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QUALITATIVE MATERIALITY: THE BIRTH, STRUGGLES, AND DEMISE OF AN UNWORKABLE STANDARD

John M. Fedders*

A quantitative standard of materiality traditionally has been employed when making disclosure decisions under the federal securities laws. The standard utilizes benchmarks of assets, earnings, and liabilities, and is measured by amount, number, or percentage. Its application produces reports of financial results and foreseeable material financial consequences—information that is economically significant to investors.

In the 1970s, a qualitative standard of materiality was introduced by the Securities and Exchange Commission ("SEC" or "Commission"). The standard employed no definable benchmarks. The measurement was by quality, kind, and essential character or conduct. The SEC viewed unadjudicated violations of law, or even antisocial or unethical conduct, as possible grounds for disclosure regardless of size or impact on business because corporate officials were willing to engage in such conduct.

The qualitative standard originated after the Watergate Special Prosecutor charged several corporations with making illegal political contributions to the Committee to Re-elect the President. After inquiry of the SEC into whether and how the violations should be disclosed, it asked how the companies accounted for the payments and whether the corporate boards, outside auditors, and investors knew of this use of corporate assets. From 1974 to 1976, the SEC issued releases and a report focusing on disclosure relating to management integrity and social matters, in and of themselves, without concern as to the economic impact on a company.

The SEC sanctioned a voluntary disclosure program whereby over 500 companies conducted internal investigations for questionable or unadjudicated illegal conduct. The companies reported the results to investors, although there were no injunctions requiring the investigations. The dis-

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closure ambiguities created by the SEC's public statements, and the fear of reprisal by a civil injunctive action if the SEC uncovered such conduct, motivated the corporations to undertake voluntary investigations and disclosure.

While the SEC's invigorated war created uncertainty for those making disclosure decisions, numerous benefits arose from its efforts. Economic life became shaped more sharply by legal and moral principles. In 1977, the Foreign Corrupt Practices Act was enacted, containing new requirements that corporations maintain accurate books and records and employ purposeful internal controls. It also embodied anti-bribery provisions making it illegal to pay foreign officials in order to obtain or retain business.

It was to the SEC’s credit that it confronted the qualitative standard of disclosure issue. However, the generalities of this standard obscured more than they clarified disclosure obligations. Those trying to parse the obligations concerning management integrity through the SEC's imprecise standard became vocal opponents of the new standard. Then, when the SEC stubbornly refused to promulgate rules designed to fill in the details of a broadly stated qualitative standard of materiality, its initiatives suffered fatal consequences.

Strange bedfellows combined to shatter the qualitative standard. In 1976, the United States Supreme Court defined a “material” fact as one that would be “viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Despite the definition, there were no pressures from investors for corporate disclosure of unadjudicated violations of law or antisocial conduct, or for ethical or moral behavior at the corporate level. There was no evidence that investors even utilized qualitative information when making voting or investment decisions. Investors instead craved economic growth, and they sought information that significantly affected a company’s financial performance and consequently translated into stock market gains or losses.

Between 1979 and 1997, federal courts in three civil cases and two criminal cases held that the securities laws do not require management to accuse itself of antisocial or illegal policies or conduct and that it was inappropriate for the SEC to use the securities laws to regulate corporate conduct. One court said such a requirement “would make a silly, unworkable rule.” In 1985, during one of the criminal cases, the Director

of the SEC's Division of Enforcement testified about his assistance with the business ethics investigation of the Southland Corporation ("Southland") in 1977-78, while he had been a private attorney. The testimony was at a Southland executive's trial for failing to disclose, in proxy materials soliciting his election as a director, that he had approved a cover-up of a bribe payment to public officials. Then, in 1986, the SEC Director's 1982 speech\(^4\) abandoning the theory of qualitative materiality was cited as an authority for the reversal of the executive's conviction.\(^5\)

In 1978, the SEC began an investigation of Citicorp to determine whether it had failed to make qualitative disclosures of questionable foreign exchange parking transactions. In 1981, before the investigation was concluded, a new SEC Chairman was appointed. Thereafter, based on conflicting staff advice, the new Commission voted three to one not to authorize an enforcement action against Citicorp. A leak of this non-public decision triggered an investigation and hearings by a subcommittee of the House of Representatives. The 1982-83 hearings trampled on principle and stood on hypocrisy. The arguments in support of a qualitative standard of materiality were so weak as to be meaningless. Those at the SEC opposing an enforcement action against Citicorp were promised, but never given, an opportunity to testify before the subcommittee. Rather than an intellectual sharing with Congress, the hearings sapped any remaining momentum for a qualitative standard. They provided no means for an intellectual resurrection of the standard.

Outside the congressional forum, SEC Commissioners and staff expressed their views about a qualitative standard of materiality. Most Commission policymakers articulated a disclosure policy based on a quantitative standard. Enforcement actions addressing mandated disclosure were assured concerning loyalty and honesty to a corporate employer, including self-dealing or conflict of interest transactions and violations of the accounting and anti-bribery provisions of the Foreign Corrupt Practices Act. However, in 1982, the SEC Director of Enforcement reported that, absent clear rules, enforcement actions would not be initiated against those who failed to disclose unadjudicated illegal acts or immoral or unethical conduct, unless failure to disclose the conduct also

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5. See United States v. Matthews, 787 F.2d 38, 47 (2d Cir. 1986).
impacted traditional quantitative standards of materiality.

With the demise of the qualitative standard, energies must be devoted to developing new disclosure techniques to provide financial information to investors. If management consultants are correct and we are witnessing a profit migration away from products to services, the SEC should foster means whereby corporations can report the economics of human resources and the value of intellectual capital.

This article examines all of the foregoing, with emphasis on the life and demise of the qualitative standard of materiality.

I. DISCLOSURE MANDATE OF THE FEDERAL SECURITIES LAWS: MATERIAL INFORMATION

Precipitated by the 1929 stock market collapse and the Great Depression, Congress established a system through which investors would be provided information material to making investment decisions. It enacted the Securities Act of 1933 ("Securities Act"), instituting a regulatory scheme for the offer and sale of securities. Congress then established the Securities Exchange Act of 1934 ("Exchange Act") to eliminate fraudulent and manipulative practices in the securities markets. The Exchange Act includes general antifraud provisions and affirmative disclosure obligations pertaining to annual, periodic, and proxy reports.

These Acts were premised on the view that investment and voting decisions "should only be made on the basis of full disclosure of all information necessary 'to bring into the full glare of publicity those elements of real and unreal values which lie behind a security.'" Each Act makes it unlawful for reporting companies to disclose any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. The Supreme Court, however, did not define the term "material" until 1976. Even with the benefit of the

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definition, disclosure decisions are arduous.

A. Mandated Disclosure

The SEC has promulgated rules specifying information that must be reported in various disclosure documents. The rules reflect the SEC's judgment of what is material and germane to an evaluation of a company's business, earnings, and prospects. Most of those mandates relate to quantitative information. For example, companies must describe their business and properties and publish financial data. The mandated disclosure requirements continue to increase. Since 1933, the requirements for disclosing financially material information have expanded to include company data by industry segment and the management's discussion and analysis of financial condition and results of operations.

Among the mandated disclosure requirements are several that relate to qualitative-like information, and reflect the SEC's judgment of what is material to an evaluation of the competency and integrity of management. They relate to a corporate official's loyalty and honesty to his employer. They require reporting of self-dealing transactions and conflicts of interest with the employer. They also require the reporting of criminal charges and convictions and any civil judgments involving violations of the federal securities laws. The rules are clear and provide instructions to determine whether a particular disclosure is necessary. Other than the duty to report a criminal proceeding, these mandated disclosure rules do not address unadjudicated violations of law or unethical or anti-social management behavior. Complying with the SEC's disclosure mandates is akin to following assembling instructions. Scrupulous adherence to directions is the prescription for success.

B. Quantitative Materiality and the Leap to a Qualitative Standard

Often it is difficult to determine whether a fact, not mandated to be disclosed by an SEC rule, is otherwise material to the total mix of infor-

16. See, e.g., Item 404 of SEC Regulation S-K, 17 C.F.R. § 229.404 (requiring the reporting of the details of transactions in which certain relationships exist).
17. See, e.g., Item 401(f) of SEC Regulation S-K, 17 C.F.R. § 229.401 (requiring the reporting of certain legal proceedings regarding those who are, or are nominated to be, corporate officials).
mation and thus required to be disclosed. Nonetheless, the task of evaluating facts and drafting disclosure language is the grueling chore of preparing prospectuses and periodic reports.

From 1933 to the 1970s, materiality decisions were almost always based on quantitative facts. Then, in the 1970s, the SEC introduced the notion of qualitative materiality. This new theory adopted the idea that if conduct was illegal, the illegality itself would be of import and material, even if the conduct itself was not financially significant to the company.¹⁸ The stretch to qualitative materiality and disclosures regarding management integrity was unlike any previously proposed SEC rule mandating expanded disclosure. This initiative raised the question “whether, and under what circumstances, [can] the Commission . . . as a matter of authority, and should [the Commission] as a matter of intelligence and discretion, compel disclosure of information not rooted in economic materiality, but bearing on the integrity of management.”¹⁹

The struggle to determine whether a fact is qualitatively material is more difficult than making determinations of quantitative materiality. Economic or quantitative materiality is characterized by facts that significantly affect a company’s financial performance and, consequently, its stock price. The disclosure determinations are made by measuring the amount, number, or percentage of assets, earnings, or liabilities. While judgments of quantitative materiality may be reached objectively without surmise, the means to reach qualitative determinations of materiality encompass subjective components and judgments and have almost no relationship to the financial condition of a company.²⁰ Determinations as to whether management conduct is qualitatively material are measured by quality, kind, and essential character or conduct. Those decisions cannot be made simply by employing arithmetic. Reasonable people will differ in their views as to whether qualitative information is material. This is a chief reason why the SEC’s efforts in the 1970s to establish a qualitative standard met with an explosion of denunciation. Moreover, few believed

¹⁸. See Milton V. Freeman, The Legality of the SEC’s Management Fraud Program, 31 BUS. LAW. 1295, 1296 (1976) [hereinafter Freeman] (comparing economic materiality with qualitative materiality and explaining the development of the latter).


that this new information would influence investors' voting or decisions regarding securities transactions.

II. FAILURES TO DISCLOSE DISLOYALTY OR DISHONESTY TO THE CORPORATE EMPLOYER

The SEC's qualitative materiality initiatives must not be confused with its enforcement actions addressing failure to report self-dealing or conflict of interest transactions. While both types of action relate to management integrity, the latter pertains to disclosure concerning loyalty and honesty to a corporate employer. Such disclosures are mandated. Three cases amply distinguish actions for failure to disclose self-dealing from actions to enforce the 1970s qualitative materiality standard.

In In re Franchard Corporation, the SEC determined that registration statements were materially deficient in their failure to disclose that the chief executive officer ("CEO") used company funds for personal benefit. The Commission concluded that the omitted information rendered misleading several affirmative statements regarding the CEO's reputation. Although the CEO's withdrawals for personal benefit never exceeded 1.5% of the corporation's total assets, the Commission reasoned that the withdrawals were material information subject to disclosure because they were "germane to an evaluation of the integrity of his management." It defined management integrity as management's "willingness to place its duty to public shareholders over personal interest." The SEC thus emphasized management's duty of loyalty to shareholders and expressed no desire to regulate the moral or ethical character of management conduct unrelated to the financial benefit of shareholders.


23. See id. at 171 & n.20.

24. See id. at 169; see also Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972) (omitting information that would have influenced plaintiffs to sell their stock); Zell v. Intercapital Income Sec., Inc., 675 F.2d 1041, 1049 (9th Cir. 1982) (omitting information in proxy statement deemed material to approving investment management agreements); United States v. Stirling, 571 F.2d 708, 713-14 (2d Cir. 1978) (withholding adverse information that was material to an accurate appraisal of the company's future).

25. See Franchard, 42 S.E.C. at 172.

26. See id. at 170 (stating that the information necessary to evaluate management integrity raises the question whether the conduct involved transactions "financially material" to the company).

27. See Branch, supra note 10, at 1458 (defining integrity of management as management's willingness to put shareholders' needs before personal interests); see also United
In *SEC v. Kalvex Inc.*, the court found that failure to disclose participation by the company’s senior officers in a kickback scheme channeling corporate funds for personal use violated the proxy rules of the Exchange Act. The *Kalvex* court, like the SEC in *Franchard*, equated management integrity with loyalty to the corporation and its shareholders. The *Kalvex* court described management integrity as an unwillingness to use the corporation for personal gain.

