

In the federal securities laws, Congress enumerated certain financial and factual information that the SEC could require corporations to disclose through registration and periodic reporting. The SEC was also granted the broad authority to make rules “necessary or appropriate in the public interest or for the protection of investors.”


8. See, e.g., Address by R. Garrett, Jr., Chairman of the Securities and Exchange Commission, American Society of Corporate Secretaries, Inc., Homily on the Glories of Right Conduct and the Wages of Sin, June 27, 1975 [hereinafter Garrett]; Newsweek, supra note 7. Congress has also begun to consider the feasibility of curtailing such conduct. See S. 3133, 94th Cong., 2d Sess. (1976); S. 3379, 94th Cong., 2d Sess. (1976); text at notes 132, 133 infra.


10. The efforts of the SEC with respect to improper corporate expenditures abroad have focused primarily on large payments intended to have a significant impact upon the company’s foreign business. See Newsweek, supra note 7; Wall St. J., Sept. 9, 1975, at 1, col. 6 and at 11, col. 1-2 (midwest ed.).

11. Some payments have been in excess of 100 million dollars. Newsweek, supra note 7, at 50. There seems to be little disagreement that payments of such magnitude must be disclosed. See generally Garrett, supra note 8; Wall St. J., Sept. 9, 1975, at 1, col. 6 (midwest ed.).

12. See note 4 supra.


14. 15 U.S.C. §§ 77a, 77j, 78l, 78n (1970). See also 15 U.S.C. §§ 77a, 78w (1970). Somewhat different language was employed with respect to section 13(a) of the Securities Exchange Act. This section confers the power to require any information in periodic reports necessary to keep the registration information current “as necessary or appropriate for the proper protection of investors and to insure fair
While this appears to be a virtually unrestricted mandate for the exercise of its rulemaking power, in practice the SEC has followed an implicit statutory requirement that only "material" facts need be disclosed. Whether improper foreign payments fall under the disclosure requirement turns largely on SEC and judicial constructions of "materiality."

The term "material" is not defined in either of the securities acts. The legislative history indicates that the primary congressional aim was to elicit financially significant information crucial to proper valuation of publicly offered securities, the type of disclosure that
would be “demanded by competent bankers from their borrowers. . . .”18 Still, there are indications that Congress recognized that other matters might be important to an investor and that “materiality” might encompass more than narrow financial concerns. This is reflected in the Senate’s view of what the provisions of the Exchange Act governing proxies19 were to provide: “In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders’ meetings.”20 The passage can be interpreted as express congressional recognition that a stockholder’s concerns as an owner about the activities of his corporation may be very broad. An example is the interest of the stockholder in the integrity and ability of directorial candidates.21 This construction of the proxy provisions certainly illuminates congressional understanding of “materiality” as used in the registration and reporting contexts. Some commentators have concluded that the language of the securities acts encompasses virtually any information of potential importance to investors, regardless of its nature or quality.22

In accord with the traditional approach of the judiciary toward corporate disclosure, the Supreme Court has recently taken an expan-
sive view of the statutory materiality concept. In *Mills v. Electric Auto-Lite Co.*,\(^{23}\) corporate directors urging approval of a merger with another corporation omitted from a proxy statement the fact that they were nominees of that other corporation. Holding this omission to be material, the Court said that it was of "such a character that it *might* have been considered important by a reasonable shareholder. . . ."\(^{24}\) Similarly, the Court in *Affiliated Ute Citizens v. United States*\(^{25}\) held that it had been a material omission for persons who bought securities from the plaintiffs not to reveal that the securities were being purchased for resale. The Court observed that "[a]ll that is necessary is that the facts withheld be material in the sense that a reasonable investor *might* have considered them important in the making of this decision."\(^{26}\) While it is arguable that a recent Supreme Court decision may now have narrowed the definition of materiality, the broad concept articulated in *Mills* and *Affiliated Ute* has been recognized by lower courts.\(^{27}\)

In all these cases, the courts made determinations of materiality in specific fact situations. It is the role of the SEC, through its rule-making power, to delineate categories of information that are material in recurring corporate contexts and that must therefore be routinely disclosed.\(^{28}\) A Commission disclosure rule could be rejected under the Administrative Procedure Act\(^{29}\) only if a court found it to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."\(^{30}\) No cases of judicial invalidation of an SEC interpretation of materiality have been found. Thus, the already expansive formulations of materiality upheld by the courts may reveal only a minimum level that could easily be broadened further through SEC rule-making.\(^{31}\) This is support for the proposition that the


\(^{24}\) 396 U.S. at 384 (emphasis added).


\(^{26}\) 406 U.S. at 153-54 (emphasis added).


\(^{28}\) "[The securities] statutes grant the SEC broad rulemaking authority. The language of the acts suggests that the SEC is empowered to exercise its informed discretion about which information will be required to be disclosed in the various corporate filings." *Natural Resources Defense Council, Inc. v. SEC*, 389 F. Supp. 689, 695 (D.D.C. 1974).


\(^{31}\) The reviewing court's decision would not properly be based upon its own, perhaps more limited, notion of materiality; "the court *will exercise* restraint and *affirm* the agency's action even though the court would on its own account have made
Commission has the authority to require routine disclosure of the improper expenditure of corporate funds in foreign countries, regardless of whether the amount involved was financially significant to the company or the investor.\(^{32}\)

In operating under its broad enabling act mandate, the SEC has adopted procedures and rules that, if read literally, would compel disclosure of any questionable foreign payment. All moderate-sized corporations\(^{33}\) and most corporations, irrespective of size, that seek investors' funds through a public offering,\(^{34}\) must file one or more forms with the SEC.\(^{35}\) The disclosure requirements of three of them\(^{36}\) embrace a concept of materiality potentially applicable to foreign payments.

