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Disclosure of Corporate Payments Abroad and the Concept of Materiality

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DISCLOSURE OF CORPORATE PAYMENTS ABROAD AND THE CONCEPT OF MATERIALITY

The controversial subject of corporate payments abroad, widely reported in the press during the past year and also the focus of numerous governmental investigations,1 raises several problems with respect to federal securities regulation. Foremost, and the particular concern of this article, is whether the Securities and Exchange Commission acts within the scope of its authority when it requires public disclosure by American corporations of corporate expenditures abroad. Critics charge that by requiring public disclosure the Commission is imposing its own standards of appropriate business conduct2 on both domestic companies and foreign governments.

At the crux of the controversy is the determination of what constitutes a “material” fact that must be disclosed to investors. This article will review the expanding and elusive concept of materiality, and examine several factors which may be helpful in measuring whether a particular payment or questionable activity is material. Such a discussion should be useful, not merely with regard to the present bribery scandal, but as a guide to analyzing future demands by investors for information which was not pre-

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1. Investigations have been made by numerous bodies and agencies including the Internal Revenue Service, Newsweek, Sept. 1, 1975, at 54; the Securities and Exchange Commission, N.Y. Times, Feb. 1, 1976, § 4 (The Week in Review), at 3, col. 1; the Senate Banking Committee, Newsweek, Sept. 1, 1975, at 50; the Senate Subcommittee on Multinational Corporations of the Senate Foreign Relations Committee, N.Y. Times, Feb. 25, 1976, at 1, col. 5. President Ford has appointed Secretary of Commerce Elliot Richardson to head a new Cabinet-level task force to consider the foreign payments matter. Wall St. J., Apr. 9, 1976, at 3, col. 3. Payments are being made directly to the host country officials involved in the governmental decisionmaking process, SEC v. United Brands Co., [Current] CCH Fed. Sec. L. Rep. ¶ 95,420 (D.D.C. Jan. 27, 1976), to local agents who know which people to pay and how much, Griffith, Payoff is Not “Accepted Practice,” Fortune, Aug. 1975, at 122, or to political parties in the form of contributions. Id. at 124. See Wall St. J., May 19, 1975, at 1, col. 6.

An investigation conducted by the SEC revealed the widespread existence of secret slush funds and falsified books which concealed from shareholders, and often directors alike, the actual use of corporate funds. In the view of the SEC, Commissioner Phillip A. Loomis, Jr. said, this “necessarily rendered inaccurate the financial statements filed with the Commission.” N.Y. Times, June 18, 1975, at 56, col. 3. The SEC moved to require disclosure of “anything that is material . . . [and which] pertains to the quality of a company's earnings and the high-risk methods of a company's doing business.” Smith, S.E.C.'s Tough Guy, N.Y. Times, Oct. 5, 1975, § 3 (Business & Finance), at 5, col. 2, quoting Stanley Sporkin, Chief of the SEC Division of Enforcement.

viously considered material for investment decisionmaking and therefore was not disclosed.

BACKGROUND

"The keystone of the entire structure of Federal securities legislation is disclosure." The Securities Act of 1933—the "truth in securities" bill—requires that companies selling securities to the public disclose the factual data necessary for an investor to make a rational investment decision. The ground rule of federal securities regulation is that the government will not judge the quality of any security, but will mandate the disclosure of necessary information so that in a fair, free, and open market, the security will rise or fall on its own merit. In his message to Congress on March 29, 1933, President Franklin D. Roosevelt said: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller."7

Under the 1933 Act and the Securities Exchange Act of 1934, the Commission may require disclosure of information that is "necessary or appropriate in the public interest or for the protection of investors," or "to insure fair dealing in the security." Rule 10b-5, promulgated under the 1934 Act, makes it unlawful "to make any untrue statement of a material fact or to omit to state a material fact . . . ."8 In order to protect investors, the

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11. SEC Rule 10b-5 was adopted in 1942 by the Commission under the Federal Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b), on the basis of a recommendation by the staff. The rule reads as follows:
Commission has promulgated regulations under section 6 of the Securities Act of 1933 and sections 12, 13, and 14 of the Securities Exchange Act of 1934. These regulations require corporations to furnish in registration statements, annual or quarterly reports, and reports included in proxy statements, information that is "material" and "necessary" to make the reports or statements fair representations and not misleading.\textsuperscript{2}

The broad disclosure requirement is aimed at matters of economic significance to the investor, and is not designed as a substitute for business regulation. Disclosure can be validly utilized, however, as an indirect form of pressure on corporations to influence conduct. For example, several items required to be disclosed are of little interest to investors and yet must be revealed:\textsuperscript{3}

\begin{quote}
[R]equirements in the prospectus and proxy statements relating to management compensation and transactions between management and the company may be of marginal value. . . . Nevertheless, compelling such disclosure may be justified as imposing a moderating influence on corporate compensation and as encouraging the elimination of as many conflict of interest opportunities as possible.
\end{quote}

The traditional view is that appropriate publicity tends to discourage questionable practices and elevate standards of business conduct.\textsuperscript{4} As long as the disclosure requirements are rooted in

\begin{quote}
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails or of any facility of any national securities exchange

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
\end{quote}


The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions; to force knowledge of

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terms of economic significance, their secondary function as tools for regulating conduct are considered justifiable.