In *Maldonado v. Flynn*, the court distinguished between the nondisclosure of self-dealing by a corporate director and the failure to disclose transactions that were intended for the corporation’s benefit and lacked any element of self-dealing. The case involved “directors using inside information to gain substantial personal benefits at the Corporation’s expense.” Because the transactions involved self-dealing, the court concluded they were “directly relevant to a determination of whether [the directors were] qualified to exercise stewardship of the company,” and hence were material. The court arrived at this conclusion by contrasting the immediate case with cases involving claims where, in an effort to benefit the corporation, directors failed to disclose that they had approved “illegal foreign payments.” The latter accusation, absent an allegation of self-dealing, was found to charge mere mismanagement. While mismanagement properly may be the subject of a state law cause of action grounded on corporate waste, the court found such an action inappropriate under Section 14(a) of the Exchange Act.

These three cases reflect the significance of management loyalty to
shareholders and compliance with the SEC's mandated disclosure rules. The holdings did not evidence concern about the ethical ramifications of management actions unrelated to the economic condition of the company and mandated disclosure.

III. WATERGATE AND THE DAWN OF A QUALITATIVE MATERIALITY STANDARD

In early 1973, the Watergate Special Prosecutor announced that voluntary and prompt disclosure by corporations of Federal Election Campaign Act violations would be considered mitigating circumstances when determining what charges to initiate against such companies. By mid-year, several enterprises came forward and revealed their activities violated the Act; criminal informations followed. There were inquiries of the SEC's Division of Corporation Finance as to how the violations should be disclosed. As the scope of the disclosures were discussed at the Commission, then under the chairmanship of G. Bradford Cook, inquiries were made by the Division of Enforcement into the facts underlying the criminal cases charging illegal political payments. The SEC's staff asked the companies' officials how they accounted for the payments, and whether the corporate boards, independent auditors, and investors knew of this use of assets. The enforcement staff concluded that there had been violations of the federal securities laws by falsification of financial records to conceal illegal payments and by the existence of undisclosed "slush" funds to make such payments.

A. SEC 1974 Release

After inquiries to the Division of Corporate Finance concerning disclosure of illegal campaign contributions, the Division published a release ("1974 Release") detailing its conclusions. The SEC announced

38. See Freeman, supra note 18, at 1296, 1302 (explaining the history of the development of qualitative materiality).
39. See id. at 1296.
40. See id. (stating that the SEC's Division of Corporation Finance responded to inquiries concerning disclosure of violations of the campaign contribution laws).
42. See McLucas, supra note 41, at 1223.
that a conviction for such a contribution is
a material fact that should be disclosed to the public . . . par-
ticularly in . . . a proxy statement where shareholders are being
asked to vote for management. Such a conviction is material to
an evaluation of the integrity of the management . . . as it re-
lates to the operation of the corporation and the use of corpo-
rates funds.  

The 1974 Release also addressed disclosure of political contributions
which might be illegal, but which had not yet been the subject of a formal
proceeding. 46 Thereby, the SEC for the first time officially broached the
topic of disclosure of unadjudicated violations of law. The release de-
cleared that, “[i]n such cases, management is usually in the best position to
inquire into, to examine and weigh the facts and circumstances and to de-
determine whether disclosure is necessary.”  

Management and its attorneys grappled with the view that “possibly
illegal” contributions might require public disclosure. A debate ensued
about whether, if possibly illegal political contributions required disclo-
sure, unadjudicated illegal activities associated with commercial transac-
tions also required disclosure. 47 Because of failures to disclose unadjudi-
cated violations, “[s]uits were brought by the Commission demanding
disclosure of payments as to which there had been no indictments.” 48
These suits illustrate the SEC’s abandonment of its previously declared
view that corporate management was best situated to make disclosure
determinations about unadjudicated conduct. 49

B. The SEC’s Voluntary Disclosure Program

By early 1975, the SEC began focusing on bribes by corporations and
their agents to foreign officials to obtain or retain business, and other
“questionable practices.” 50 The inquiries revealed that many companies,
including large enterprises, falsified records to conceal corrupt practices and often employed schemes to hide the payments from auditors. As a result of the initiatives, an undefined theory of "ethical materiality" developed concerning the quality and integrity of management and accounting controls, earnings, and assets. This theory became the bedrock for the qualitative materiality standard. But the idea of a broad qualitative materiality concept cut against the rule of law. This standard would prove to be a source of mischief and great harm to the established system of disclosure.

At the time, no United States law or SEC regulation prohibited illegal foreign payments. Yet, the Division of Enforcement instituted a program to promote disclosure of corporate disbursements of questionable legality, thereby creating an indirect method to discourage the practice of questionable foreign payments. The SEC asserted that a company could not fulfill its disclosure obligations under the securities laws, and its duty to file accurate financial statements, "while maintaining off-the-books slush funds and making questionable payments" improperly documented in accounting records.

In 1975, the SEC initiated injunctive actions alleging that corporate books were falsified in order to conceal questionable or illegal activities. Several months later, the Division of Enforcement determined that the magnitude of the problem required an additional disclosure mechanism to supplement these lawsuits. Under the leadership of Stanley Sporkin, then Director of Enforcement and widely regarded for his startling law enforcement virility, the SEC encouraged voluntary disclosure of illegal or questionable payments and practices by urging companies to conduct independent, internal investigations. Corporations with problems con-
cerning questionable payments could meet their disclosure obligations by authorizing an independent investigation and disclosing the material results in reports filed with the SEC. Each volunteer also was required to provide the Division of Enforcement with access to the report of its investigative counsel and the underlying documentation. The SEC announced further that those companies finding questionable activities should terminate the practices and implement a policy prohibiting them. The process trapped corporations into lengthy probes of conduct that professional prosecutors were not likely to pursue. Consequently, the program removed the important check of prosecutorial discretion.

Although the SEC formally stated that participation in its program did not insulate a company from an enforcement action, such participation greatly diminished the probability of an agency proceeding. Companies were motivated to comply with the program by this fact and by the disclosure ambiguities of the SEC's public statements and the fear of an investigation and civil injunctive action if the government independently learned of corrupt conduct. As a result, corporate America acquiesced to the SEC's novel and statutorily questionable disclosure initiative.

Before 1980, over 450 companies publicly reported the results of their inquiries. An indeterminate number, believed to be several hundred, conducted investigations without making any public report. The public reports revealed that hundreds of millions of dollars had been disbursed for bribes, payoffs, or kickbacks. These reports disclosed that falsification of corporate books and the existence of secret slush funds were not isolated problems among multi-national corporations. Rather, bribery had been an integral part of international commerce. The SEC's efforts, and those of the volunteers, exposed that corporate legal and ethical

Commissioner Philip A. Loomis, Jr.

57. See Randall, supra note 41, at 662. Recent court decisions reveal, however, that the confidentiality of these reports is uncertain. See In re Perrigo Co., 128 F.3d 430, 441 (6th Cir. 1997); In re Subpoena Duces Tecum Served on Willkie Farr & Gallagher, M8-85 (JSM), 1997 U.S. Dist. LEXIS 2927, at *5 (S.D.N.Y. Mar. 14, 1997) (eliminating the privilege protection afforded to reports of outside counsel in connection with internal investigations once the conclusions underlying those reports have been disclosed to outsiders).

58. See McLucas, supra note 41, at 1225; see also Randall, supra note 41, at 661-63 (explaining the various benefits available to corporations electing to participate in the voluntary program).

59. See Branch, supra note 10, at 1465 (noting the Commission combined the program’s “subjective and judicially untested interpretations of materiality together with traditional economic analyses of the activities in question”).

60. See id. (reasoning why hundreds of corporations opted for disclosure despite judicial criticism of the program’s authority).

61. See id. at 1463; Randall, supra note 41, at 663 n.25.

62. See Randall, supra note 41, at 663; see also Branch, supra note 10, at 1463.
principles had deteriorated beyond anyone's expectation. Yet, the disclosures of illegalities were of no consequence to investors who generally were ambivalent to punishment for the wrongdoers.

No definitive conclusions can be drawn by comparing the reported results of the investigations. The criteria employed to determine whether a particular course of conduct was "questionable," "illegal," or both, and therefore required to be publicly reported, varied markedly among the companies. Some corporations searched for particular corrupt practices not even reviewed by others. Others reported any activity that met their criteria for "questionable," including conclusions based on conjecture. Still other companies reported no activity unless they were able to conclude beyond a reasonable doubt that it was both illegal and susceptible to prosecution.

The differences among activities reported as "questionable" or "illegal" also varied by reason of the structure and methodology of the investigations. In some instances, corporate boards, audit committees, and special committees of the board directed investigations. Most often the corporation's regular outside counsel conducted the inquiry. However, more independent investigations occurred under the direction of outside counsel who had no prior relationship with the corporation. Conversely, less independent investigations were conducted by in-house counsel. In a few circumstances, auditors managed the inquiry. The methodology of the investigations varied dramatically. Most investigations utilized questionnaires followed by interviews or depositions. Some of the interviewees were prohibited from having counsel in attendance, although others were required to have counsel. Some companies followed the practice that no one outside its employ would be questioned. Those conducting the investigations had neither subpoena power nor the ability to sanction perjury.

Although the SEC initiated the voluntary program, it was the participation of hundreds of corporations that rendered it successful. They willingly spent millions of dollars for legal fees, and incurred the disruption of their business activities, to investigate themselves. The SEC could not have investigated and sued a fraction of the volunteers.

64. See id. § 62.02, at 62-11.
65. See id. § 62.06, at 62-40.
C. SEC 1975 Release

In the midst of promoting its voluntary program, the SEC issued a rulemaking proposal contradicting its prior statements concerning disclosure of unadjudicated questionable conduct. The release concerned disclosure of environmental and other matters of social concern, including equal employment matters. The October 1975 release\(^{66}\) ("1975 Release") tacitly acknowledged that the range of information suggested for inclusion in prospectuses and public reports was virtually infinite. It listed over 100 social and ethical concerns recommended for disclosure, including corporate policy on employment discrimination, political contributions, the Arab boycott, and internal managerial procedures, which necessarily implicated management ability and integrity.\(^{67}\) The release acknowledged that there existed substantial disagreement about the significance of such information to investors, and serious difficulties in disclosing the information meaningfully and fairly. The SEC reported it would not require disclosure of violations of the laws against employment discrimination and concluded the following:

[...]he primary interest of investors is economic. After all, the principal, if not the only reason why people invest their money in securities is to obtain a return. A variety of other motives are probably present in the investment decisions of numerous investors but the only common thread is the hope for a satisfactory return, and it is to this that a disclosure scheme intended to be useful to all must be primarily addressed.\(^{68}\)

The 1975 Release should have provided comfort that illegal employment practices, like other illegal social behavior, did not warrant disclosure. Yet, it did not provide solace because at the time of the 1975 Release, the SEC staff was initiating lawsuits and accepting consent decrees, thus compelling disclosure of questionable or unlawful acts concerning these same "social matters."\(^{69}\) In apparent contradiction to the policy stated in the 1975 Release, the SEC continued to focus on disclosures relating to management integrity and social matters, regardless of their economic impact on the disclosing companies. This contradiction raised speculation concerning the Commission's reasons for publishing one

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67. See id. at 85,724 & n.72. The 1975 Release listed over one hundred "social matters" that would require disclosure, the SEC asserted, if disclosure of unlawful employment activities was warranted. See Freeman, supra note 18, at 1298.

68. 1975 Release, supra note 66, at 85,721.

69. See id. at 85,724; see also Freeman, supra note 18, at 1298.
policy, yet acting in contravention to it.\textsuperscript{70} One commentator reasoned that companies would rather submit to the SEC’s demands than risk deprivation of access to the markets and shareholders.\textsuperscript{71}

\textbf{D. May 1976 Report on Questionable and Illegal Corporate Payments and Practices}

In a Report on Questionable and Illegal Corporate Payments and Practices\textsuperscript{72} ("1976 Report") to the Senate Banking, Housing, and Urban Affairs Committee, the SEC presented the results of its investigations concerning questionable foreign payments and its actions toward rectifying falsification of records and financials. The report described the SEC’s voluntary disclosure program and offered legislative and other proposals. The 1976 Report documented the change from the congressionally mandated SEC policy requiring corporate disclosure of quantitatively material information to a broader initiative mandating the disclosure of information deemed qualitatively material.\textsuperscript{73}

\textbf{E. SEC Rulemaking Authority}

The rulemaking provisions of the securities laws grant the SEC the

\textsuperscript{70} See Freeman, \textit{supra} note 18, at 1301-03.