First, each form requires that, "if the registrant and its subsidiaries engage in material operations in foreign countries, or if a material portion of sales or revenues is derived from customers in foreign countries, appropriate disclosure shall be made with respect to different findings or adopted different standards." Greater Boston Television Corp. v. FCC, 444 F.2d 841, 851 (D.C. Cir. 1970), cert. denied, 403 U.S. 923 (1971).

32. The SEC objects that the provision of S. 3133, 94th Cong., 2d Sess. (1976), requiring disclosure of any expenditure that exceeds 1000 dollars would deny the Commission needed flexibility. SEC Report on Questionable Practices, supra note 21, at 60. Yet the Commission is also of the view that questionable or illegal payments, if unknown to the board of directors, could be grounds for disclosure regardless of the size of the payment itself or its impact on dependent business because the fact that corporate officials have been willing to make repeated illegal payments without broad knowledge and without proper accounting raises questions regarding improper exercise to corporate authority and may also be a circumstance relevant to the "quality of management" that should be disclosed to the shareholders. Id. at 15.


35. The Commission has adopted a variety of specialized reporting forms that a corporation must submit in order to register securities under either of the acts or to comply with the periodic reporting requirements of section 13 of the Securities Exchange Act. See 17 C.F.R. §§ 239.4 to 239.61, 249.208a to 249.450 (1975). The basic forms include: Form S-1 to be employed in registration under the Securities Exchange Act, 17 C.F.R. § 239.11 (1975); Form 10 to be employed under the registration requirements of section 12(b) of the Securities Exchange Act, 17 C.F.R. § 249.210 (1975); and Form 10K to be employed under the annual reporting provisions of section 13 of the Securities Exchange Act, 17 C.F.R. § 249.310 (1975). These forms require disclosures that, in the proper circumstances, could apply to improper foreign payments, including demands for the following information: on the use of anticipated proceeds from the sale of a new security issue, Item 3 of Form S-1, 2 CCH Fed. Sec. L. Rep. ¶ 7123, at 6203 (1974), on pending legal proceedings against the corporation of a material nature, Item 12 of Form S-1, 2 CCH Fed. Sec. L. Rep. ¶ 7123, at 6211-13 (1976), and Item 5 of Form 10K, 3 CCH Fed. Sec. L. Rep. ¶ 31,103, at 22,057 (1976), and on past and pending criminal actions against a director or executive officer, Item 16 of Form S-1, 2 CCH Fed. Sec. L. Rep. ¶ 7123, at 6214 (1974).

the importance of that business to the registrant and the risks attend­
ant thereto.37 The disclosure of special risks may be appropriate
where favorable treatment in a foreign nation is dependent upon
improper payments, since discovery of such practices could lead to
serious repercussions for the company.38 Second, each requires a
financial statement,39 the deliberate falsification of which is a viola­
tion of the securities laws.40 A clear example of deliberate falsity
would be the operation of a secret “slush fund” by the corporation:
“Phony book entries and unaccounted for funds are wholly inconsist­
ent with financial integrity. When they are deliberately produced by
the conscious policy of top management, or its benign neglect, the
problem is serious and investors ought to know about it.”41 Even if
it includes disbursements in the accounting statements, management

37. Item 9 of Form S-1, 2 CCH FED. SEC. L. REP. ¶ 7123, at 6211 (1974);
Item 1 of Form 10, 3 CCH FED. SEC. L. REP. ¶ 27,303, at 21,306 (1976); Item 1
of Form 10K, 3 CCH FED. SEC. L. REP. ¶ 31,103, at 22,055 (1976). Another form
 provision that may have application requires, “If a material part of the business is
dependent upon a single customer or a few customers, the loss of any one or more
of whom would have a materially adverse effect on the business of the registrant,
the name of the customer or customers, their relationship, if any, to the registrant
and material facts regarding their importance to the business of the registrant [must be
reported].” Item 9 of Form S-1, 2 CCH FED. SEC. L. REP. ¶ 7123, at 6207 (1974);
Item 1 of Form 10, 3 CCH FED. SEC. L. REP. ¶ 27,303, at 21,302 (1976); Item 1
of Form 10K, 3 CCH FED. SEC. L. REP. ¶ 31,102 at 22,053 (1976). Depending on
the definition given to the word “material,” it appears that a company doing a large
volume of business with a foreign country would be required to divulge conditions
critical to that business, e.g., kickback agreements with foreign officials.

38. The discovery of such conduct in foreign countries has had diverse con­
sequences. The Japanese government, for example, indicated that it would exclude the
Lockheed Corporation from consideration as a contractor on a one-billion-dollar anti­
Disclosure of bribes to government officials in Honduras led to demands for national­
ization of the wrongdoing corporation’s assets and was shortly followed by the over­
throw of the country’s president, a suspected recipient of the bribe. Wall St. J., May
15, 1975, at 1, col. 6 (midwest ed.). According to one analysis, “[P]ublic knowledge
that a company is making such illegal payments, even of a minor nature in one for­
egnival country could cause not only expropriation of assets in that country but also
a similar reaction or a discontinuance of material amounts of business in other coun­

39. Item 21 of Form S-1, 2 CCH FED. SEC. L. REP. ¶ 7123, at 6218 (1974);
Item 18 of Form 10, 3 CCH FED. SEC. L. REP. ¶ 27,303, at 21,317 (1976); Item 10
of Form 10K, 3 CCH FED. SEC. L. REP. ¶ 31,103, at 22,060 (1976).