Since securities regulation centers on the policy of disclosure, it is understandable that the entire system depends upon the integrity of full and accurate reporting and the maintenance of complete records. In the market system, as in the court system, the appearance of honesty and fairness is as important as honesty and fairness. Securities regulation, enacted in the aftermath of the financial community's greatest crisis and during the nation's most severe depression, was designed by Congress not merely to provide information to investors, but to restore confidence in the investment system.

**Materiality**

Rule 405, promulgated under the 1933 Act, provides:

The term "material" when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.

The average prudent investor is not concerned with the omission of insignificant details or with minor inaccuracies. Investors who are contemplating a purchase or sale are interested only in those "facts which have an important bearing upon the nature or condition of the issuing corporation or its business." Determination

them into the open is largely to restrain their happening. Many practices safely pursued in private lose their justification in public. Thus social standards newly-defined gradually establish themselves as new business habits.


16. President Roosevelt explained in a message to Congress that securities legislation was necessary for "what we seek is a return to a clearer understanding of the ancient truth that those who manage... other people's money are trustees acting for others." 77 CONG. REC. 937 (1933).

Representative Sam Rayburn said:

the purpose of the bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller.

... When a people's faith is shaken in a business the business becomes halting and lame...
of materiality is a prerequisite to evaluating whether there is liability on the part of persons obligated to make disclosure. "Materiality in the abstract is a meaningless concept." Materiality, within the meaning of the securities acts, is the significance of the misstatement or omission of fact under consideration to a reasonable investor's judgment in deciding to buy or sell. Notwithstanding the Act's attempt to define materiality, it remains an elusive concept. Its meaning can be defined only by examining all aspects of a particular transaction.

Judicial Interpretation of Materiality

 Authorities are divided on the nature of the burden of proof necessary for a plaintiff to establish materiality. The ALI Federal Securities Code adopts the position of the First Restatement of Torts that materiality is determined by whether "a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question." A considerably lower threshold of proof than the "would" standard defines materiality as those facts "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities" or which "might have been considered important by a reasonable shareholder who was in the process of determining how to vote." The Supreme Court used the "might" test in Mills v. Electric Auto-Lite Co., but also included language that arguably limits a broad reading of the "might" test:

26. Id. at 384 (emphasis in original). The outcome of Northway v. TSC Industries, 512 F.2d 324 (7th Cir.), cert. granted, 96 S. Ct. 33 (1975), should end the uncertainty that has existed since the Mills decision. The difference between "might" and "significant
Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. . . . This requirement that the defect have a significant propensity to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a). [Citations omitted.]

Two years later, however, the Court made no reference in a 10b-5 case to the "significant propensity" designation. In Affiliated Ute Citizens v. United States,27 the Court indicated that the following is the correct test to be applied to determine materiality:28

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. [Citations omitted.]

Several courts,29 particularly in the Second Circuit, have

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propensity" may appear to be negligible, but Judge Swygert's opinion in Northway demonstrates the importance of the distinction:

Different results could flow from a test requiring only that the omitted fact "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote" than would flow from a test requiring that the fact have "a significant propensity to affect the voting process."

[Footnote omitted.] On a motion for summary judgment, the "might have" test would ask whether a reasonable mind could conclude that the omitted fact is so irrelevant that it would never reasonably be considered important. The "significant propensity" test would ask whether a reasonable mind could conclude that the fact is less than significant in its potential to affect the voting process. Many facts which are relevant within the first test could reasonably be said to have less than a significant propensity to affect the voting process taken as a whole, even though for some few stockholders these same facts could be determinative.

Id. at 330.


29. See, e.g., Smallwood v. Pearl Brewing Co., 489 F.2d 579, 604 (6th Cir.), cert. den. 501 F.2d 386 (6th Cir.)
expressed dissatisfaction with the “might” test. Judge Friendly of the Second Circuit rejected the test as being “too suggestive of mere possibility, however unlikely.” He preferred instead the “significant propensity” test enunciated in Mills, because the language “comes closer to the right flavor.” In fact, Judge Friendly seems to have combined the “might” and “significant propensity” tests in 1968, in General Time Corp. v. Talley Industries, Inc., another section 14(a) case. He stated:

The test, we suppose, is whether, taking a properly realistic view, there is a substantial likelihood that the misstatement or omission may have led a stockholder to grant a proxy to the solicitor or to withhold one from the other side, whereas in the absence of this he would have taken a contrary course.

The question of which materiality standard applies clearly influences the determination of whether a particular fact will be held to be material. Resolution of the “would,” “might,” and “substantial likelihood . . . may” controversy, however, will only provide a departure point for analysis.

**Viewing Materiality as Consisting of Quantitative Data**

Material information has traditionally been viewed from a quantitative perspective. Investors and the Commission have usually considered balance sheet profit and loss information—hard data—as important. Examples of material items also include:

[M]aterial changes from period to period in the amounts of the items of revenues and expenses, . . . [and] changes in accounting principles or practices.