\textsuperscript{71} See \textit{id.} at 1302-03.

\textsuperscript{72} See generally \textit{Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, Submitted to the Senate Banking, Housing, and Urban Affairs Comm., 642 Fed. Sec. L. Rep. (CCH), pt. II (May 19, 1976) [hereinafter 1976 Report]. The Introduction stated that the purpose of the SEC’s action in the area of questionable payments was “to restore the efficacy of the system of corporate accountability and to encourage the boards of directors to exercise their authority to deal with the issue of questionable payments.” \textit{id.} at b. The SEC Chairman at that time was Roderick M. Hills, who served from October 1975 to April 1977.

\textsuperscript{73} See generally \textit{id.} at 1-56 (setting forth the substance of the SEC’s disclosure policy). The 1976 Report expressed the Commission’s 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 board knowledge and without proper accounting raises questions regarding improper exercise of corporate authority and may also be a circumstance relevant to the ‘quality of management’ that should be disclosed to the shareholders.

\textit{id.} at 15; Russell B. Stevenson, Jr., \textit{The SEC and Foreign Bribery}, 32 BUS. LAW. 53, 69 (1976) (describing the goals of the legislation). In pursuit of this goal, the 1976 Report included proposed legislation requiring registrants to keep books and accounts that “fairly reflect” the company’s transactions and disposition of assets. See \textit{1976 Report, supra} note 48, at 63-64. The goal of the proposed legislation was to establish internal accounting procedures and prohibit both the falsification of accounting records and the making of false or misleading statements to accountants in connection with the completion of audits. See \textit{id.}
authority to require the disclosure of information “necessary to carry out the provisions” of the federal securities laws.\textsuperscript{74} In addition, the Commission is able to prescribe rules “as . . . necessary or appropriate in the public interest or for the protection of investors.”\textsuperscript{75} Irrespective of this broad statutory language, the SEC has interpreted its congressional mandate narrowly, acknowledging that the primary focus of its disclosure requirements is to compel companies to provide “economically significant” information.\textsuperscript{76} These, and other disclosure requirements, are consistent with the Commission’s stated purpose of the protection of investors and the “furtherance of fair, orderly and informed securities markets.”\textsuperscript{77}

As to the voluntary program and the attendant qualitative materiality initiatives, commentators argued that the Division of Enforcement improperly stretched the parameters of the SEC’s mandate and required disclosure solely for the purpose of prescribing corporate conduct.\textsuperscript{78} Critics asserted that not only did the voluntary program force the SEC to violate its statutory mandate, but it inappropriately claimed jurisdiction to police “corporate morality.”\textsuperscript{79} In other words, the SEC “imprecisely

\textsuperscript{74}15 U.S.C. § 77s(a) (1994); see also id. §§ 77a to 77aa; §§ 78a to 78kk.

\textsuperscript{75}15 U.S.C. §§ 77(g), 77j(c); see also id. §§ 78(b), 78m(a), and 78n(a) (limiting the Commission’s rulemaking authority to information “as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security”).

\textsuperscript{76}See Ferrara, supra note 20, at 557; see also 1975 Release, supra note 66, ¶ 80,310, at 85,710 (stating that “[t]he Acts and the relevant legislative history also suggest that a prime expectation of the Congress was that the Commission’s disclosure authority would be used to require the dissemination of information which is or may be economically significant”). In addition, the Senate draft of the Exchange Act stated that “nothing in this title shall be construed as authorizing the Commission to interfere with the management of the affairs of an issuer.” H.R. REP. NO. 73-1838, at 35 (1934); Homer Kripke, The SEC, Corporate Governance, and the Real Issues, 36 BUS. LAW. 173, 174 n.2 (1981).

\textsuperscript{77}1975 Release, supra note 66, ¶ 85,713 (stating that “although the Commission’s discretion to require disclosure is broad, its exercise of authority is limited to contexts related to the objectives of the federal securities laws”).

\textsuperscript{78}See generally Kripke, supra note 76 (advocating that corporate governance should stem from new legislation; reform cannot emerge from “imaginative interpretations” of the securities laws); William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 702 (1974). Former SEC Commissioner Roberta S. Karmel described the foreign payments program as a “witch hunt” reaction to Watergate, and maintained that the SEC imposed its own rules of morality on corporations, an action outside the scope of the federal securities laws. See McLucas, supra note 41, at 1225 (citing ROBERTA KARMEL, REGULATION BY PROSECUTION 158 (1982)). Those who supported the SEC’s initiative claimed that a narrow reading of the statutes precluding the concept of qualitative materiality would have caused bribery and questionable payments to proliferate. See id.

\textsuperscript{79}See Kripke, supra note 76, at 188 (stating that the SEC had “become a Don Quijote, a Sir Galahad, a Phantom, or a Superman seeking to right all sorts of wrongs . . .
redefine[d]" the concept of materiality to promote the importance of management's integrity as a justification for mandatory disclosure of questionable payments, irrespective of whether this disclosure was within the purview of the securities laws.80 As a result of this approach, commentators also debated whether the deterrence of immoral conduct was a proper goal of the securities laws and, accordingly, of the SEC.81

F. The SEC's Civil Injunctive Actions Alleging Corrupt Activities: The Settled Actions

Between mid-1974 and 1978, the SEC filed multiple civil injunctive actions82 alleging violations of the federal securities laws by reason of a failure to disclose corrupt practices. Most of the defendant companies promptly consented to the injunctions and made various undertakings.

It is clear from a hindsight study of those complaints that, for the most part, the alleged facts failed to support the charged violations of the securities laws under the prevailing law after 1979. For example, often there were no facts supporting allegations that disclosure of the omitted information was mandated by any SEC rule or schedule. There were no allegations that any corporate official self-dealt by receiving an undisclosed bribe or kickback. Frequently, there were no supporting allegations that the information the individual corporations allegedly failed to disclose was economically material to the well-being of the corporation or its shareholders. Finally, there were no allegations that the economic investments of the corporation's shareholders were harmed. If anything, the shareholders benefited from the alleged corrupt payments inasmuch as the practices resulted in increased business for the corporation. Consequently, each action was based solely on the theory of qualitative materiality.

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80. Id. (criticizing the SEC for its policing of "corporate morality" in the corrupt practices context, and for exhibiting no recognition of a distinction between management's improper self-dealing and misconduct resulting from management's belief that they were acting in the corporation's best interest). Other commentators suggested that, under traditional theories of financial or quantitative materiality, disclosure of foreign payments is required "only where management is aware of the payments and the payments entail significant possibilities of legal penalties." THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, THE AD HOC COMMITTEE ON FOREIGN PAYMENTS, REPORT ON QUESTIONABLE FOREIGN PAYMENTS BY CORPORATIONS: THE PROBLEM AND APPROACHES TO A SOLUTION 21 (1977).

81. See Kripke, supra note 76, at 188 (stating that the SEC's statutory authority to pursue its voluntary disclosure program fell short of the goals set by the SEC in the 1976 Report).

82. See generally 1976 Report, supra note 48.
IV. JUNE 1976: TSC INDUSTRIES, INC. v. NORTHWAY, INC.- MATERIALITY DEFINED

In June 1976, twenty-six days after the SEC issued its 1976 Report, the Supreme Court defined the term "material" as used in the Exchange Act's proxy rules. In TSC Industries, Inc. v. Northway, Inc.,83 the Court addressed an action brought by a shareholder claiming that TSC's proxy statement was materially misleading in violation of Exchange Act section 14(a) and Rules 14a-3 and 14a-9 promulgated thereunder, and incomplete because it failed to state that the transfer of interests in TSC had resulted in a change of control.84 In defining a standard of materiality, the Court reasoned that

[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . What the standard . . . contemplate[s] is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.85

The Supreme Court's materiality definition begged the question whether the SEC would have pursued with such compulsive vigor its corrupt practices initiatives if the TSC opinion had been rendered in 1972. The fact is that "reasonable shareholders" responded with apathy to the reports of corrupt practices. There is no evidence that they attached "actual significance" to the questionable payments reports in the "total mix" of information available when voting or making investment decisions.86

84. See id. at 441-43.
85. Id. at 449.
86. In 1988, the Supreme Court applied the materiality standard established in TSC to the anti-fraud provisions and to the context of discussions surrounding mergers. See generally Basic Inc. v. Levinson, 485 U.S. 224 (1988). The Court ruled that the existence of preliminary merger discussions may amount to a material fact, and that the parties to the discussions do not have to reach an "agreement-in-principle as to price and structure" to render such discussions material as a matter of law. Id. at 236. The Court held that the materiality of preliminary merger discussions must be decided on a case-by-case basis and involves the balancing of the "probability" that the merger will take place against the "magnitude" or significance of the merger to the corporation. Id. at 239. When determining the materiality of unadjudicated illegal conduct in light of Basic, the test for disclosure involves the balancing of the "probability" that there will be a criminal or civil action against the "magnitude" of the economic consequences to the corporation if there is a conviction or adverse finding.
V. POST-MAY 1976: JUDICIAL RESPONSE TO QUALITATIVE MATERIALITY ALLEGATIONS

Although corporations reacted with fear and compliance to the SEC's voluntary program, challenges and litigation still arose. Only a few courts adopted the SEC's interpretation of qualitative materiality. By 1981, the prevailing decisions refocused on the traditional economic materiality standard and rejected a qualitative standard.

SEC v. Joseph Schlitz Brewing Co. is often cited as support for the qualitative materiality theory. The court permitted an SEC complaint, in which three million dollars of improper payments were alleged, to survive a motion to dismiss. Schlitz argued the payments were immaterial when measured against 1976 net sales of $1 billion. Although the court stated that "the question of the integrity of management gives materiality to the matters the Commission claims should have been disclosed," its unwillingness to dismiss the section 14(a) claim rested equally on the conclusion that the payments in question may have proved to be economically material. The illegal payments alleged in Schlitz also were the subject of a pending criminal proceeding, bringing that action within the

The accounting industry also has developed qualitative characteristics for determining materiality of financial information. See QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2 (Financial Accounting Standards Board 1980) [hereinafter CON 2]. CON 2 addresses the issue of materiality judgments. It indicates that the nature of the judgment item in question and the attendant circumstances should be considered, but notes that materiality judgments are primarily quantitative in nature. See id. ¶ 123. It also comments that the materiality threshold may be lower if the item turns a loss into a profit or reverses the trend of earnings from a downward to an upward trend. See id. ¶ 128(b). Conversely, when the item, error, or omission does not affect such a trend, the materiality threshold may be higher. See id. APB Opinion No. 20, paragraph 38, states that "[m]ateriality should be considered in relation to both the effects of each change separately and the combined effect of the changes." ACCOUNTING CHANGES, APB Opinion No. 20, ¶ 38 (Financial Accounting Standards Board 1971) [hereinafter ACCOUNTING CHANGES]. CON 2 further states that, in almost every case, "the relative rather than the absolute size of a judgment item determines whether it should be considered material in a given situation." CON 2, supra. The materiality threshold for judging items in quarterly interim reports is higher than that of fiscal years. CON 2 also establishes that in determining the materiality of a judgment item, it is highly useful to assess the item in the context of historical trends.

See Ferrara, supra note 20, at 565 (drawing conclusions from pertinent case law decided before, during, and after the voluntary program regarding when liability would arise).

See id. at 567 (discussing the courts' varied responses to disclosure of company information relating to management competency and integrity).


Id. at 830. The court accepted the SEC's argument that the small payments were material because it believed that further discovery might reveal that the payments were much larger than three million dollars. See Branch, supra note 10, at 1466-67.
disclosure mandates of the Exchange Act. Although the SEC argued that the payments were quantitatively material and subject to disclosure, the decision is not clear upon which of the SEC's arguments (i.e., quantitative or qualitative materiality) the holding is based. Later courts distinguished Schlitz on the ground that it involved known misconduct that also was quantitatively material.

Berman v. Gerber Products Co. involved a company's failure to disclose bribes in tender offer disclosure documents. The target company argued that the offeror failed to disclose information regarding questionable payments in its offering materials in violation of Exchange Act section 14(e). The court reasoned that the questionable payments might bear on management integrity and, therefore, may be disclosable, but found that their omission from the tender offer material was not materially misleading.