40. 17 C.F.R. § 240.10b-5 (1975). For this rule to apply to corporate mis­
statements, it is not necessary that the corporation itself be directly involved in the sales
See also Garrett, supra note 8, at 21-22.

The SEC has concluded that “the existence of inaccurate records has . . . often
provided an independent basis for requiring some form of disclosure or the initiation
of Commission enforcement action, regardless of whether the payments themselves
were of material size or a material amount of business depended on their continuation.” SEC Report on Questionable Practices, supra note 21, at 15. The SEC, how­
ever, has suggested, in draft legislation proposed by the Commission, that the effect
of such falsifications be made even clearer. Id. at 64.

41. Garrett, supra note 8, at 22. See also note 40 supra.
may attempt to hide transactions through the use of “euphemistically
titled account[s].” However, Regulation S-X, the Commission's
accounting rules, contains a “catch-all” requirement for disclosure
in those situations that cannot be anticipated or enumerated in the
general accounting specifications but in which disclosure is “necessary
to make the required statements, in light of the circumstances
under which they are made, not misleading.” The registration and
reporting forms are supplemented by SEC rules that require disclo­
sure of “material information . . . necessary” to avoid the making of
misleading statements and by comparable proxy solicitation rules.

In deciding their applicability to foreign payments, these forms
and rules on disclosure must be considered in the context of the SEC's
definition of materiality: “The term 'material,' when used to qualify
a requirement for the furnishing of information as to any subject,
limits the information required to those matters as to which an
average prudent investor ought reasonably to be informed before
buying or selling the security registered.” Although it is no easy
task to ascertain the needs of the average investor, it can be said that
the SEC is disposed to define them in terms of economic significance.

This is demonstrated by Natural Resources Defense Council, Inc.
v. SEC, in which plaintiffs sought disclosure of environmental
impact analyses of corporate activities and of specific statistics on

42. Garrett, supra note 8, at 22.
44. 17 C.F.R. § 210.3-06 (1975). Even if the placement of these payments un­
der an accounting title such as “miscellaneous operating expenses” were to be found
not to violate Reg. S-X, disclosure would not necessarily be excused under other re­
quirements. See text at notes 45-46 infra.
45. 17 C.F.R. §§ 240.12b-20 (promulgated under the Securities Act of 1933),
disclosure is, in fact, a requirement in any statement by the corporation, including
communications made outside of the SEC reporting system. Rule 10b-5, promulgated
under the Securities Exchange Act to prevent deceptive practices in all situations in­
volving security transfers, makes it unlawful for any person to omit a material fact
from any statement that would have the result of misleading investors in connection
with a security transaction. See, e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F.2d
90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971), rehearing denied, 404 U.S. 1064
(1972) (liability imposed upon the corporation for misstatements contained in a
press release).
46. See 17 C.F.R. §§ 240.14a-9 (1975) (“No solicitation subject to this regulation
shall be made by means of any proxy statement, form of proxy, notice of meeting
or other communication, written or oral, containing any statement which at the time
and in the light of the circumstances under which it is made, is false or misleading
with respect to any material fact, or which omits to state any material fact neces­
sary in order to make the statement therein not false or misleading. . .”).
47. 17 C.F.R. § 240.12b-2(j) (1975). The rule promulgated under the Securities
Act is identical except that it applies only to those matters about which an “investor
ought reasonably to be informed before purchasing the security registered.” 17
minority hiring. The district court held that a class of "ethical investors" had been improperly denied an opportunity for input during the SEC rulemaking process. The court recognized that the plaintiffs might be primarily motivated by a concern for the environment but argued that their concern might "also proceed from the recognition that awareness of and sensitivity to environmental problems is the mark of intelligent management." The court was "not prepared to say that [ethical investors] are not rational investors and that the information they seek is not material information within the meaning of the securities laws."

Following remand, the Commission held extensive hearings "to obtain the views of the public concerning whether, and to what extent, information that does not necessarily have direct and immediate economic significance might nevertheless be the type of information that a reasonable investor would wish to have in making an investment decision or giving a proxy." Consistent with the court, it found that even investors who advocated disclosure of matters of social significance were motivated by long-term economic concerns. However, by identifying a category of "pure" social matters for which disclosure is unjustified, the Commission appeared not to share the court's deference toward investor decisions made in accord with "high principles and societal interests." Thus, economic significance was