... Changes in product mix or in the relative profitability of lines of business; changes in advertising, research, develop-

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31. Id.
32. 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969); see Northway v. TSC Industries, 512 F.2d 324, 331 n.13 (7th Cir.), cert. granted, 96 S. Ct. 33 (1975), where the court agreed that Judge Friendly had applied a “mixed” test in General Time.
33. Id. at 162 (emphasis added).
ment, or product introduction or other discretionary costs; . . . acquisition or disposition of a material asset other than in the ordinary course of business; . . . unusual charges or gains . . . ; changes in assumptions underlying deferred costs and the plan for amortization . . . [and] changes in assumed investment return and in actuarial assumptions used to calculate contributions to pension funds . . . .

Information viewed as material has also encompassed "dividend information, . . . significant shifts in operating or financial circumstances, such as litigation, cash flow reductions, major write-offs, and strikes at major facilities." Thus information has been considered material when it is composed primarily of significant economic and financial data.

The concept of materiality has been greatly expanded and the resulting erosion of traditional financial and economic approaches to this concept has generated widespread confusion and concern among members of the securities bar. Former Commissioner A. A. Sommer, Jr. has observed that occasionally the Commission staff will suggest that lengthy portions of a registration statement be omitted, only to find that counsel for underwriters and issuers insist upon disclosure for fear that a later court might determine the omitted portion to be material.

Commissioner Sommer, among others, regards the advent of the "ethical" investor, one concerned about public interest ramifications in addition to profit, as an important factor in the increasing expansion of the concept of materiality. Social activist groups have discovered that securities laws can be a means to compel corporate disclosure of the role that the particular company plays in matters concerning equal employment, civil rights, and environmental protection. It is more likely, however, that pressure to expand the notion of materiality is partially due to the fact that many investors have come to realize that traditional information—profit and loss data—is no longer sufficient.

36. Address by former Commissioner A.A. Sommer, Jr., Practising Law Institute Seminar on Materiality, in New York City, Dec. 8, 1975. See also Sommer, supra note 20, at 1.
37. Id.
38. Id.
39. See note 129 infra and accompanying text.
Incorporating Other Factors to a Determination of Materiality

There are four tests which might be more beneficial to a determination of materiality than the use of a traditional quantitative approach. The first of these tests is to examine materiality in terms of information that scrutinizes management's integrity and ability. It is universally recognized that the quality of management is crucial in evaluating the ultimate success or failure of a business enterprise. In \( \text{In re Franchard Corp.} \), a prospectus which omitted any reference to improper withdrawals of money by the chief executive officer for his personal use was held to be materially deficient. Even though the principal's indebtedness to the registrant never exceeded 1.5 percent of the gross book value of the registrant's assets, the Commission ruled that the significance of the transaction turned not on dollar amounts in relation to equity or cash flow, but on the importance to prospective investors of information concerning the officer's managerial ability and personal integrity. In another case, the failure to disclose that officers and directors faced derivative litigation for fraud and breach of fiduciary duty was held by the court to be a material omission. In \( \text{Cooke v. Teleprompter Corp.} \), the fact that the chairman and chief executive officer had been convicted of bribery and perjury was held to be material. Similarly, in \( \text{SEC v. Kaluex} \) proxy material which failed to reveal that a director and officer received kickbacks from the corporation's business transactions was held to be false and misleading.

The Commission further supported the view that an investor is entitled to have information about management integrity when

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42. Id. at 82,041.
43. Id. at 82,043.
it issued Securities Act Release No. 5466.47 In the context of illegal domestic campaign contributions, the Commission ruled that:48

[T]he conviction of a corporation and/or its officers or directors for having made illegal campaign contributions in violation of 18 U.S.C. Section 610 is a material fact that should be disclosed to the public and specifically to shareholders, particularly in the context of 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 of the corporation as it relates to the operation of the corporation and the use of corporate funds.

The Commission also concluded that any pending indictment under the Act "should" be disclosed.49

Although it is true that the majority of the aforementioned lawsuits concerned management that catered to self-interest, often at the expense of the company, these cases nonetheless established a growing awareness that corporate methods and scruples are relevant to the investor. The concept of materiality must be sufficiently broad, therefore, to encompass information pertaining to the quality and integrity of management.

A second guide to a determination of materiality is to analyze whether a substantial number of shareholders want the information. It has been suggested that information not usually regarded as crucial to investment decisionmaking can become material when a significant percentage of investors determine that a factor might be worthy of consideration.50 In Feit v. Leasco Data Processing Equipment Corp.,51 a case involving the adequacy of disclosure in a prospectus, District Judge Jack B. Weinstein pro-

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48. Id. at 83,874.
49. Id. Whether this means that the Division of Enforcement will regard nondisclosure of a pending indictment as "material" is not clear. The final sentence of the release characterizes management as being in "the best position" to determine if disclosure is necessary.