The court concluded that "none of the contentions . . . involve[d] sufficient allegations of deception to state a claim under section 14(e)." It also explained that pursuit of this information was a question of mismanagement unrelated to a tender offer. Moreover, under the Supreme Court's decision in Santa Fe Industries, Inc. v. Green, breach of fiduciary duty without deception, misrepresentation, or nondisclosure is excluded from the disclosure obligations of section 14(e).

In Amalgamated Clothing & Textile Workers Union v. J.P. Stevens &
the complaint alleged that the company's proxy solicitations were materially deficient in failing to disclose that board nominees had participated in a conspiracy "to thwart the labor laws of this country." In a firm, correct decision, the court dismissed the claim, finding the nondisclosures immaterial as a matter of law. Referring to the statement in *Maldonado v. Flynn* that "illegal foreign payments" need not be disclosed so long as they are "intended for the corporation’s benefit," the court found that rule equally applicable to the conspiracy alleged in *Amalgamated*. Noting that the SEC’s own regulations require the disclosure of only "criminal convictions and criminal proceedings," the court found that the "proxy rules simply did not require management to accuse itself of antisocial or illegal policies." A contrary conclusion was characterized as "silly and unworkable." The court recognized that management cannot be expected to confess to uncharged crimes in proxy solicitation materials. The rule, if it were construed to require disclosure of unadjudicated illegality, would not succeed in bringing such information to investors. Such an interpretation would not enhance the purposes of the proxy rules, but merely would license retrospective litigation and foster insecurity in the tenure of management.

In contrast to the ambiguous *Schlitz* decision, the *Amalgamated* holding limited the breadth of integrity disclosure, linking the materiality of omissions to either management self-dealing or adjudicated criminal conduct. Without explicitly stating its intent, the *Amalgamated* court sharply narrowed the disclosure obligations espoused in the 1976 Report and the SEC’s voluntary program.

SEC v. Chicago Helicopter Industries, *Inc.* expanded the *Amalga-
mated holding and further narrowed the SEC's qualitative materiality theory. The SEC alleged that failure to disclose conduct in violation of the National Bank Act created a material omission because "the transaction reflect[ed] adversely upon the integrity of management, thus rendering it an important factor in shareholders' investment decisions." Nonetheless, the Commission admitted that "the transaction . . . had no significant impact on the financial well-being of the bank, thus eliminating the possibility of 'financial materiality.'" The court concluded that financial well-being and past determinations of illegality are important to the reasonable investor and measurable, but that application of the disclosure rules to "alleged unethical or antisocial conduct would rob the rule[s] of [any] objective basis." The court said that "in the absence of an adjudicated finding of illegality . . . [it was] not at liberty to assume or make its own finding of . . . illegality."

In Chicago Helicopter, a court for the first time rejected the SEC's argument that management integrity is material and should be disclosed. The court said that the conduct in question did not reflect quantitative materiality, self-dealing, or adjudicated illegal conduct. The Gaines v. Haughton decision contains a discussion of the attempted overlay of a qualitative standard of materiality on the proxy rules. In Gaines, the court refused to require disclosure of a range of

pursuant to settlement Mar. 7, 1980).

107. Id. at *4-5.
108. Id. at *3 n.2.
109. Id. at *7. The court favorably cited a speech by former SEC Commissioner Roberta S. Karmel in which she expressed concern that a qualitative standard of materiality would cause the SEC to perform too great an enforcement role with respect to company disclosures. See id. at *10 & n.5 (citing Commissioner Roberta S. Karmel, Qualitative and Differential Disclosure, Remarks to Financial Executives Institute International Conference, Atlanta, Ga. (October 17, 1979), and Annual State-Federal Cooperative Enforcement Conference, Denver, Co. (October 19, 1979)); see also Karmel Cites Trend away from Economic Materiality as Disclosure Problem for both SEC and Business, 526 Sec. Reg. & L. Rep. (BNA) at A-8 (Oct. 31, 1979). She also envisioned such a standard would require company employees to announce their own illegal acts. See Chicago Helicopter, 1980 LEXIS 17214, at *10.
111. See Branch, supra note 10, at 1474 (discussing the holding in Chicago Helicopter and its impact on the SEC's policy requiring disclosure of qualitatively material information bearing on management integrity).
112. 645 F.2d 761 (9th Cir. 1981).
113. See id. In contrast, the court in Decker v. Massey-Ferguson, Ltd. held under similar circumstances that the district court erred in dismissing without discovery a complaint under Rule 10b-5 that alleged the company's annual report contained misleading statements about management and its financial condition; the report failed to state that the company's foreign subsidiaries made undisclosed, illegal payments totaling thirty million dollars over a five year period. See Decker v. Massey-Ferguson, Ltd., 681 F.2d 111,
Lockheed Aircraft Corporation management misconduct, including over thirty million dollars of foreign payments which may have met with investor disapproval. Affirming dismissal of a section 14(a) claim based on nondisclosure of corrupt foreign payments, the court stated that "[t]he distinction between 'mere' bribes and bribes coupled with kickbacks to the directors makes a great deal of sense, indeed, is fundamental to a meaningful concept of materiality under [section] 14(a) and the preservation of state corporate law." Only the latter behavior evidences "dishonesty or deceit which inures to the direct, personal benefit of the directors—a fact that demonstrates a betrayal of trust to the corporation and shareholders and the director's essential unfitness for corporate stewardship." The self-dealing nature of the conduct was held to require disclosure.

The Schlitz and Gaines decisions, and those decided in the interim, were issued between June 1978 and through May 1981, a period closely paralleling the April 1977 through March 1981 tenure of SEC Chairman Harold M. Williams. During Williams's service, courts consistently rejected the concept of qualitative materiality. Moreover, his tenure was marked by (a) contentions within the Commission, (b) a noticeable tide turning against the SEC in federal courts, (c) the emergence of a corporate governance notion threatening "to eliminate the separation of political and economic power on which a private enterprise system depends," and (d) the end of the voluntary disclosure program.

Under Williams's leadership, the Commission attempted to develop regulatory standards through law enforcement initiatives. Prior to the 1970s, the SEC rarely lost court cases. It litigated in a zone of precedents, generally receiving favorable responses from the courts. Courts showed deference to the agency's views. In the late 1970s and early 1980s however, the SEC began to lose cases at a previously unheard of

118-19 (2d Cir. 1982) (noting that the Gaines decision is inconsistent with prior case law concerning financial materiality but that it is consistent with authority addressing self-dealing conduct); see also Branch, supra note 10, at 1476. The Gaines case has not gone without other criticism:

Gaines purports to establish a per se rule of immateriality for director misconduct without the element of self-dealing -- at least for proxy statements. The opinion seems to rest on the rather cynical assumption that shareholders, in exercising their rights of corporate suffrage, care plenty about a management that is stealing from the company, but are concerned not a whit about a management that is stealing for the company. (emphases omitted).

Longstreth, supra note 19, at 6.

114. See Gaines, 645 F.2d at 765.
115. Id. at 778.
116. Id. at 779.
117. ROBERTA S. KARMEL, REGULATION BY PROSECUTION 166 (1982).
The losses were accompanied by a loss of credibility. The Williams Commission was marked by rivalries, particularly concerning the issue of qualitative materiality. Williams's promotion of independent directors on boards and committees was deemed desirable. However, his view regarding corporate governance—"the corporation ha[d] ceased to be private property" and had become a "quasi-public" institution without the rights of a "self-perpetuating oligarchy that constitutes management"—was denounced by corporate America.

Finally, the minority view of Commissioner Roberta Karmel on qualitative materiality prevailed in the courts. While Williams's and Sporkin's successors were credited with dismantling qualitative materiality, it was the pioneering work of Karmel, Freeman, and Kripke, and their arguments for the rule of law and objective standards of materiality that were the rationales cited by the courts rejecting the qualitative concept.

Despite the impact of the 1976 Report, the SEC's voluntary program, and the Williams Commission, by 1981, courts sharply rejected the SEC's expansive concept of materiality and returned to a more exacting construction of statutory law.

VI. THE FOREIGN CORRUPT PRACTICES ACT OF 1977

Although the Commission's efforts to establish a qualitative standard of materiality were denounced, and the Commission exceeded its legislative charter, its efforts forever heightened the legal standards of corporate America. A practical reality of the SEC's efforts is that by 1981, multinational corporations had adopted codes of business ethics and had taken steps to implement and enforce the policies. For example, corporate internal audit staffs were expanded to police corporate irregularities. Also, audit committees increased their oversight responsibilities of corporate accounting practices and their liaison with independent auditors. These efforts improved global business standards.

Congress held hearings to review the findings of the SEC concerning corrupt practices. Congressional discontent with the startling number of bribes which were disclosed fueled the drafting and passage of the For-

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119. See KARMEL, supra note 117, at 230-38.

eign Corrupt Practices Act (FCPA). The SEC played a major role in that legislative initiative. By enacting the FCPA, Congress expressed its intent "to bring . . . corrupt practices to a halt and to restore public confidence in the integrity of the American business system."²

The FCPA amended provisions of the Exchange Act. The Exchange Act contains books, records, and internal control requirements, as well as anti-bribery provisions. The accounting provisions apply only to SEC registrants. In contrast, the anti-bribery provisions apply to domestic entities and to SEC reporting companies and issuers. Moreover, directors, shareholders, officers, agents, and employees of a corporation subject to the FCPA are individually subject to the Exchange Act, while foreign officials are not liable as bribe recipients.³

The accounting provisions have served for twenty-one years as the nexus for expanding the duties of corporate accounting staff. The provisions have promoted an ongoing debate concerning the obligations of outside auditors to detect fraud.⁴ The provisions are cited regularly in the charging paragraphs of SEC complaints alleging financial fraud. On the other hand, the FCPA anti-bribery provisions have an awkward place in the law that is designed to protect investors and to assure the integrity of our capital markets. It is not reasonable to expect prosecution under those provisions to be an enforcement priority. Lawsuits for off-shore bribery will not have such "actual significance" to "reasonable share-

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¹ See Randall, supra note 41, at 664.
² S. REP. NO. 95-114, at 4 (1977). For the legislative history of the Foreign Corrupt Practices Act, see Lewis v. Sporck, 612 F. Supp. 1316 (N.D. Cal. 1985). The FCPA reflected five objectives developed by Congress in response to the corruption revealed by the Watergate hearings and the SEC's voluntary program; (1) payment of bribes was contrary to the values of American citizens; (2) Congress wanted to eradicate the scandals that bribery created; (3) Congress wanted to eliminate the distortion of international, commercial competition that bribery caused; (4) Congress wanted to limit the spread of corruption to foreign governments; and (5) Congress wanted to improve the United States' reputation for honest business dealings. See Tamara Adler, Comment, Amending the Foreign Corrupt Practices Act of 1977: A Step Toward Clarification and Consolidation, 73 J. CRIM. L. & CRIMINOLOGY 1740, 1745 (1982).
⁴ See generally ACCOUNTING CHANGES, supra note 86; THE AUDITOR'S RESPONSIBILITY TO DETECT AND REPORT ERRORS AND IRREGULARITIES, Statements of Auditing Standards No. 53 (American Inst. Of Certified Pub. Accountants 1988); CON 2, supra note 86; CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 82 (American Inst. Of Certified Pub. Accountants 1997). These standards are the highest standards that typically apply to an independent auditor.
holders” to justify devoting enforcement staff to their prosecution. FCPA bribery actions have no impact on the integrity of our capital markets. The occasional anti-bribery action over the past twenty-one years has been an enforcement yawn.

A. The FCPA’s Books, Records, and Internal Controls Provisions

Sections 13(b)(2)(A) and (B) are the accounting and bookkeeping provisions of the FCPA. They were enacted to assure that companies make and keep their books, records, and accounts in a manner that facilitates their compliance with the disclosure obligations under the securities laws. The rules promulgated by the SEC specify that “[n]o person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.” The rules also state that a director or officer of an issuer may not make “a materially false or misleading statement, or . . . [o]mit to state, . . . any material fact . . . in connection with (1) any audit or . . . (2) the preparation or filing of any . . . report required to be filed with the Commission.” The FCPA also requires issuers to maintain a system of internal accounting controls to ensure that issuers have reliable information from which to prepare disclosure documents.