49. 389 F. Supp. at 692.
50. The court took notice of "individuals and institutions such as our great universities and foundations which have large funds to invest and need the information . . . to make investments and voting decisions in accordance with their high principles and societal interests." 389 F. Supp. at 693. See also J. SIMON, THE ETHICAL INVESTOR (1972).
51. 389 F. Supp. at 700 (the court remanded the issue to the SEC so that the plaintiffs could have an input into the Commission's final result).
52. 389 F. Supp. at 700.
53. 389 F. Supp. at 700.
56. The argument presented to the Commission was "that in the long run, corporate social responsibility determines the public relations and regulatory framework within which a company operates." Securities Act Release No. 5627, Securities Exchange Act Release No. 11,733, supra note 54, at 85,724. It is likely that the comments submitted were deliberately cast in economic terms because of the Commission's propensity to focus on matters relating to financial concerns when considering disclosure requirements.
57. Id. at 85,713. ("[D]iscretion vested in the Commission under the Securities Act and the Securities and Exchange Act to require disclosure . . . does not generally permit the Commission to require disclosure for the sole purpose of promoting social goals unrelated to those underlying these Acts"). See also note 15 supra.
58. See note 50 supra.
The fairness of the Commission's procedures must be questioned. Although no-
affirmed as the core of the SEC's understanding of materiality. 59

This remains true, despite the Commission's recent departure in its policy requiring the disclosure of all indictments and convictions under the Federal Election Campaign Act. 60 The amount of money contributed and its purpose are evidently irrelevant to the duty to disclose. The Commission has obviously concluded that such information is per se important to the average investor, even without evidence of its economic significance, for "a conviction is material to an evaluation of the integrity of the management of the corporation . . . " 61

Although the conclusions reached by the Commission concerning the materiality of "pure" social matters and of illegal corporate campaign contributions appear irreconcilable, the disparity can be understood in terms of judicial manageability. Socially significant corporate activities embrace a virtually infinite variety of conduct; determining the standards of materiality would be an extremely difficult task 62 that the Commission is understandably reluctant to undertake. This is not a problem in the case of indictments and convictions for illegal campaign contributions that have been specifically defined by Congress. 64

tice of SEC hearings is published in the Federal Register, it is unlikely that many average investors would be aware of the opportunity to make their views known.

Moreover, the Commission based its decision to limit disclosure not on the finding that social matters do not have a relation to the long-term financial well-being of a corporation, but rather upon the practical difficulties of disclosing social matters and the speculative conclusion that lines could not be drawn to distinguish various matters of social concern. The Commission felt that disclosure in one area would lead to disclosure in others—creating too great a burden on the system. See Securities Act Release No. 5627, Securities Exchange Act Release No. 11,733, supra note 54.


This commentator argues:

Notwithstanding pressures from "public interest" groups, the Commission has thus far refused to expand its disclosure requirements to include matters pertaining to social and environmental issues, except where the information would have a material effect on the financial condition of the corporation. The existence of widespread public interest in a public policy issue is not considered a relevant basis for compulsory disclosure if the public policy concern does not constitute a material element in investor evaluation of securities.

Id. at 1038.


61. Id.

62. In response to the Commission's request for investor interest in socially significant matters, some 100 different interests were identified. Securities Act Release No. 5627, Securities Exchange Act Release No. 11,733, supra note 54, at 85,724 n.72.

63. Id. at 85,724-25.

64. 18 U.S.C. § 610 (1970), as amended, 18 U.S.C. § 610 (Supp. IV, 1974) ("It is unlawful for . . . any corporation whatever, or any labor organization to make a contribution or expenditure in connection with any election at which Presidential or
Improper corporate expenditures in foreign countries seem to bear a close resemblance to improper campaign contributions. Because there has thus far been no legislative finding that particular foreign payments are illegal under United States law, however, the problem of setting standards in this area is analogous to that of defining matters of general social concern. The SEC has therefore relied principally upon traditional notions of financial significance in determinations of the materiality of corporate expenditures abroad. This is evident in recent SEC actions against companies that have paid relatively large amounts of money to acquire significant contracts or concessions.

Adoption of a financial perspective of materiality by no means dispenses with all uncertainty in its application to specific situations. In determining whether a particular payment was improper and material, corporate managers must somehow weigh various factors: the identity of the persons making and receiving the payment; the amount...

65. A bill has been introduced that would make such payments illegal under United States law. S. 3133, 94th Cong., 2d Sess. (1976) reads in part:

PAYMENTS TO OFFICIALS

Sec. 30A. It shall be unlawful for any issuer of a security registered pursuant to section 12 to make use of the mails or of any means or instrumentality of interstate commerce to—

(1) offer, pay, or agree to pay any money or offer, give, or promise to give anything of value to an individual who is an official of a foreign government or instrumentality thereof for the purpose of inducing that individual to use his influence within such foreign government or instrumentality to obtain or maintain business for or with the issuer or to influence legislation or regulations of that government;

(2) pay or agree to pay any money or give or agree to give any thing of value to any person knowing or having reason to know that all or a portion of such moneys or thing of value will be offered, given or promised directly or indirectly to any individual who is an official of a foreign government or instrumentality thereof for the purpose of inducing that individual to use his influence within such foreign government or instrumentality to obtain or maintain business for or with the issuer or to influence legislation or regulations of that government;

(3) pay or agree to pay any money or give or agree to give any thing of value to any foreign political party or official thereof or any candidate for foreign political office for the purpose of inducing that party, official, or candidate to use its or his influence with a foreign government or instrumentality thereof to obtain or maintain business for or with the issuer or to influence legislation or regulations of that government; or

(4) pay or agree to pay any money or give or agree to give any thing of value in a manner or for a purpose which is illegal under the laws of a foreign government having jurisdiction over the transaction.

66. The conduct involved can have widely varying characteristics and, because of the diverse laws and customs of the many countries involved, it is not possible to distill a single standard by which to judge the propriety of the conduct. See generally Garrett, supra note 8, at 17; Newsweek, supra note 7, at 50.