In Lyman v. Standard Brands, Inc., 364 F. Supp. 794 (E.D. Pa. 1973), the fact that three members of the proposed independent auditor's office were indicted for violations of the federal securities laws was held to be immaterial. In Lyman, the accounting firm had 749 partners, 10,577 employees, and the indicted accountants were not working on this account.

posed using a statistical solution to determine whether "it is more probable than not that a significant number of traders would have wanted to know [the fact] before deciding to deal in the security at the time and price in question." He suggested that if 10 percent of either the number of potential traders or those potentially making 10 percent of the total number of sales claimed that they would have wanted to know the fact in question before making a decision, that would be sufficient for maintaining that the fact was material.

This concept of polling investors to determine materiality could be adopted in two ways. First, investors of a particular company might demand specific information from their company's management, and the results of a survey of investors would be an indication (to a court, if necessary) whether significant numbers of investors of that company desired the non-disclosed facts. Second, if significant numbers of investors were to petition the SEC and request that certain data be disclosed, the Commission would then mandate the release of that information. Since materiality is defined in terms of information for the "average" or "reasonable" investor, if more than an incidental number of investors demand information not previously disclosed, the notion of what is, or should be, material would be altered to adjust to the needs of the "new" average investor.

A third approach to a determination of materiality is to assess the significance of business affected where a quantitative approach is inadequate. Accountants and auditors have long had to decide what constitutes a material item for disclosure purposes. This has been done by examining the amount in question. An expense, for example, which exceeds 5 percent of all expenditures, must be itemized. Sometimes the figure used is as high as 10 percent. Where, however, an item is less than a particular percentage and ordinarily not disclosed, it can nevertheless have a greater impact than the quantitative data would indicate.

It is conceivable that a substantial amount of a company's business could be affected indirectly by an item which would otherwise seem trifling. The cost of fuel or raw materials may be

52. Id. at 571.
53. Id.
54. See note 145 infra and accompanying text.
55. DEFLIES, JOHNSON & MACLEOD, MONTGOMERY'S AUDITING 35 (9th ed. 1975). See also id. at 32-34.
a relatively small amount, but shortages of these items could retard production.\textsuperscript{57} The risk characteristics of certain assets have been substantially changed by recent economic conditions; assumptions which have formed the basis of accounting principles in some situations are now subject to extreme uncertainty.\textsuperscript{58} The Commission has recognized these possibilities and recently ordered the disclosure of unusual risks and uncertainties in financial reporting.\textsuperscript{59} This means that an item can become material even though it does not now significantly affect business.

A fourth approach to determining materiality is to examine the accuracy and integrity of the books and records of the corporation. Implicit in investor confidence in a company's financial accounting is the honesty and accuracy of its reporting system.\textsuperscript{60} Financial accountability is contingent upon the maintenance of complete and reliable reporting; failure to so account is a serious violation of the federal securities laws. Disclosure of falsified accounting records or utilization of unrecorded cash funds would certainly cast doubt on everything else reported by management. Integrity in the financial statement has "always been the foundation stone of the entire disclosure system."\textsuperscript{61}

**FOREIGN PAYMENTS IN THE MATERIALITY SCHEME**

**Recent Disclosures of Bribery**

Bribes and other payments in the course of business are by


\textsuperscript{59} Id. at 62,431.

\textsuperscript{60} False financial reporting is extremely serious. Even where the purpose of fraudulent reporting, as in one case, was to defraud the government and not investors, and the independent auditors who were charged with the fraud had not personally gained from the misstatements, liability was found by the court. Investors and the public were nevertheless hurt because the purpose of financial reporting is to "inform the man on the street" and to have truthful information in buying. The alleged misstatements misled the public and fraudulently induced the sale of securities. Drake v. Thor Power Tool Co., 282 F. Supp. 94, 104 (N.D. Ill. 1967).

\textsuperscript{61} N.Y. Times, Nov. 7, 1975, at 53, col. 3, quoting Alan B. Levenson, Former Director of the Division of Corporate Finance, SEC. Former Chairman Garrett expressed the same view in Homily on the Glories of Right Conduct and the Wages of Sin, American Society of Corporate Secretaries, June 27, 1975; accord, Commissioner Sommer, The Limits of Disclosure, Address before the Wharton—AICPA Advanced Management Program for CPA Firm Partners, June 24, 1975; Commissioner Loomis, Statement before Subcomm. on Int'l Economic Policy of the House Comm. on Int'l Relations, at 5, June 17, 1975 (prepared but not delivered on that date). Copies of the speeches are available from the Securities and Exchange Commission.
no means of recent origin. In the 1600's, the British East India Company gave Mogul rulers "'rare treasures,' including paintings, carvings, and 'costly objects made of copper, brass, and stone'" in exchange for duty-free treatment for its exports. Although the practice appears to be long-standing, the magnitude of the payments is not.63

The least common and least subtle form of bribery is exemplified by the experience of the United Brands Company which paid $1.25 million to the President of Honduras to secure a reduction of the export tax on bananas.64 The bribe was made in a desperate effort to save the company after it had suffered devastating losses caused by a hurricane.65