B. The FCPA’s Anti-Bribery Provisions

The FCPA’s anti-bribery provisions render illegal any payments to foreign officials, officials of foreign political parties, or any agent acting for a foreign official or political party made for the purpose of influenc-


129. See Exchange Act § 13(b), 15 U.S.C. § 78m(b). A chief purpose of the internal controls provisions, mirroring the goals of the voluntary disclosure program, is to afford issuers a means to detect and prevent questionable payments to foreign officials, and to ensure that their books accurately reflect the business. See Mann, supra note 125, at 309.

Qualitative Materiality

Charges under the FCPA arise from domestic entities using interstate commerce and corruptly paying foreign officials for the purpose of influencing official acts in order to obtain or retain business. Charges under the FCPA arise from domestic entities using interstate commerce and corruptly paying foreign officials for the purpose of influencing official acts in order to obtain or retain business.

VII. A RETURN TO PRINCIPLES OF QUANTITATIVE MATERIALITY

Prior to 1981, the pressure for the SEC to retreat from its qualitative materiality initiatives came largely from outside the Commission. The denunciation by respected attorneys and the judicial decisions rejecting the standard were the most obvious external pressures. Investor indifference also greeted the SEC's initiatives. Passage of the FCPA made illegal many of the foreign payments of the type uncovered and disclosed prior to 1977. Self-policing by corporate America improved the level of legal standards in international and domestic trade. Corporate bribery was assumed to be subsiding. As a result, the momentum for a qualitative standard had dissipated by 1980 when Ronald Reagan was elected as President.

In 1981, personnel changes at the SEC resulted in a reexamination of the standard. The Commission's failure to approve an enforcement action against Citicorp, and adverse decisions in two criminal cases, hastened the demise of the qualitative standard. The criminal actions were brought without consultation with the SEC staff and in the face of decisions in civil actions renouncing the standard.


In 1981, following a three-year investigation, the Commission voted not to initiate an enforcement action against Citicorp for its failure to

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134. See Branch, supra note 10, at 1450-51 (citing Playing the Money Game, TIME, Mar. 1, 1982, at 67 (reporting that the presence of SEC Chairman John S.R. Shad and Division of Enforcement Director John M. Fedders suggested that the SEC would no longer view itself as an enforcer of management conduct)).
disclose transactions designed to avoid local currency, tax, and foreign exchange restrictions. Although the negative vote has no legal precedent, the histrionics associated with the Commission's deliberations reveal that the vote assured the decline of the qualitative standard and a change in SEC policy. The ensuing pandemonium following the leak of the SEC's nonpublic decision, the media's Commission-bashing, and the subsequent congressional hearings point to a House subcommittee as being responsible for trivializing SEC enforcement and the qualitative standard. The matter also is significant, to an SEC voyeur, because the SEC's investigative files, internal memoranda, and the transcripts of its nonpublic meetings were published during the congressional hearings.

A. Enforcement Recommendation and Opposition

In May 1978, the Commission approved a formal order of investigation into Citicorp's failure to disclose foreign currency trades conducted by Citibank's European branch offices. The allegations that the company engaged in "parking" transactions were based on the offices reselling currencies to branches in the Bahamas for repurchase at a later point. The SEC was tipped off by an employee in Citicorp's Paris office who believed that the office was engaging "in a practice of circumventing European exchange control laws and tax laws by causing the New York and Nassau branches of Citibank ... to record on their books thousands of non-arm's length, structured transactions as arm's length foreign exchange purchases/sales or as deposits." 

135. See Milton V. Freeman, The SEC and the Citicorp Case: The Legal Issue of Materiality, NAT'L L. J., Nov. 15, 1982, at 20 [hereinafter Freeman Citicorp] (stating that the Citicorp matter is "important because it seems to mark the definitive abandonment of the commission's post-Watergate adventure and [a] return to the principles that governed the SEC in the first 40 years of its existence").


137. See, e.g., Citicorp Hearings I, supra note 136; Citicorp Hearings II, supra note 136.

138. See Citicorp Hearings I, supra note 136, at 96-108, 265. The Commission vote in favor of the formal order of investigation was 5-0, including an approving vote of Commissioner Karmel. See id. at 108; see also Freeman Citicorp, supra note 135, at 120 (describing the transactions at issue in the Citicorp investigation).

139. See Citicorp Hearings I, supra note 136, at 104, 266; see also Branch, supra note 10, at 1477 (discussing Citicorp and its ramifications on enforcement policy).

140. See Citicorp Hearings I, supra note 136, at 15, 263.

141. Id. at 264.
Foreign exchange income was then a line item in Citicorp’s financial statements and, in the years in question, represented between 15% and 35% of Citibank’s net income. In SEC filings, Citibank discussed certain risks involved in foreign exchange trading. The SEC staff concluded that during the period of 1974-78 Citibank earned $417 million from foreign exchange, and that at least $46 million was generated by parking transactions. The staff also decided that the complete risks of those transactions were not disclosed to Citicorp’s shareholders. Significantly, the staff’s determinations were reached despite no actual proof of illegality concerning any transaction, but instead were based on a mere belief that such transactions were highly questionable.

In 1981, as the Citicorp investigation was being concluded, John S.R. Shad, a wise chieftain, was confirmed as SEC Chairman. Shortly thereafter, Sporkin, who was prepared to recommend the initiation of an administrative proceeding against Citicorp, resigned from the SEC. In June 1981, John Fedders was appointed Director of the Division of Enforcement.

In Fall 1981, the new Director was urged by his staff to endorse an enforcement recommendation against Citicorp. After a debate, he was confronted by the dilemma of a recommendation for a proceeding promoted by Sporkin which the new Director believed to be unsupportable in fact and in law. He recognized that if he exercised his authority and stopped the recommendation from proceeding to the Commission, his decision would be controversial, likely be leaked to the press, and receive a politically charged reaction. He permitted the Enforcement staff to make its recommendation and to include his opposition.

On December 9, 1981, the Division’s memorandum was sent to the

142. See id. at 263, 274.

143. See id. at 264. The investigation took over forty-two months. It was based on documents collected by a law firm that conducted an inquiry of Citibank’s question able practices on the foreign exchange market, and the testimony of Citibank employees. See id. at 30, 42-43.

144. See id. at 264.

145. See id. at 288; see also Freeman Citicorp, supra note 135, at 20 (stating that, although an Associate Director recommended filing proceedings against Citicorp, he testified that he had not acquired proof that Citicorp violated the laws of foreign countries and he had not gathered expert opinions certifying the illegality of any Citicorp transactions).

146. See Citicorp Hearings I, supra note 136, at 16; Freeman Citicorp, supra note 135, at 20 (explaining Sporkin’s views regarding Citicorp immediately before his departure from the Commission).

147. See Citicorp Hearings I, supra note 136, at 33; Freeman Citicorp, supra note 135, at 20.

148. See Citicorp Hearings I, supra note 136, at 261.
Commission with the Director's opposition. The recommendation was for an administrative proceeding charging noncompliance in Citicorp's periodic reports with section 13(a) of the Exchange Act and the rules promulgated thereunder. However, Citicorp was not to be charged with fraud or with false statements in proxy materials. The staff argument was based on Citibank's efforts to evade various European tax and exchange control laws, its efforts to disguise those activities from auditors and government authorities, and its tampering with books going "to the heart of the securities laws in that it expose[d] the corporation to substantial risks . . . and . . . impact[ed] the corporate accountability system." The recommendation concluded that although Citicorp was not required to make public statements about its foreign exchange activities, what it did say was materially misleading and incomplete. The Director's opposition was based on an opinion that the legal theory underlying the recommendation was contrary to prevailing law, and that, even if illegal, the conduct did not, and was not likely to, result in significant economic harm to Citicorp or reflect poorly on the integrity of management. His opposition also was based on a lack of proof of the alleged illegalities.

On December 18, 1981, the Office of the General Counsel and the Division of Corporation Finance joined in the Enforcement Director's opposition. They concluded that Citicorp's filings were not misleading, and "that the information the Enforcement staff would have . . . included or emphasized" was not material. They contended that because Citicorp had never represented that its senior management had "honesty and

149. See id. at 33, 288; see also Freeman Citicorp, supra note 135, at 20.
152. See Citicorp Hearings I, supra note 136, at 288; see also Branch, supra note 10, at 1478 (discussing Fedders's response to Citicorp and the standard of materiality used in the decision not to file an administrative proceeding).
153. See Citicorp Hearings I, supra note 136, at 292; Freeman Citicorp, supra note 135, at 21 (reporting that the Director of Corporation Finance and General Counsel joined Fedders in recommending against bringing an administrative proceeding).
integrity,” it had no duty to disclose breaches of those standards.

B. Commission Deliberations

On December 22, 1981, two issues were posed to the Commission.\textsuperscript{155} The first issue was whether, absent an express rule requiring disclosure, Citicorp was obligated to disclose all material facts, including questionable practices and risks, regarding each line item in the financial statements contained in its periodic reports. The second issue was whether, even though no affirmative statements were made in Citicorp’s periodic reports other than itemizing foreign exchange income as a separate line item, the company’s reports were rendered false and misleading by failing to disclose its questionable currency, tax, and foreign exchange practices and the risks related thereto.\textsuperscript{156} The Commissioners discussed whether the undisclosed risks were either qualitatively or quantitatively material, and whether the level of proof was sufficient to support the charge. The SEC then declined to initiate action against Citicorp by a three to one vote.\textsuperscript{157} Chairman Shad and Commissioners Philip Loomis, Jr. and Bevis Longstreth voted against, and Commissioner John Evans voted in favor of, an action; Commissioner Barbara Thomas was recused.

Early in 1982, both the Commission’s decision and staff memorandum were leaked to the New York Times.\textsuperscript{158} In the ensuing pandemonium, media reports questioned whether the Shad Commission was devoted to an aggressive enforcement program, or whether the Citicorp decision evidenced an intention to go soft on corporate America.\textsuperscript{159} The reports

\textsuperscript{155} See id. at 261.

\textsuperscript{156} See id.

\textsuperscript{157} See id. at 305-33. The Office of the Comptroller of the Currency also investigated Citicorp’s alleged parking transactions. It did not bring any legal action at the time it concluded its investigation in December 1980. Instead it told Citicorp to cease the practices. See id. at 44; cf. Freeman Citicorp, supra note 135, at 21; Branch, supra note 10, at 1477-78 (describing the Commission’s conclusions that (1) involvement in the Citicorp matter was not warranted due to lack of materiality and (2) the stance taken by the Division of Enforcement during the SEC’s voluntary disclosure program was not supported by case law).

\textsuperscript{158} See Jeff Gerth, S.E.C. Overruled Staff on Finding That Citicorp Hid Foreign Profits, N.Y. TIMES, Feb. 18, 1982, at A1; see generally Steven Brill, What Price Loyalty, THE AMERICAN LAWYER, Aug. 1982, at 1 (noting that the SEC enforcement division lawyer Thomas VonStein’s memo detailing his investigation into Citibank’s foreign exchange transactions was leaked to a New York Times reporter); Susan Dentzer et al., The Citi Never Sleeps – But Does the SEC?, NEWSWEEK, Mar. 1, 1982, at 61 (reporting that the documents leaked to the New York Times may have contained information suggesting that the SEC overlooked illegal practices of the Citibank corporation); Roy Rowan, The Maverick Who Yelled Foul at Citibank, FORTUNE, Jan. 10, 1983, at 46 (detailing the story of David Edward’s investigation into the practices of Citibank).

\textsuperscript{159} See Richard L. Hudson, Flabbier Cop? SEC May Be Losing Its Former Tough-
lacked any analysis of the rationale underlying the decision, and the distorted impressions caused the Commission concern. So great were the concerns that on March 5, 1982, the SEC took the unprecedented step of issuing a press release announcing the factors that influenced its decision not to bring the case and requested the opportunity to provide an account of its handling of the matter before a congressional committee. Six factors were stated as influencing the decision not to bring the Citicorp case. The second factor was that "[e]ven if established, the alleged amounts for the years in question were not material to Citicorp;" and the fourth factor was that "[t]he law concerning disclosure of unadjudicated allegations is unclear. There would have been a serious possibility of court reversal of the Commission's action, which would have been bad precedent."161

C. Congressional Hearings

The Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce of the House of Representatives investigated the SEC's decision.162 Congressional staff reviewed thousands of pages of the nonpublic investigative and deliberative files. There were clandestine staff efforts at the SEC to aid that investigation, somehow hoping they would prove the Commission's decision to be incorrect.