67. It is possible, of course, to argue that this result stems from a practical allocation of resources to those situations representing the "worst" abuses of the disclosure system. For a highly useful summary of the actions taken by the SEC, see SEC Report on Questionable Practices, supra note 21, at B-1 to B-24.
of the payment; the method and correctness of accounting for the payment; the benefits expected to accrue to the corporation; the ethical code of the foreign country involved; and the potential reactions of the host country's government, its citizens, the corporate stockholders and the American public should the payment be discovered. Given the absence of meaningful SEC standards for combining and weighing these factors and the financial motivation that normally exists to keep the payments secret, corporate officials can generally be expected to strike the balance in favor of nondisclosure, except in the most extreme situations of financial materiality.

While the SEC has had some success with the current disclosure requirements, the fact remains that the effectiveness of the system rests largely on good faith, voluntary compliance by corporations. The flexibility of accounting techniques, the scarcity of SEC resources, and the fact that the conduct in question takes place in distant countries combine to make the potential for successful avoid-

68. Garrett, supra note 8, at 21. More recently the SEC has suggested a similar list of relevant considerations, "including the accounting treatment accorded the payments in question; the amount of the payment and its legality under local law; the recipient of the payment and the purpose for which it is made; the knowledge or participation by senior management; the frequency and pervasiveness of the payment practices; and whether the company has taken measures to terminate the activities." SEC Report on Questionable Practices, supra note 21, at 17.

69. The long-awaited guidelines contained in the SEC Report issued as this Note was being prepared for publication are of very little help. They tend to concentrate almost entirely on accounting procedures and requirements and do not give rules that would tell a businessman, or even his lawyer, that certain expenditures must be specifically disclosed, so long as they are properly entered on the books. See generally SEC Report on Questionable Practices, supra note 21.

70. Potentially severe costs may flow from the disclosure of an improper foreign payment. See note 38 supra and accompanying text; text at notes 119-34 infra.

71. But see Wall St. J., May 13, 1976, at 2, col. 3 (midwest ed.) ("By hedging its advice with extensive qualifications, moreover, the SEC made it unlikely that many companies will feel sufficiently confident to omit disclosure without first seeking further commission advice"). The author of this Note does not believe that vagueness and uncertainty will lead to expanded disclosure.

72. But see Wall St. J., Sept. 9, 1975, at 1, col. 6 (midwest ed.) ("SEC enforcement officials bristle at [the claim that guidelines are necessary]. 'The only people who have any difficulty interpreting what we are trying to do are the lawyers' . . . .").

73. At least 14 consent decrees have been entered, and approximately 100 companies have admitted making questionable payments. SEC Report on Questionable Practices, supra note 21, at 54.

74. See Newsweek, supra note 7, at 50. "In the end, the agency can only hope that business plays fair. And despite the current furor over corporate malfeasance, neither the public nor the Congress seems to want a wholesale reformation of the system itself. What they do seek, however, is a business community that lives up to the letter and spirit of the law." Id. at 54 (emphasis in original).

75. See Newsweek, supra note 7. For all their sense of regulatory fervor these days, SEC officials admit that as businesses intent on hiding something in their books learn to build better mousetraps, the investigator's job grows tougher." Id. at 54.

76. See Garrett, supra note 8, at 19; SEC Report on Questionable Practices, supra note 21, at 43.
ance of disclosure obligations a significant concern. Attention must therefore be focused on whether uncertainty can be eliminated and good faith compliance maximized by the framing of a clear standard for compelling disclosure in specific fact situations. It must then be asked whether SEC regulation of the payments through disclosure obligations is a desirable method to use if deterrence is the primary goal.

At least two new approaches to clarifying requirements can be suggested: formulation of bright-line rules concerning size, method and purpose of payment as well as factors such as risk of disclosure to the company; or adoption of a materiality per se rule similar to that used in the illegal campaign contribution context. An initial obstacle to developing bright-line rules is the difficulty of formulating definitive disclosure obligations that meet the informational needs of both the traditional and the "ethical" investor. While SEC Commissioners have the expertise and experience to develop specific requirements concerning financial significance, they have no special capacity to decide which of many social issues should be given priority attention by investors. Nor do they possess unique qualifications to determine ethical standards for corporations and their employees. Moreover, any attempt by the SEC to integrate matters other than financial significance or actual illegality into a bright-line rule will

77. See Newsweek, supra note 7, at 54.

78. A third approach, currently employed by the SEC, relies upon sanitizing the contents of a disclosure to minimize the corporate motivations for not disclosing in the first place. It suggests that "multinational corporations making payments abroad be required to disclose, generically, the existence of such a corporate practice, and perhaps, the extent to which it's engaged in, without specifically identifying who got what." Garrett, supra note 8, at 28. Such an approach is arguably a waste of effort, for it is possible that there will be neither a deterrent effect nor disclosure of information adequate for an investor to quantify the risk involved in the conduct. See SEC Report on Questionable Practices, supra note 21, at 32-33.

79. See generally Garrett, supra note 8, at 26.

80. See generally Garrett, supra note 8, at 20 ("As you can see, if we require disclosure of all violations of laws against bribery or political contributions on the ground that illegal payments are material per se, we may be hard pressed to explain that other illegal corporate acts are not equally material for the same reason") (emphasis in original).