Bribes have also taken the form of contributions to political parties. Mobil Oil Corporation allegedly contributed $2 million to Italian political parties and recorded the payments as advertising and research expenditures.66 Exxon purportedly paid $46 million between 1963 and 1972 for secret political contributions.67 Lockheed, by its own admission, has paid $22 million since 1970 to political parties and government officials, while some reports claim the figure is closer to $200 million.68 Gulf Oil Corporation contributed $3 million to the party of President Park of South Korea after Gulf's former President Dorsey was told by the chief fundraiser, in terms "that left little to the imagination,"69 that the company's $300 million investment would not otherwise be safe.70 These contributions, often reported to be legal in the countries in which they are made, may, in fact, be illegal.71 For example, in Italy there appears to be a dispute whether contributions

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63. Over a three-year period, for example, Northrop Corporation (a major aerospace concern) reportedly paid out $30 million, about equal to the company's total net income for that same three-year period. FORTUNE, supra note 1, at 202.
65. Id. at 23, col. 2. The United Brands situation has been one of the most widely reported examples of corporate bribery. While it is usually noted in the press that the company's chairman, Eli Black, most certainly knew of and approved the plan, it is less often reported that he preferred and frequently utilized social contributions, the public donation of hospitals, medical supplies, and emergency aid, to ingratiate the company with the host country. Id. at 21, col. 2.
68. NEWSWEEK, Sept. 1, 1975, at 50.
69. NEWSWEEK, May 26, 1975, at 65.
70. Id.
71. Id. at 66.
can be made legally by corporations. Government sources argue that payments are legal in Italy if there is shareholder approval and proper entry of records on company books.\textsuperscript{72} In the case of Esso Italiana, for instance, the Exxon subsidiary which allegedly contributed $46 million to Italian political parties, these two conditions were not met. Esso’s sole shareholder (Exxon, Inc.) authorized the payments, thus fulfilling the first qualification. There was not adequate compliance, however, with the second part of the test: Esso did not disclose the real use of the funds in their records and maintained that political parties did not want the payments disclosed.\textsuperscript{73}

Monies have frequently been paid to influential persons by an agent who receives 4 to 6 percent of the contract price for large contracts, although the percentage can be as high as 25 percent for smaller contracts.\textsuperscript{74} Agents introduce the company to knowledgeable and important officials and brief the company on industrial, economic, and political policies of the foreign country.\textsuperscript{75} These agents also offer market and technical information, interpreter and translation services, counseling on local law, visa and exit permits, and assistance in observing customs and traditions. The agent may also serve the interests of the foreign government by undertaking tasks that the officials could not in good conscience perform themselves. In Saudi Arabia, for example, sales agents execute documents providing for interest payments since officials cannot, for religious reasons, sign such documents.\textsuperscript{76}

Some companies report that they must resort to the use of agents in certain foreign countries in order to do business. Del Monte Corporation tried for 18 months to buy a 55,000 acre banana plantation in Guatemala but the local government procrastinated.\textsuperscript{77} The company eventually followed the suggestion of the United States Ambassador which had been made at the outset and hired a “consultant” for $500,000. Suddenly the government

\textsuperscript{72} N.Y. Times, July 13, 1975, § 1, at 22, cols. 3-4.
\textsuperscript{73} Prospectus of the Exxon Pipeline Co., Oct. 16, 1975.
\textsuperscript{74} \textit{FORTUNE}, supra note 1, at 205.
\textsuperscript{75} Thomas V. Jones, President and Chairman of Northrop Corporation, explained to the independent auditing committee commissioned by Northrop that “you don’t attempt to go into these countries and bribe people, but that you have to know who you should talk to and then just wait for the right opportunity to do so.” Documents Relating to Foreign Sales and Operations of the Northrop Corporation, at 70. A copy of this report is on file in the office of the \textit{Hofstra Law Review}.
\textsuperscript{76} \textit{Id.} at 511-12.
\textsuperscript{77} Wall St. J., July 14, 1975, at 1, col. 6.
reversed itself.\textsuperscript{78} That experience is common, according to inter-
views of American business executives conducted by the Wall
Street Journal.\textsuperscript{79} Many companies “operate through local distrib-
utors, representatives, sales agents or ill-defined ‘consultants’
who are well-connected citizens” who spread the cash around.\textsuperscript{80}

There are some major companies such as Xerox, I.B.M. and
R.C.A. which purportedly refuse to participate in these types of
activities regardless of the gains to be made.\textsuperscript{81} Other companies,
particularly the highly regulated natural resources companies or
capital investment companies (such as aerospace which must rely
heavily upon government contracts) find that they must pay
bribes, kickbacks, political contributions, and agent’s fees in
order to transact business abroad.\textsuperscript{82}

\textbf{Analyzing Bribery Under the Four Tests of Materiality}

In analyzing the materiality of bribery, the threshold
question is whether the information is the sort that an average,
reasonable investor “might” need, or in “substantial likelihood
. . . may” need, in order to make an investment decision.\textsuperscript{83} When
economic information is directly related to an evaluation of the
worth of a security, the information is “material” to the decision-
making process.