On September 13 and 17, 1982, the subcommittee held hearings.163 Its Chairman, John Dingell, began by stating that

what is most important about the Citicorp matter is what it signifies for the Commission's role in assuring that level of management integrity which is so vital to the proper functioning of the American free enterprise system. In rejecting a recommen-

160. See, e.g., Citicorp Hearings I, supra note 136, at 334-35.
161. Id. The other factors were the following: first, "[t]he allegations were not adequately established"; third, "[t]he Comptroller of the Currency had concluded that no action was warranted under U.S. banking laws"; fifth, "[t]he matter was essentially a banking or tax case, not a securities case;" and sixth, "[t]he case was old. The practices in question occurred in 1973 to 1978." Id.
163. See generally Citicorp Hearings I, supra note 136 (providing a complete transcript of the hearings and of the documents introduced into the record).
dation to bring an enforcement action against Citicorp, the Commission overturned long-established precedents and introduced new criteria for disclosure.\textsuperscript{164}

Of course, the securities laws provide no role to the Commission in assuring management integrity. Chairman Dingell was incorrect in suggesting that the SEC was introducing new criteria for disclosure.\textsuperscript{165} Instead it was returning enforcement policies to long-established disclosure criteria and away from those which were being renounced by courts. Dingell said the Citicorp case revealed that “a clear pattern of events has emerged showing there has been a fundamental shift in the attitude of the Commission toward its responsibilities.”\textsuperscript{166} In fact, except for the sharp disparity on the qualitative standard, the differences on enforcement issues between the Shad Commission and its predecessor were scant.\textsuperscript{167}

At the first two days of the hearings, Sporkin, the Associate Director, and the staff attorney in the Division of Enforcement responsible for the Citicorp investigation were among six witnesses.\textsuperscript{168} The SEC staff acknowledged the judicial decisions which opposed the theories supporting the recommendation and recognized that the SEC lacked both proof that Citicorp violated foreign laws and expert opinions certifying the illegality of the transactions.\textsuperscript{169} On June 28, 1983, the subcommittee held a further

\textsuperscript{164} Id. at 1-2.

\textsuperscript{165} George Orwell said that political language “is designed to make lies sound truthful and murder respectable, and to give the appearance of solidity to pure wind.” \textit{Politics and the English Language}.

\textsuperscript{166} \textit{Citicorp Hearings I}, supra note 136, at 2.


\textsuperscript{169} \textit{See id. at} 47, 94; Freeman \textit{Citicorp, supra note 135, at 20.}
hearing that included testimony from Citicorp. The company's representatives provided a critique of the SEC investigation memorandum regarding Citicorp.

The unstated purpose of the hearings was to level scorn at the Commission. But the criticism was petty, and what happened to the Commission before the House subcommittee was politics. It was a civics lesson not taught in schools. The subcommittee trivialized the SEC law enforcement process and the issue of qualitative materiality. The hearings were a disservice to investors. Those at the SEC opposing a Citicorp action were promised, but never given, an opportunity to testify before the subcommittee. From the time the hearings were scheduled, the SEC staff prepared for an intellectual discussion of qualitative materiality. The Commission was anxious to debate its ideas outside of an enforcement action. However, it was robbed of that opportunity because the congressional hearings were nearly without any substantive discussion of materiality. If it had not been for the questions of a minority member of the subcommittee, Bob Whittaker, no one would have understood that legal precedent and the absence of evidence guided the Commission not to act against Citicorp.

The stated purposes of the hearings were never fulfilled. Without the presence of SEC Commissioners, there was never an explanation of the rationale underlying the Citicorp decision. The Citicorp hearings fulfilled neither the objective of providing oversight of the activities of an independent agency nor the goal of providing examination of the need for legislation.

IX. 1982: COMMISSIONERS' AND STAFF'S PUBLIC STATEMENTS ABOUT QUALITATIVE MATERIALITY

During the eighteen month span of the congressional investigation and hearings concerning Citicorp, two Commissioners and one staff member delivered speeches concerning qualitative materiality.

A. Evans on Disclosure of Business Ethics

In June 1982, Commissioner Evans delivered an uncharacteristically
strident speech promoting disclosure of management integrity.\textsuperscript{174} Although he did not refer to Citicorp by name, he harshly attacked an SEC staff memorandum opposing the action. Evans expressed support for a qualitative standard of materiality and declared that

\begin{quote}
information may be qualitatively material if it is relevant to the competency or the integrity of management. This could include such things as... questionable or illegal activities of management . . . . It must be obvious that because qualitative materiality deals with factors that are harder to measure, such as competence and integrity, it is much more difficult to determine. Despite the fact that the law with respect to qualitative materiality is unsettled, many investors consider the quality of management to be the most important factor in their decision-making.\textsuperscript{175}
\end{quote}

No other Commissioner has ever proclaimed "quality of management" information to be the most important factor in many investors' decision making.

Evans quoted from the Office of General Counsel's and the Division of Corporation Finance's opposition to a Citicorp action: "it would be inappropriate to allege disclosure violations based on unadjudicated illegal or improper conduct by a company's officers and directors unless there were affirmative representations as to management's honesty and integrity in some document."\textsuperscript{176} Evans denounced that view on the basis that it did not reflect "an official Commission position" or the view of all SEC staff.\textsuperscript{177} He declared he could not "readily accept the concept that there is no implied representation of management honesty or integrity,"\textsuperscript{178} and added that

\begin{quote}
[i]f some kind of representation is thought to be necessary, rather than suggesting that management should not be held accountable to disclose illegal acts unless there is an affirmative representation as to its honesty and integrity, it would seem more appropriate that management be held accountable unless there is a prior negative representation as to its honesty and in-
\end{quote}

\begin{footnotes}
\textsuperscript{175} \textit{Id.} at 5.
\textsuperscript{176} \textit{Id.} at 6 (quoting a statement from an internal staff memorandum to the Commission).
\textsuperscript{177} \textit{Id.}
\textsuperscript{178} \textit{Id.}
\end{footnotes}
Evans’s speech was more substantive and combative than were his comments at the Commission’s December 1981 closed meeting when the decision was reached not to initiate a proceeding against Citicorp.

B. Longstreth on Disclosure Regarding Management Integrity and His Senate Reconfirmation Testimony

In October 1982, Commissioner Longstreth addressed SEC disclosure policy regarding management integrity. With keen insight into investors’ interests, he was uniquely qualified for the task.

His remarks are the most comprehensive by a Commissioner regarding that subject. Longstreth suggested that in light of the voluntary disclosure program, the 1976 Report, and the Citicorp decision, the SEC needed to refine its views concerning disclosures of management integrity. He described the SEC’s rulemaking authority in the area of self-dealing as contrasted with generic management integrity. Longstreth emphasized that the SEC is not unconcerned with management integrity, but recently is observing the legal limits of disclosure requirements under the securities laws more closely, as the SEC in the 1970s may have “exceeded those limits at times.” He argued that the Commission should not mandate “line item disclosure of the ethical behavior of management,” because such a requirement would contribute “nothing of importance to investors.”

In August 1982, Longstreth testified before a Senate committee at his reconfirmation hearing to remain a member of the SEC. He was questioned about the Citicorp matter and his vote not to commence an action. The questions focused on whether the Commission considered charging Citicorp with violations of the FCPA, and Longstreth responded that no such recommendation had been made.

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179. Id.
181. See Longstreth, supra note 19, at 1.
182. See id.
183. See id. at 4-5, 8.
184. Id. at 13.
185. Id. at 13-14 (stating that with respect to a director describing how honest he or she has been, “[n]o meaningful disclosure is likely to result”).
186. See generally Nominations of Bevis Logstreth and James C. Treadway, Jr.: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong. (1982) [hereinafter Longstreth Hearing].
187. See id. at 24-25 (letter from Bevis Longstreth, Commissioner, Securities & Exchange Comm’n, to the Honorable William Proxmire, Senate Comm. on Banking, Hous-
C. Enforcement Director’s Speech on Failure to Disclose Illegal Conduct

The Director of Enforcement prepared testimony for the House Subcommittee’s Citicorp hearings. When that opportunity passed, the remarks became part of a November 1982 speech. His premise was that the SEC only should initiate enforcement actions where (1) failure to disclose unlawful conduct violates traditional economic standards of materiality, (2) a company fails to disclose self-dealing or conflict of interest transactions, (3) there is a failure to disclose information mandated by SEC rules governing proxy materials, periodic reports, or registration statements, and (4) when untrue statements of material fact are made, or statements are rendered misleading by the omission of material facts.

Absent the foregoing, he asserted that the “Commission generally should not utilize the antifraud provisions of the securities laws . . . where there is a failure to disclose conduct which may be considered qualitatively material.”

The Director’s views reflected the courts’ sharp rejection of the undefined concept of qualitative materiality and the prevalence of the views of Freeman, Karmel, and Kripke. Although ignored by the pundits, the Director’s objective was to articulate a means for the SEC to achieve a moral end without foregoing the rule of law; the Commission had the means to do so. The Director articulated standards of objective, quantitative materiality which allowed the SEC to police corporate failures to disclose illegal behavior. By establishing the guidelines, he sought to achieve this goal within the defined rule of law and without uncertainty.

The Director reasoned that information concerning illegal behavior is not per se material to investors. However, it becomes material if such behavior results in “quantitatively significant economic harm” to a company. He maintained that if there is a “reasonable likelihood” that a company’s, or its management’s, illegal behavior will have a “material
effect on earnings, assets or liabilities,” the information warrants disclo-
sure. Disclosure also is required when a “material amount” of a com-
pany’s business is contingent upon the illegal behavior. Finally, with
respect to illegal corporate behavior, he said that disclosure of illegal
corporate conduct may be necessitated if a reasonable possibility exists
that discovery of the illegality will result in “expropriation of a material
amount of assets or . . . material criminal fines or civil damages.”

The Director acknowledged that his views differed from his predeces-
sor’s concerning the need for enforcement actions in situations reflecting
failure to disclose qualitative information not specifically required to be
disclosed in SEC rules, not involving self-dealing, and not otherwise nec-
essary to prevent statements made from being materially misleading.
In those situations, he deemed enforcement action inappropriate.

The Director’s speech engendered debate with respect to the intended
message. Sporkin responded that if the SEC is unwilling to sue com-
panies for certain disclosure deficiencies, “that puts a lot of pressure”
on corporate attorneys to disclose even less. He maintained that the
new Director’s narrow interpretation of materiality prompted newspaper
headlines to state, “SEC to Limit Pursuit of Unethical Conduct,” and
Sporkin suggested that this perception of the SEC’s enforcement agenda
was “troublesome.”

192. Id. (emphasis omitted) (explaining required disclosures in the context of illegal
corporate behavior).
193. Id. (emphasis omitted).
194. Id. (emphasis omitted).
195. See id.
196. See id. at 7 (asserting that the lack of case law reviewing the use of the anti-fraud
provisions to enforce qualitative disclosures intimates that enforcement is inappropriate).
197. See generally Richard L. Hudson, The Changing Face of the SEC, WALL ST. J.,
Dec. 27, 1982, at 8 (discussing the Fedders Remarks and Sporkin’s response thereto).
198. Id. (quoting Sporkin). But see Milton V. Freeman, Letters to the Editor, The
[hereinafter Freeman Letter].
199. Hudson, supra note 197, at 8 (quoting Sporkin). Sporkin also said the narrow in-
terpretation of materiality could allow larger companies to effectively conceal more un-
ethical conduct than a smaller company. See id. Fedders’s former law partner defended
strict adherence to quantitatively material disclosure principles stating that
except for the period 1974-1976, one of the great attributes of the SEC . . . has
been its strict adherence to the law. The law gives the SEC authority to protect
investors against economic loss by a process of disclosure. It does not grant the
SEC broad legal authority to act as a commission on ethics, to discourage busi-
ness from engaging in “tawdry practices” or “questionable ventures” or to pre-
vent “unethical conduct” generally. It is fundamental that a law enforcement
agency . . . must itself obey the law.

Freeman Letter, supra note 198, at 23 (defending the Commission’s return to a narrow
X. United States v. Matthews: The Southland Corporation Matter and Another Drubbing of the Qualitative Standard

The Southland matter resulted in a precedent-setting 1986 decision of the Second Circuit that reversed the conviction of an executive for failure to disclose, in proxy materials soliciting his election as a director, that he had approved the cover-up of payments of bribes to public officials. Although the bribes were never paid, nevertheless there was evidence of a conspiracy. The 1984 indictment represented the first time that the Justice Department or a United States Attorney’s office had commenced a prosecution on the theory that qualitative material management disclosures must be made. The Second Circuit’s 1986 decision was preceded by an internal Southland investigation, followed by a grand jury investigation, several indictments and trials, and an SEC investigation.