81. For example, Item 12 of Form S-1, employed for registrations under the Securities Act, requires the description of material legal proceedings. In the instructions accompanying that form the Commission has indicated that disclosure is only required if the damages prayed for exceed ten per cent of current assets. 2 CCH Fed. Sec. L. Rep., ¶ 7123, at 6211-13 (1976).


83. See generally Garrett, supra note 8.

84. The Commission could clearly rely on actual indictments or convictions as it has in the area of corporate campaign contributions. See text at note 60 supra; note 69 supra and accompanying text.
undoubtedly produce challenges from public interest and corporate representatives objecting to the rules as being arbitrarily under- or over-inclusive.\footnote{See generally Garrett, supra note 8, at 30 ("We can attempt to set guidelines, but in the end I suspect we will all be less than satisfied with the product of our efforts, unless they are predicated upon actual business experience after consultation with those that have that experience").}

Even if financial significance is the exclusive test for disclosure, it remains a formidable task to articulate definite rules for considering the distinctive features of a foreign payment: method, size, purpose and risk.\footnote{These four factors were noted by former Commissioner Garrett, but were not necessarily intended by him to suggest definite rules. See Garrett, supra note 8, at 21.} If each factor were to be the subject of an individual rule, inadvertent loopholes would undoubtedly permit circumvention of the disclosure obligations in situations in which payments would be plainly material under current practice. On the other hand, if a rule required that all factors be considered together, the materiality of expenditures of equal size would depend on whether they were included in the normal accounting process, whether they were approved or ordered by top management, whether they were connected with future business as opposed to routine service functions, and whether the company would suffer financially if officials of the host country discovered the payments.\footnote{See Garrett, supra note 8, at 21-26.} A realistic disclosure system for foreign payments would have to take this interplay of factors into account; this may be even more difficult to apply than the currently used ad hoc approach to materiality.

It would seem that the difficulties inherent in establishing bright-line rules could be avoided by requiring the disclosure of any improper foreign payment. The adoption of this materiality per se policy, however, would necessitate the promulgation of a clear and explicit definition of the word “improper.” Yet this might again confront the Commission with the intractable problem of trying to encompass concepts of both lawfulness and ethics in its definition. A decision to focus exclusively on legislatively established norms of lawful conduct would simplify the task considerably. Thus, the per se rule could require disclosure of conduct that would have been unlawful had it taken place in the United States. Alternatively, or in addition, conduct that was unlawful in the country where it occurred could be deemed “improper” and disclosure made mandatory. A possible model for this type of provision is the section of the Internal Revenue Code that denies business expense deductions for certain foreign expenditures.\footnote{Int. Rev. Code of 1954, § 162(c). This section states in part: “No deduction shall be allowed . . . for any payment made . . . to an official or employee of any government . . . if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment...}
Such a per se approach is not free of difficulties. Whether conduct is unlawful under either domestic or foreign law is often not immediately obvious; the determination will require individual adjudication in many cases. The uncertainty as to what constitutes illegality may, in fact, create a situation distressingly similar to the present one, in which companies faced with disclosure obligations that are determined on an ad hoc basis in the absence of specific guidelines normally make a reasonable, good faith choice of nondisclosure. The materiality per se approach can encourage disclosure, however, to the extent that corporate managers knowingly involved in unlawful activities will now be put on notice that such conduct is necessarily material.

The materiality per se approach might, moreover, be limited to disclosure only of indictments or convictions of corporate officers and directors relating to improper foreign payments, in a fashion analogous to that currently employed with respect to illegal corporate campaign contributions. This would not involve any interpretation by either the SEC or the regulated corporations, nor would it require a distinction between legal and ethical concepts. The price for this administrative convenience, however, is that it allows companies that escape prosecution also to avoid disclosure obligations. Further, the disclosure will be primarily of historical interest, since it will occur long after the information would have been most useful to investors and probably after any sanctions on the company have been imposed by the host country. As such it will have little informational or deterrent value and therefore is not a viable alternative.

Arguably, the ambiguity in disclosure obligations would be resolved by completely omitting the concept of lawfulness and by requiring companies to report all fees or commissions above a specified amount having any connection with a foreign business transaction. This, however, presents two distinct problems. First, if the

would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee.”

89. See generally notes 68-72 supra and accompanying text.

90. Good faith compliance with a definitive disclosure requirement does not mean that the unlawful conduct will be stopped. See Wall St. J., March 3, 1976, at 3, cols. 1-3 (midwest ed.).

91. See text at note 60 supra.

92. Foreign bribery and payoffs are apparently a common practice among corporations. See note 7 supra and accompanying text. Increasingly, companies are coming forward with disclosure of such conduct. Wall St. J., March 16, 1976, at 28, col. 4 (midwest ed.). In spite of these revelations, very few prosecutions have been initiated.

93. It is possible that the recent extensive media exposure has a greater impact than limited circulation SEC reports.

94. A proposed bill would establish such a threshold amount. S. 3133, 94th Cong., 2d Sess. (1976) reads in part:
threshold amount were a relatively low figure, for instance 1000 dollars as has been recently proposed, the SEC and investors would be inundated with pages of useless information concerning trivial transactions. It may be that theoretically, the objective of full disclosure would best be served by having (1) as many issuers as possible (2) disclose as many facts as possible (3) as completely as possible (4) on a fully current basis (5) with perfect accuracy and objectivity (6) in such form as to be most readable and accessible by all interested investors.

Practically, however, reporting the daily routine of activities in order to ensure disclosure of any improper transactions will simply flood the system with so much information that any value to the average investor would be substantially diluted.