As discussed earlier, a traditional determination of material-
ity requires the examination of amounts in question and other
quantitative data.\textsuperscript{84} Since the companies involved in the bribery

\begin{footnotes}
\footnotetext[78]{Id.}
\footnotetext[79]{Wall St. J., May 9, 1975, at 10, col. 2.}
\footnotetext[80]{Id.}
\footnotetext[81]{FORTUNE, supra note 1, at 122.}
\footnotetext[82]{Crittenden, \textit{Closing In on Corporate Payoffs Overseas}, N.Y. Times, Feb. 15, 1976,§ 3 (Business & Finance), at 1, col. 4, citing a survey of 73 American executives by the
Conference Board.}
\footnotetext[83]{See notes 21-33 supra and accompanying text.}
\footnotetext[84]{See notes 55 & 56 supra and accompanying text.}

The accounting profession is in the process of deciding how to deal with the reporting
of foreign payments abroad. The Executive Committee on Auditing Standards of the
American Institute of Certified Public Accountants has proposed a revised standard to be
voted upon by the membership of the A.I.C.P.A. The proposal adopts the traditional focus
of materiality, which is to examine the dollar amounts of a particular payment. In addi-
tion, however, it directs auditors to consider “the related contingent monetary effects.”
Wall St. J., Apr. 19, 1976, at 8, col. 3. These would include “fines, penalties and damages,
and such ‘loss contingencies’ as expropriation.” \textit{Id.} The proposal also suggests that if a
substantial amount of business is contingent upon an illegal payment, that risk would
have to be disclosed. \textit{Id.; see} notes 98-119 \textit{infra} and accompanying text.
\end{footnotes}
controversy are, for the most part, large multinational corporations, this approach is inapposite since the amount of bribes will frequently be small, relative to that company’s assets or earnings. In the case of Lockheed any future amount paid in bribes might well be regarded as material, since the Emergency Loan Guarantee Board has warned the company that a repetition of improper practices will subject Lockheed to the risk of losing loan guarantees which substantially enable the corporation to continue to operate.\textsuperscript{85}

Examining the legality of bribery or the general lack of enforcement of laws prohibiting the practice is likewise not a helpful guide. Many of the foreign payments that have been disclosed by SEC and congressional investigations were arranged by means which were not illegal (for example the use of a sales agent or consultant), yet still rendered the transactions riskier than might appear to uninformed outsiders. The controversy which surrounds the utilization of “consultants” or “agents” stems not from allegations of illegal conduct by the corporation, but from the dubious activities of local citizens on behalf of the company. Political contributions are also legal in some countries. Yet disclosure might reveal that management is being extorted by officials—a fact which could escalate into a more significant problem. General condonation by host law enforcement officials of outright illegal activity may appear to obviate a need for concern. Serious consequences could result, however, should a change of governmental policy or personnel lead to more stringent enforcement of the law.\textsuperscript{86}

The important question which ought to be asked by the SEC is whether the investor is provided with enough financial information to make an informed judgment to buy, sell, or hold. By examining bribery in light of the four methods of determining materiality discussed earlier, one could conclude that most foreign payments are material, not because they are improper, im-

\textsuperscript{85} Wall St. J., Aug. 26, 1975, at 2, col. 3.

\textsuperscript{86} Indeed, Stanley Sporkin, Director of the SEC’s Division of Enforcement, is reported to have said at a recent seminar that some of the penalties in foreign countries for bribery “scare the heck out of me. They throw the person away for long periods of time or parts of his body away for long periods of time.” Address by Stanley Sporkin, Seventh Annual Institute on Securities Regulation, Practising Law Institute, New York City, Nov. 8, 1975, quoted in Brief for Respondents at 4, SEC v. Lockheed Aircraft Corp., Misc. No. 75-0189 (D.D.C. Nov. 11, 1975).
moral, or illegal per se, but because they constitute important items of economic data needed by the investor.

1. **Integrity of Management**

Investors concerned with gauging the integrity and capability of management as an indicator of a company's possible success, would be interested in examining the means used in transacting business. An investor would have to examine the nature, size, and origin of the bribe, contribution, or consultant's fee to determine the purpose of the payment. A differentiation can be made between money spent to acquire a contract, and money spent after a contract is awarded to retain the business. As an example of payments made to acquire business, Lockheed is reported to have spent as much as $3 million in order to sell each $22 million plane. Investors might have assumed that the plane sold well in Saudi Arabia, Canada, Great Britain, and Japan because it is qualitatively superior to others which are similarly priced. It has been reported, however, that government investigators believe that payoffs were involved in virtually every case, and that these payoffs more likely explain the sales. That management employs payoffs as a means to secure sales, instead of using the capital to improve the product, or conversely, to reduce the per-plane cost in order to compete better, is information that enables the shareholder to assess the quality and methods of management. It is possible that shareholders will accept these tactics and even demand that they continue, but it is nonetheless a matter of great significance to the company, the shareholder, and the prospective shareholder.