A. Southland Internal Inquiry

In November 1976, Southland received a letter from the SEC requesting that the corporation determine whether it had participated in any “illegal or questionably illegal transactions . . . from January 1, 1969 to the present”. In 1977, Southland initiated an internal investigation that it entitled the Business Ethics Review. It was conducted by Southland’s legal department under the supervision of the audit committee and with the limited assistance of outside counsel, including Fedders. During its course, inquiry was made into a $96,500 payment to an attorney. The investigators sought to determine whether any of the money was used to bribe an unnamed employee of the New York State Tax Commission regarding sales taxes owed by Southland franchisees in New York.
The Audit Committee, along with the Southland legal department and outside counsel, ultimately determined that the evidence was insufficient to confirm any suspicion of wrongdoing in connection with the retention and payment of the $96,500 fee to the attorney. They agreed not to include the legal fee matter in the written Business Ethic Review report, but rather to present it to the Board of Directors. After the report was submitted and the topic was discussed at the January 1978 directors’ meeting, Southland decided there was no need to publicly disclose the findings of its internal investigation.

B. Grand Jury Investigation of Southland

In 1979, a grand jury investigation began and continued for several years, not ending until August 1984. Fedders testified several times after joining the SEC in 1981. Litigation arose when Southland asserted privileges as to a portion of the materials subpoenaed. In March 1982, the discovery issues ended with a decision of the Second Circuit Court of Appeals which identified Arnold & Porter’s role in the Business Ethic Review. By June 1982, media speculation arose regarding Fedders’s role in the Southland internal investigation and reports that he had testified before the grand jury. The Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce began an investigation in 1982 of Fedders’s role in the Southland investigation. Despite Fedders’s request for an open hearing regarding his role, the Justice Department prevailed upon Subcommittee Chairman John Dingell...

205. See id. at 34-36. In addition to the lack of evidence of illegality, a factor contributing to the decision not to include the matter in the report was concern of a defamation action if it was included. See generally David B. Fein & Bruce E. Yannett, Internal Investigations Can Result in Libel Suits, NAT’L L.J., June 8, 1998, at B8.

206. See Fedders Testimony, supra note 203, at 34, 36.

207. See generally Southland Corp. Officer Appealing Jail Term in Probe, WALL ST. J., April 26, 1983, at 6 (reporting jail term ordered for ‘evasive answers’ to a grand jury investigation of Southland).

208. See generally In re John Doe Corp., 675 F.2d 482 (2d Cir. 1982).

209. See id. at 484 n.2.


to hold the hearing in Executive Session to avoid prejudicial publicity. In September 1982, Fedders testified before the subcommittee, but because he had been instructed by Southland not to answer questions regarding his legal work for the company, he did not answer questions regarding the Business Ethics Review.\footnote{212}

In August 1982, the SEC began a twenty-five month inquiry to determine whether it should act with respect to allegations regarding the conduct of Southland. This matter included an investigation of Fedders's role as outside counsel. Because of Fedders's position at the SEC, the inquiry was conducted by the Commission's Atlanta Regional Administrator. More than 3,000 hours were devoted to the investigation; eighteen witnesses testified or gave statements; and one witness was given immunity pursuant to a Commission order. Fedders ultimately testified in September 1982.

C. Indictment

In May 1983, an indictment was returned against Southland and one of its employees.\footnote{213} Later that month, Fedders's counsel was advised by the prosecutors that "out of an abundance of caution," Fedders, along with anyone else who participated in the preparation of the Business Ethics Review, would be a "subject" of the grand jury investigation.\footnote{214} Given such status, and the fact that his conduct was being called into question publicly, Fedders notified the appropriate Senate and House committees of his willingness to testify publicly.\footnote{215} Southland also waived the applicable privileges. On June 28, 1983, Fedders testified before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs about his role in the Southland Business Ethics Re-


\footnote{214. Fedders Testimony, supra note 203, at 17-19; see also Mary Thornton, Chief Enforcer at SEC Subject of Jury Probe, WASH. POST, May 30, 1983, at A1.}

\footnote{215. See Fedders Invites Hearing on His Role in Alleged Bribery Matter, 15 Sec. Reg. & L. Rep., at 1019-20 (June 3, 1983); SEC Official Offers To Give Testimony About Southland, WALL ST. J., June 1, 1983, at 10; SEC's Top Cop Says He'll Testify Now, WASH. TIMES, June 1, 1983, at 8B; Southland Tax Inquiry, N.Y. TIMES, June 1, 1983, at D2.}
view.  

In September 1983, the indicted Southland employee pled guilty to Travel Act conspiracy in return for his cooperation.  

A superseding indictment was then issued against Southland, adding another of its employees, and charging conspiracy with the objectives of violating the Travel Act and committing fraud upon the Internal Revenue Service.  

After a trial at which Fedders testified, Southland was found guilty only of conspiracy to defraud the Internal Revenue Service. The jury was unable to reach a verdict with respect to the individual.  

In the early 1980s, Clark Matthews was asked to stand for election to Southland's Board of Directors. He asked counsel whether he should disclose in the proxy solicitation his status as a subject of the grand jury investigation. He was told that his status did not require disclosure, and no disclosure was made. Subsequently, Matthews was elected as a Southland director. In August 1984, Matthews was indicted and the Southland employee whose prior trial had resulted in a mistrial was reindicted. The first count charged Matthews with knowingly joining a conspiracy to bribe New York State tax officials in violation of the Travel Act.
Qualitative Materiality

Act and the tax collection authority of the Internal Revenue Service. The second count contained a charge of violating section 14(a) of the Exchange Act and Rule 14a-9 by failing to disclose in the proxy statement that Matthews "had engaged in a conspiracy to bribe New York public officials and to defraud the United States." In early 1985, Matthews was tried and Fedders testified as a defense witness. Matthews was acquitted on the first count, but convicted on the second securities count. He appealed, and in 1986, the Second Circuit reversed his conviction.

D. Appeal of Conviction

The Second Circuit framed the issue as "not whether the jury found Matthews guilty of conspiracy in 1985, but whether Matthews should have publicly pronounced himself guilty [in the proxy statement] in 1981," or whether Matthews should have pronounced himself guilty three years prior to the indictment. The court focused on the language of section 14(a) and Rule 14a-9, and noted that the SEC's line item disclosure requirements in Regulation S-K, applicable to proxy statements through Schedule 14A, require a candidate for director to disclose only whether he or she has been convicted in a criminal proceeding within the past five years or is now a named subject of a criminal proceeding. It noted that courts "almost universally have rejected efforts to require that management make qualitative disclosures that were not at least implicit in the Commission's rules." In addition to discussing the Fifth Amendment implications of requiring a nominee to declare himself guilty of an uncharged crime, the court ruled that nondisclosure of un-

225. See Matthews, 787 F.2d at 44; Redwood, supra note 188, at 353.
226. Matthews, 787 F.2d at 45.
227. See id. at 39.
228. See id. at 43.
229. Id. Exchange Act section 14(a) makes it unlawful for any person to solicit, or permit the use of his name to solicit, any proxy "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78n (1994).
230. See Matthews, 787 F.2d at 43 (ruling that, "we find no merit in the Government's argument that Matthews violated section 14(a) and Rule 14a-9 by not confessing that he was guilty of conspiracy three years before he was indicted on that charge"). In addition, the Second Circuit pointed out that no bribe took place. See id. at 40.
231. See id. at 43-44. Item 401(f)(2) of Regulation S-K states that a public company must determine whether any of its directors, director nominees, or executive officers has been convicted or named in a criminal proceeding during the previous five years and then disclose that information if it is deemed material to that person's ability or integrity. See 17 C.F.R. § 229.401(f) (1998); see also Lynch, supra note 98, at 13 (analyzing the Second Circuit's use of Item 401(f) of Regulation S-K in Matthews).
232. Matthews, 787 F.2d at 48.
charged criminal conduct, which is not required by any SEC rule to be disclosed, cannot be a criminal violation.\(^{233}\)

**E. SEC Findings**

In September 1984, before Matthews’ 1985 trial, the SEC staff concluded its investigation of Southland and of Fedders’s role in the Business Ethics Review. The staff did not recommend an enforcement action.\(^{224}\) In its memorandum, the staff analyzed the issue of the materiality of “management integrity” information and whether an enforcement action should be filed against Matthews for the same conduct for which he was under indictment.\(^{226}\) The staff concluded that there was no legal precedent supporting an action against Matthews for the conduct for which he had been indicted.\(^{227}\) Also, the SEC found that Fedders neither violated nor aided and abetted violations of the securities laws and that he was instead a victim of a conspiracy between Matthews and a Southland assistant general counsel.\(^{228}\) The Commission’s action, while non-public, was leaked to the press and reported.\(^{229}\)

**XI. UNITED STATES v. CROP GROWERS: A FINAL RENUNCIATION OF THE STANDARD**

In *United States v. Crop Growers Corp.*,\(^{240}\) the Office of Independent

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233. See id. at 49; Lynch, supra note 98, at 13 (discussing the Second Circuit’s concern with the Fifth Amendment implications of Matthews’s conviction).


235. Id.

236. See generally id.

237. See id. at 81-82.

238. See id.


240. 954 F. Supp. 335 (D.D.C. 1997). Many other courts relied on the *Matthews* holding for the proposition that suspected criminal wrongdoing should not be the subject of mandated disclosure until a violation is charged. See Lynch, supra note 98, at 13 (explaining case law relying on the *Matthews* holding); see also *In re Teledyne Defense Contracting Deriv. Litig.*, 849 F. Supp. 1369, 1383 (C.D. Cal. 1993) (relying on *Matthews* in holding that, until conduct is actually charged as criminal, neither the investigation nor the underlying conduct warrants disclosure). The court in *Roeder v. Alpha Industries, Inc.*, 814 F.2d 22 (1st Cir. 1987), ruled, in a civil securities fraud suit for damages, the *Matthews* holding does not render any material information immune from disclosure. In that case,
Counsel charged three defendants with failing to disclose in filings with the SEC

(a) that Crop Growers violated [the Federal Election Campaign Act ("FECA") by making illegal campaign contributions; (b) that a material contingent liability existed for potential criminal and civil fines because of said violations; (c) that Crop Growers' financial statements were misleading; (d) that Crop Growers maintained false books and records; and, (e) that Crop Growers, its subsidiaries, and their key officers faced criminal and civil sanctions

that could affect its ability to operate. The defendants also were indicted for making false statements under 18 U.S.C. § 1001 and the court noted that the majority of circuits had determined that a violation of § 1001 based on concealment, necessitated that the defendant must have possessed a legal duty to disclose the facts at issue at the time of the alleged concealment. The defendants cited Matthews in support of their argument that Crop Growers possessed no duty to disclose that it violated the FECA by making illegal campaign contributions or illegally maintaining false books or records.

The court dismissed the counts alleging disclosure failures and found that "Matthews . . . is a logical extension of the omission/duty principles." The holding is consistent with the Matthews notion that, "so long

however, the court concluded that the conduct did not warrant disclosure. See id. at 26. The Ninth Circuit, however, in California Architectural Building Products, Inc. v. Franciscan Ceramics, Inc., 818 F.2d 1466, 1472 (9th Cir. 1987), declined to follow the First Circuit's ruling in Roeder. The court said that fraud could occur only if the entity breached an "independent duty" (e.g., fiduciary or statutory) by not disclosing. Id.; cf In re Par Pharmaceutical, Inc. Sec. Litig., 733 F. Supp. 668, 674-78 (S.D.N.Y. 1990) (duty to disclose that FDA approval had been obtained through bribery); Ballan v. Wilfred Am. Educ. Corp., 720 F. Supp. 241, 249-50 (E.D.N.Y. 1989) (duty to disclose that vocational school had encouraged students to obtain funding to be paid to the school with fraudulent loan applications).

241. Crop Growers, 954 F. Supp. at 344; see also Lynch, supra note 98, at 17-18 (describing the counts in the indictment).

242. See Crop Growers, 954 F. Supp. at 344. 18 U.S.C. § 1001 (1994) provides that [w]henever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both.

Id.