The second problem with the specified monetary-limit approach is that it will be difficult to interpret and enforce. Are all amounts spent, such as payments for meals and taxis, to be aggregated in determining whether disclosure is required? If disclosure is required, should individual items be listed? Should the term "transaction" be broadly or narrowly construed? Can realistic valuations of payments be made when there is a transfer of tangible objects, such as paintings or consumer goods, rather than of cash? An attempt to resolve these questions with certainty would create the same dispute as to over- and under-inclusiveness that led to rejection of bright-line rules.

Sec. 2. Section 13 of the Securities Exchange Act is amended by adding at the end thereof the following new subsection:

(g) Each issuer of a security registered pursuant to section 12 shall file with the Commission periodic reports relating to any payment of money or furnishing of anything of value in an amount in excess of $1,000 paid or furnished or agreed to be paid or furnished by the issuer during the period covered by the report (i) to any person or entity employed by, affiliated with, or representing directly or indirectly, a foreign government or instrumentality thereof; (ii) to any foreign political party or candidate for foreign political office; or (iii) to any person retained to advise or represent the issuer in connection with obtaining or maintaining business with a foreign government or instrumentality thereof or with influencing the legislation or regulations of a foreign government.

95. S. 3133, 94th Cong., 2d Sess. § 2(g) (1976).

96. See Wall St. J., May 19, 1976, at 2, col. 3 (midwest ed.) ("The SEC chairman [said] a requirement to disclose payments in excess of $1000 would put 'a burden on the commission' and 'on the disclosure documents' that registered corporations must file").

97. Cohen, supra note 22, at 1367.

98. See Garrett, supra note 8, at 20 ("If our processes should become so encumbered, we very much fear that they will become less effective for [investor protection]").

99. Reported transactions have included the offer of sporting goods to a purchasing agent in order to make a sale and the gift of an expensive painting from an office wall. See Newsweek, supra note 7, at 52.

100. See text at notes 81-87 supra.
This analysis of the bright-line and materiality per se alternatives has demonstrated the impracticality of designing definitive regulations that would ensure disclosure by good faith registrants. Reluctance to formulate rigid rules governing the materiality of improper foreign payments is reinforced by a review of the possible consequences of a finding that disclosure had been required in a particular case. Thus, if information is material it must be disclosed.\textsuperscript{101} If the disclosure is inaccurate or if part is omitted so that statements made are misleading, certain liabilities may be imposed upon the party required to disclose.\textsuperscript{102} If the disclosure or omission is in a registration statement for a public offering, the defendant may be liable for damages to every buyer.\textsuperscript{103} There is no reliance requirement\textsuperscript{104} and no defense allowed the issuer other than that the plaintiff actually knew the truth.\textsuperscript{105}

It is less clear what damages are available if the misleading statement or omission is not made in a registration statement, but rather, in an annual report\textsuperscript{106} or a press release.\textsuperscript{107} Very few cases under rule 10b-5\textsuperscript{108} ever reach a judgment on the merits,\textsuperscript{109} and settlements, even when published,\textsuperscript{110} do not provide legal authority. It is certain, however, that damages can be very high\textsuperscript{111} and could result in immediate bankruptcy of even the largest companies.\textsuperscript{112}

\textsuperscript{101} See text at note 45 supra.


\textsuperscript{104} "The plaintiff normally need not show any reliance upon the false statement in an action under Section 11; although the defendant may establish a defense by proving that the plaintiff at the time of his acquisition of the security 'knew of such untruth or omission.' " R. Jennings & H. Marsh, supra note 103, at 1026.


\textsuperscript{107} See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (damages available for misleading statements in a press release).

\textsuperscript{108} 17 C.F.R. § 240.10b-5 (1975).


The consequences of a materiality determination are thus potentially quite serious. In the direct privity situation, in which the buyer fails to disclose to the seller information of basic importance or otherwise misleads him, it seems entirely proper that the seller have full recovery. But that is a far cry from holding the buyer of one hundred shares on the New York Stock Exchange liable to every seller during the period a misleading statement or omission was operative. Specifically, consider the situation where a company's annual report fails to disclose that improper payments are being made in connection with the acquisition of foreign contracts. Suppose the payments are not of a character or amount that would be material under traditional standards based on financial significance. It is submitted that liability to every holder or purchaser for the decline in value of the corporation's stock during the period of nondisclosure would be an absurdity. However morally objectionable the conduct, a civil penalty of such magnitude without substantial proof that the specific actions caused the loss is blatantly unfair and can only be described as draconian. It is certainly arguable that the materiality question, whether the information might be important to the average investor, should be analyzed separately from the issue of appropriate damages. The wrong and the remedy must ultimately be harmonious, however, if respect for the legal system is to be maintained. This is a principle from which the SEC and the courts have only rarely departed.

Even if these pragmatic problems of uncertain standards and potentially disproportionate sanctions could be avoided or minimized, the actual deterrence produced by any disclosure system may be insufficient to cause termination of the undesirable corporate conduct. Disclosure of particular activities does not automatically invoke direct condemnation and expressions of corporate blameworthiness. This is illustrated by the SEC reaction to disclosures by Rollins, Inc. that it had made and would continue to make payoffs to local government officials in Mexico in connection with its outdoor

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116. While the preceding discussion suggests that, at least theoretically, the damages for misleading statements or omissions can be astronomical, the seeming unreality of such an eventuality may lessen the deterrence stemming from those potential liabilities.
117. SEC Chairman Roderick M. Hills said, "U.S. companies can continue making payments 'extorted' by foreign tax, customs and other officials as the price of doing business overseas." Wall St. J., April 21, 1976, at 3, col. 1 (midwest ed.).
advertising business. The company claimed that such payments were “customary” in Mexico, a view disputed by a State Department official, and that they would be authorized in the future “where no reasonable alternative is available.” This brought no objections from the SEC.