Even when management is opposed to the use of payoffs to acquire business, a company may be coerced into bribery once it has begun doing business in the host country. Columnist William F. Buckley, Jr. reported, for example, that broadcasting networks routinely bribe foreign officials "to facilitate the delivery of their precious cargo." If customs laws in many countries were strictly enforced, cans of video tape would have to be searched for drugs which would delay the sending of newsfilms and would soon put the networks out of the news business. The

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88. *Id*.
result is that "everybody does it."\textsuperscript{90} Gulf's former President Dorsey testified that his company had paid $200,000 "as the only way" to obtain permits to operate an oil installation in which the company had invested $150 million.\textsuperscript{91}

These "after-the-fact" payments would be less likely to alarm shareholders than the disclosure that management could operate successfully only by buying contracts. An inefficient management, driven to make a profit, may tender bribes to offset its ineptitude, risking corporate assets and reputation in an effort to maintain its position at the helm. This analysis could lead to the conclusion that while payments of a few thousand dollars made to acquire a contract might properly be regarded as material, payments of many thousands of dollars to expedite deliveries (for example, cans of video film) might well be immaterial.

2. \textit{A Significant Number of Shareholders Want Information}

The Commission could adopt Judge Weinstein's suggestion in \textit{Feit v. Leasco Data Processing Equipment Corp.}\textsuperscript{92} and apply it to the question of bribery. The test that information is material if there is a "substantial likelihood" that an investor "may" want to know, arguably is met if more than an insubstantial number of shareholders regard the information as important. This approach recognizes that investors have changing needs, and therefore data once considered only peripherally useful may now be more highly regarded. Investment decisionmaking will never be risk-free nor can the Commission (or anyone, for that matter) know with certainty all the information investors need for successful evaluation. The Commission can only surmise which data is useful and require its disclosure. Investors might, for example, consider it necessary to inquire about any payments made for permits or licenses, the denial of which would cause economic harm. Should more than an incidental number of shareholders decide that a pattern of extortionate demands is significant in determining risk, their desire to obtain relevant information would cause immaterial data to become material.

Gulf's President Dorsey was solicited in 1966 for a $1 million campaign contribution to President Park of South Korea, which

\textsuperscript{90.} \textit{Id.}

\textsuperscript{91.} Wall St. J., May 2, 1975, at 1, col. 6.

\textsuperscript{92.} 332 F. Supp. 544, 571 (E.D.N.Y. 1971); see notes 50-54 \textit{supra} and accompanying text.
he eventually made. Assuming that the payment was legal (which it apparently was not), the contribution, per se, may not have been material. In 1970, however, Mr. Dorsey was solicited for a contribution of $10 million, and when he was convinced that the company's holdings in the country were in jeopardy, he negotiated a $3 million contribution. This payment could be material because it was directly related to the economic survival of substantial assets of the corporation. The difference between these two contributions is that an average investor is likely to regard the latter payment to be of greater significance to the question of investment security, and consequently to the decision to buy, sell, or hold, than the earlier donation. An investor may view the second payment as clear evidence of a developing pattern of extortionate demands on the company. Likewise, a political contribution or the use of "whitemail"—philanthropic gestures—might be useful to maintain good relations and good will, whereas extortionate demands, which fluctuate with political pressures, could foretell future financial problems. Clearly then, the line between these distinctions, and their consequential effect on materiality, will at times blur. One safeguard would be to call for the release of pertinent information whenever a significant number of shareholders decide that there is a substantial likelihood that their decisionmaking may depend upon the released information.

Under this analysis the SEC would relinquish some responsibility for deciding what is important for the investing public to know. Information would not be material because it is in fact useful for investment evaluation, but because substantial numbers of investors, notwithstanding the judgment and experience of professional analysts and the Commission, perceive it to be of importance to their decisionmaking process.

The SEC's failure to respond to investor needs may have been a factor considered by millions of investors who have deserted the market place in the past three years. The SEC is charged by Congress with the responsibility of providing infor-

94. Id.
95. Wall St. J., Nov. 12, 1975, at 33, col. 4. A poor market is an obvious factor. James Needham, Chairman of the New York Stock Exchange believes that it could also be evidence of disenchantment with the management of the national economy by people who have traditionally had faith in the private enterprise system. Id.
information to investors\(^*\) so that they will have the confidence to invest.\(^{97}\) It accomplishes this by supplying to investors that which the Commission in good faith decides investors need to know. When controversy surrounds “soft data,”—information not directly related to profits and losses—the decision of what is materially significant to the investor can best be determined by the SEC, together with the recommendations and requests of the investing public.

3. The Degree of Risk

The “degree of risk” criterion is perhaps of most importance to the investor in determining the materiality of a given bribe, contribution, or consultant’s fee. That standard attempts to assess the impact of the payment on the business involved, taking into account its size in relation to the company’s assets in that country and in the world-at-large; the result if payments were stopped or the name of the recipient made public; and whether payments were made to officials at the highest level of government who may soon be out of office,\(^*\)\(^*\) or to low level officials such as bureaucrats with ministerial duties.