243. See Crop Growers, 954 F. Supp. at 347 (explaining the defendants' argument that, under Matthews, they had no duty to disclose uncharged criminal conduct).

244. Id. at 346.
as uncharged criminal conduct is not required to be disclosed by any rule lawfully promulgated by the SEC, nondisclosure of such conduct cannot be the basis of a criminal prosecution."\textsuperscript{245} The \textit{Crop Growers} court stated that "the SEC clearly knows how to write specific disclosure requirements into its regulations, and has chosen not to do so for uncharged criminal conduct."\textsuperscript{246} The court concluded, in conformity with the Second Circuit in \textit{Matthews}, that Item 401(f) of Regulation S-K does not require the disclosure of uncharged criminal conduct.\textsuperscript{247}

\section{XI. Conclusion}

The qualitative materiality standard has come and gone. It died at the bar of common sense. It was a standard that had no standards. Outside of its SEC proponents, it had no champion. Its intended beneficiaries—investors—ignored corporate qualitative disclosures. Moreover, the standard was pronounced unfit for use by the courts because it licensed the Commission to allege disclosure failures for unadjudicated misconduct, or the like, based on its own discretion, not by the rule of law. What is interesting about the qualitative materiality initiative and the questionable corporate payments and practices era of the 1970s is what has survived the demise of these policies.

\textit{The Commission.} The SEC is almost always effective in accomplishing its goals. It has functioned on an even keel for sixty-four years, even through dramatic political and economic changes. Its purpose is to protect investors from fraud, and its focus is the wants and needs of investors. However, through its qualitative materiality initiatives, the Commission abandoned its focus and exceeded its statutory authority. Now, it no longer pursues its qualitative materiality theories.\textsuperscript{248} It may have blithely abandoned respect for legal precedent, but it is wrong to think that those initiatives weakened the agency. Its great stature continues unabated, yet, notwithstanding the Commission's good faith undertaking of those initiatives and its successful institution of improved corporate standards, law enforcement extremism in the defense of investor protec-

\begin{itemize}
\item \textsuperscript{245} United States v. Matthews, 787 F.2d 38, 49 (2d Cir. 1986).
\item \textsuperscript{246} \textit{Crop Growers}, 954 F. Supp. at 346; Lynch, \textit{supra} note 98, at 18 (analyzing the \textit{Crop Growers} court's discussion of \textit{Matthews}).
\item \textsuperscript{247} \textit{See} \textit{Crop Growers}, 954 F. Supp. at 347 (explaining that, with respect to Item 401(f), the court's "own examination of the language" led it to the same conclusion reached by the \textit{Matthews} court); Lynch, \textit{supra} note 98, at 19; \textit{see also} 17 C.F.R. \textsection 229.401(f) (1998).
\item \textsuperscript{248} "Governments will always do the right thing—after they have exhausted all other possibilities." John Fund, \textit{Politics, Economics, and Education in the 21st Century}, \textit{27 IMPRIMIS}, May 1998, at 1, 2.
\end{itemize}
tion is a vice. To remain a premiere law enforcement agency, the SEC must obey the law and attend to the economic interests of investors.

The Commission is movement, not monument. One is dynamic, the other is lifeless. The pioneering enforcers were vigorous. Their vitality helped to explain the appeal and permanence of the agency. It is those who will call themselves SEC enforcers, who will commit themselves to enforcing the securities laws to avoid permitting their inspired movement from becoming uninspired monument.

The Rule of Law. The tendency of the law must always be to narrow the field of uncertainty, so that citizens may know by what standards their conduct will be judged. The securities laws are broadly stated and provide the SEC great discretion in the exercise of its law enforcement responsibilities. Despite that discretion, the Commission must avail every opportunity to specify what conduct is illegal. Due process intends that market participants are entitled to be judged by discernable standards of which they have fair notice. All SEC rules should therefore bespeak fair notice. The Commission should be unwilling to establish new rules through enforcement action, and should always expose its new theories through rulemaking. The qualitative materiality enforcement initiatives were not preceded by rulemaking or by fair notice of the disclosure standards to which registrants would be held.

The Commission's failure in enforcement actions to identify the standards applicable to alleged violations again has become a problem. In 1998, the United States Court of Appeals for the District of Columbia Circuit, which has jurisdictional review authority over SEC administrative orders, held that Rule 2(e)(1)(ii) of the Commission's Rules of Practice fails to establish a standard for determining when accountants engage in "improper professional conduct." Ordering dismissal of one

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249. One ground specifically asserted by the Supreme Court, in favor of a narrow reading of Rule 10b-5 liability, is found in Chiarella v. United States. See 445 U.S. 222, 235 n.20 (1980) (stating a concern that the broad reading proposed by the dissent "would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity").


253. Checkosky v. SEC, 139 F.3d 221, 223 (D.C. Cir. 1998) (dismissing the lawsuit because even on remand, the SEC failed to articulate a standard by which to evaluate whether professional conduct is improper); see also Checkosky v. SEC, 23 F.3d 452, 454 (D.C. Cir. 1994) (remanding the case to the SEC for a determination of the standard for
such charge, the court declared that not only does the Commission "provide no clear mental state standard to govern Rule 2(e)(1)(ii), it seems at times almost deliberately obscurantist on the question."254 The court chastised that "(t)here is no justification for the government depriving citizens of the opportunity to practice their profession without revealing the standard they have been found to violate."255

The facts underlying reversal of this SEC administrative order reflect an unwillingness by the Commission, similar to that demonstrated in the 1970s, to promulgate rules designed to fill in the details of the broadly stated qualitative standard of materiality.256 The SEC exercises commanding police power when it arbitrarily determines disclosure requirements by refusing to establish clear guidelines.257 The SEC should not hold companies to regulatory standards it has not made clear. Instead, the Commission more often should use its rulemaking power to delineate what constitutes appropriate conduct and then set standards for compliance. If Congress wants the SEC to require disclosure of qualitative information, how are we to establish the morality, ethical, or unadjudicated
determining "improper professional conduct"). The SEC's administrative order in Checkosky may reflect a return to Commission practices of the 1970s when it violated the rule of law, exceeded its statutory authority through qualitative materiality initiatives, and was unwilling to provide standards or definitions. The SEC must be vigilant not to return to those prior habits.

254. Checkosky, 139 F.3d at 225.
255. Id. at 225-26.

256. When the media reported on Checkosky and other court decisions rejecting Commission efforts to hold alleged disclosure violators responsible in the absence of an SEC rule, the SEC's then General Counsel and now Director of the Division of Enforcement, Richard H. Walker, was reported to have said “[w]e will of course pay attention to what the court decisions say... but... you can't overregulate and micromanage, because the system suffers when you do everything by rule.” Beckett, supra note 250, at B7. The securities industry suffers when the SEC fails to establish standards that would allow market participants to determine by what standards their conduct will be judged. Although the SEC's mission is critical to the integrity of our capital markets, its processes cannot usurp the rights of individuals. The notion that people should trust federal officials because they are government employees has too often failed citizens' rights. Individual rights must be the preeminent consideration in the creation of government initiatives.

257. See Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1035 (4th Cir. 1997) (addressing whether debt security markups were fraudulently excessive). The court found it "puzzling," and said it was "acutely uncomfortable" with the SEC's amicus curiae argument, that the Commission, having chosen not to require disclosure of markups under Rule 10b-10, would argue for a judicially created disclosure rule under the general antifraud rule, Rule 10b-5. See id. The decision is representative of a line of cases in which judges have rejected SEC attempts to use enforcement actions or amicus participations in private litigation to develop regulatory standards appropriately established through rulemaking proceedings or prospective policy announcements. Judges are increasingly receptive to defense arguments that their clients failed to receive fair notice of the standards by which their conduct would be judged.
norms? What is the corporate behavior morality that we want disclosed? Of course, we want our leaders to be ethical, but all ethics are not codified in law.

The Qualitative Standard. The rule is that corporations need not disclose unadjudicated violations of law or antisocial or unethical conduct unless the information is quantitatively significant to investors and alters the total mix of information made available. The compelled disclosure of uncharged and unadjudicated criminal conduct would violate the Fifth Amendment.

In awareness of this difficulty in 1982, the Director of Enforcement defined standards of objective quantitative materiality by which the Commission could initiate enforcement actions for the failure to disclose illegal conduct. Those objective standards permit registrants to make informed disclosure decisions, and provide a rule of law by which the SEC can initiate enforcement actions for the failure to disclose illegal conduct.

Investors. "They're in it for the dollars." Ordinarily, investors dismiss ethical and moral norms when saving and investing. Investor education lacks moral focus.

Investors are educated to save, invest, diversify, sell if dissatisfied, and to avoid fraud. This education has caused investors to focus their investment analysis on assets, income, and earnings. Even in the 1970s, the SEC undertook no effort to capture the interest of investors by educating them about qualitative information analysis. It also failed to educate the courts that investors use information about corporate moral norms. Consequently, reports of bribes and kickbacks did not capture the interest of investors, nor impact their saving and investing. Investors perceived that the information was irrelevant to their economic decisions and portfolios.

Why should investors' interest in the moral norms of corporate chieftains be any different from society's interest in the morality of elected officials? Most Americans tell pollsters that, even if President Clinton did commit adultery, did lie about it, and did attempt to obstruct justice, he should nevertheless remain in office.

The common interest of investors is a reasonable return on savings; this economic interest is their sole focus. Thus, they are concerned with information that helps them make decisions that they believe will add value to their portfolios. Consequently, the SEC's disclosure policies must be oriented to regulating according to quantitative standards, not standards based on morality.

Corporate Conduct. The disclosures in the 1970s of bribes and payoffs
shocked even the hardened cynic. However, the responsive undertaking of voluntary self-examinations and promulgation of corporate codes of conduct and internal mechanisms for policing those standards was impressive. For better or worse, corporate morality will be driven by economic return.\textsuperscript{258} Although disclosure of qualitative information failed to influence investment decisions, the disclosures caused many enterprises to alter their internal business practices. While the SEC made a valiant effort to improve corporate conduct by instituting a qualitative standard of materiality, the SEC’s efforts to accomplish those goals violated the rule of law, and thus could not be maintained.

The argument that the securities laws do not require disclosure of qualitative information is not a suggestion that illegal conduct should be condoned. As a society, we have achieved a consensus that bribes and kickbacks are serious crimes—ones that have adverse effects on business and society. There can be no reasonable argument supporting those illegal acts. But, beyond its responsibilities under the securities laws, including the FCPA, the SEC has no role in the prosecution of those who engage in illegal or antisocial conduct.

“Workers, owners, managers, stockholders, and consumers are moral agents in economic life. By our choices, initiatives, creativity and investment, we enhance or diminish economic opportunity, community life, and social justice.”\textsuperscript{259} Ethics must be upheld in business dealings. Personal responsibility is essential.

The chief responsibility for policing corporate conduct falls upon boards of directors. Pressure for ethical and moral behavior must come from a sense of propriety that cannot be mandated by law. Instead, corporations must depend upon their internal discipline and on their managers to make moral decisions. Companies must expand their internal controls for self-policing; sentences for criminal conduct can be reduced if a corporation has internal compliance and supervision procedures which are effectively implemented. Under circumstances where misconduct is discovered, corporate directors have the responsibility to sanction wrongdoers and correct corporate practices.

Those supporting the SEC’s efforts to promote disclosure of qualitative information ask how institutional behavior will be policed if not by the SEC. In addition to internal corporate discipline and criminal prose-


cutions, corporate wrongdoing will continue to be uncovered by securities analysts and investigative reporters. Misconduct will be revealed by disgruntled employees, competitors, underwriters performing due diligence investigations, and independent auditors and counsel. These watch-dogs exercise significant oversight of corporate conduct.

The Future of Disclosure. There is always a need for the SEC to develop new disclosure techniques for corporations to better report the source from which they derive their value. We are witnessing a profit migration away from products to services. Nonetheless, financial statement presentations today do not provide information about how intellectual capital adds value. To remedy this incongruence, the SEC should develop a technique for reporting intellectual capital.

Markets cannot survive without transparency. Investors need information about sources of profits, asset quality and location, and financing activities. To the extent that companies confuse the market by distributing misleading information, their operations and markets will suffer severe disruption when a previously concealed truth unexpectedly is disclosed. The same cannot be said about undisclosed facts regarding unadjudicated corporate misconduct, or antisocial or unethical behavior. The revelation of such information does not translate into stock market gains or losses.
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