The disclosure obligation under these circumstances thus amounts to little more than a tariff on business operations in the foreign country. There may be a basic loss in favorable public relations for the company. More direct consequential costs could include civil and criminal prosecutions under the tax laws, loss of significant amounts of potential future business, law suits seeking contract damages, removal of responsible corporate officers, criminal prosecutions in the foreign countries involved, shareholder suits against directors responsible for the payments, expropriation or nationalization of corporate assets located in the foreign countries, and, perhaps most damaging, liability under the securities laws for omission or misrepresentation of material facts in any disclosure document. These costs could obviously vary widely in any given case; public disclosure will be an effective deterrent only if the anticipated costs of disclosure exceed the anticipated benefits. Since the gains are immediate and tangible whereas the costs are speculative and prospective, the financial balance weighs in favor of continuing improper payments. Disclosure will not adequately police corpo-

119. Id. at 3, col. 2-3.
120. Rollins, Inc. fully complied with all United States laws. "Under U.S. law, the payments made aren't illegal, and the company said it didn't deduct the $127,000 for corporate income tax purposes. Nor did the money come from any slush fund or other secret account outside normal channels of corporation accountability . . . ." Id. Three other companies have similarly indicated that they may continue to make such payments. See SEC Report on Questionable Practices, supra note 21, at 46-47.

121. Many investors may believe that there are limits to the means that should be employed by management in pursuit of profits, but undoubtedly some feel that a well-placed bribe leading to increased profits is a mark of good management.
122. Indirect costs would include such things as legal fees and lost productive time for top management officials.
125. Id.
126. Id. See also Wall St. J., Jan. 15, 1976, at 1, col. 6 (midwest ed.).
127. Wall St. J., Feb. 18, 1976, at 4, cols. 2-3 (midwest ed.).
128. Id.
129. Wall St. J., May 15, 1975, at 1, col. 6 (midwest ed.).
130. See text at notes 101-15 supra.
131. See text at notes 117-20 supra. The Rollins Corporation is unwilling to cease paying bribes in light of the profits that are conditioned upon such payments. See generally Wall St. J., March 3, 1976, at 5, cols. 2-4 (midwest ed.).
rate conduct abroad because its effectiveness depends entirely on the vagaries of business profitability.

If the public and its representatives believe that payments made abroad are unethical and should be terminated rather than merely disclosed, direct civil or criminal sanctions are appropriate. A Senate resolution requiring the executive branch to work toward development of an international code of corporate conduct in future trade negotiations\(^{132}\) is a step in this direction, but it did not specify sanctions for a company's failure to comply and therefore contemplates an insufficient deterrent. Senator William Proxmire has taken the next step and proposed legislation that would make it a crime for United States corporations to use bribery in foreign transactions.\(^{133}\) Such direct sanctions have a distinct advantage over the disclosure approach. Civil or criminal penalties for violation of the laws could be set to impose the maximum deterrent effect commensurate with the gravity of the offense involved. The judiciary would have the authority to adjust the penalty in light of the particular circumstances, to guard against the kind of arbitrariness inherent in the disclosure system.\(^ {134}\)

Decisions concerning what conduct is to be proscribed and what sanctions are appropriate will, of course, be as difficult as the analogous decisions concerning disclosure obligations. The former, however, will be made in the context of traditional approaches to harmful conduct, will be accompanied by the safeguards for defendants associated with any criminal proceeding,\(^ {135}\) and will be made by the people's representatives in Congress rather than by the more narrowly constituted SEC.

These qualitative differences between direct and indirect controls on improper corporate conduct are persuasive evidence for the desirability of maintaining the separation of punitive and regulatory laws.\(^ {136}\) The criticism of securities laws that are now over four decades old\(^ {137}\) can only increase in volume and scope if the deterrence of unethical conduct is expressly added to existing goals. The disclosure system may already not be performing adequately the limited task of providing investor information;\(^ {138}\) it is certainly ill-equipped


\(^{133}\) Baltimore Evening Sun, March 12, 1976, at 1, cols. 2-3. See also S. 3133, 94th Cong., 2d Sess. (1976).

\(^{134}\) See text at notes 121-31 supra.

\(^{135}\) If civil rather than criminal sanctions are imposed, the procedural safeguards, such as the burden of proof, would not be as rigorous.

\(^{136}\) This conclusion would seem to apply to the situation in which the securities laws are currently being employed in the area of illegal campaign contributions. See text at notes 60-61 supra.

\(^{137}\) For a recent criticism of the effectiveness of the SEC disclosure system as a tool for economic valuation, see Kripke, A Search for a Meaningful Securities Disclosure Policy, 31 Bus. LAW. 293 (1975).

\(^{138}\) Id.
to take on additional burdens. 139 Perhaps more fundamentally, the hard question of whether society in fact considers corporate payments abroad inimical and demands their cessation should not, and in the long run cannot, be avoided so easily.

139. See Garrett, supra note 8, at 20.