In the case of United Brands, the payment of $1.25 million may not have been significant in relation to the company’s size.\(^{99}\) Once that payment was disclosed, however, the company’s tax and trade concessions in Honduras were revoked and its stock dropped 40 percent in value.\(^{100}\) The State Department has expressed concern that a company which has been linked with payments might have property in another country expropriated, not because of misconduct in that country, “but simply on the grounds that it was an undesirable firm.”\(^{101}\) Indeed, United Brands’ holdings in Panama were later expropriated.\(^{102}\) Therefore, while an original payment may be relatively small, it could precipitate an injurious snowball effect to the corporation and be

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\(^{96}\) See notes 3-7 supra and accompanying text.

\(^{97}\) See note 16 supra.

\(^{98}\) Gulf made payoffs of $350,000 in Bolivia and gave the President a $110,000 helicopter. Not long after the President died in a helicopter crash, the new regime expropriated Gulf’s holdings. Now that the bribe has been disclosed, Bolivia is threatening to withhold $57 million owed to Gulf in indemnity. \(\text{FORTUNE, supra note 1, at } 124.\)


\(^{100}\) \(\text{Gwirtzman, supra note 62, at 100, col. 1.}\)

\(^{101}\) Statement by Mark Feldman, Deputy Legal Adviser, \(\text{Dep’t of State, before the Subcomm. on Int’l Policy of the House Comm. on Int’l Relations, June 5, 1975, at 2, reprinted in Dep’t of State Bull., June 7, 1975, at 40.}\)

\(^{102}\) \(\text{Gwirtzman, supra note 62, at 100, col. 1.}\)
Materiality of Payments Abroad

responsible for substantial economic harm. The United Brands executives had what they believed to be the best interests of their stockholders in mind when they decided to purchase favorable tax treatment. This does not, however, lessen the significance and therefore the materiality of the decision.

Much of the controversy at the time of this writing concerns the extent of disclosure of bribery that is truly helpful to investors. Lockheed, for example, has argued that public revelation of the names of bribe recipients (or even the names of the countries in which they were paid), would jeopardize the safety of the officials involved, the company's present and future contracts, and perhaps its corporate existence. Secret testimony before the SEC would also be inadequate because the Freedom of Information Act allows public access after the investigation is completed.

The SEC has adopted a general policy which allows companies that volunteer information about illicit activities to "probably" escape enforcement action by the agency. What this policy fails to recognize is that companies which come forward on their own volition may succeed in avoiding disclosure of sufficient data pertaining to the degree of risk to be meaningful to investors. Conversely, the Commission vigorously seeks countries, names, and amounts from noncomplying corporations when in fact the information may be extraneous, or not necessarily crucial, to an evaluation of risk. The SEC justifies its reliance upon voluntary compliance on the basis of the inability of its small legal staff to police all companies.

103. N.Y. Times, Feb. 5, 1976, at 1, col. 5. Following public disclosure of Lockheed's bribes, see note 115 infra, a $1.3 billion contract in Japan for planes which the company had "high hopes" of securing was lost. Wall St. J., Feb. 13, 1976, at 12, col. 2. The company also feared losing a $750 million contract with the Canadian government, although the company claims to have salvaged the sale. N.Y. Times, Feb. 20, 1976, at 45, col. 5.


106. One SEC lawyer reports that most of the disclosures made in response to the Commission's voluntary cooperation program have been so insignificant that they "should never have come in." Wall St. J., Mar. 29, 1976, at 26, col. 1. Imprecise disclosure standards have encouraged some corporations to furnish needless details, and at the same time have enabled other companies to avoid appropriate disclosure. Id.


Generic disclosure has been suggested as a possible solution. Under this system, a company would be required to describe in general terms the kinds of activities in which it had engaged. Former Commissioner Sommer, mindful of the harm which might result from the indiscriminate release of information, has proposed the tailoring of a disclosure pattern in which the company would inform the SEC and investors that it was engaged in certain illicit practices in the host country, the extent to which the business overseas depended upon or was secured as a result of the payments, and the consequences which would probably occur were the bribes to cease. In short, generic disclosure would reveal the impact of the payments and their import to the business involved. Names of recipients and countries would not be included. This proposal confronts the fundamental issue: whether, with respect to each given situation, the shareholder, or would-be shareholder, is adequately apprised in order to make an intelligent investment decision. A company would disclose the extent to which it relied upon means other than performance and pricing to sell its goods, the relative position in the government of persons aiding the company, the amount of earnings generated, and the amount of investment capital involved in the country. The company would thus reveal as much information as a reasonable investor “might” need to know in order to evaluate that company’s relative stability and prospects, while at the same time there would be a sensitivity toward the possible adverse effects which would flow from indiscriminate disclosure.

When it was first revealed that several companies were engaged in widespread bribery, corporate executives claimed that such conduct was necessary to conduct their business in certain parts of the world. If American corporations were to be prohibited from making bribes, or compelled to disclose specific information about such continued practices, foreign decisionmakers

111. Id.
112. Cities Service Company reported in a Form 8-K that it had spent $30,000 “in a foreign country” for political purposes and disclosed that the “legality [of the payments is] not free from doubt.” The company indicated that “a subsidiary operating overseas paid $15,000 . . . to a lobbyist in the country of the subsidiary’s operation.” The Cities Service 8-K is probably an indication of the minimum type of disclosure that the SEC will permit. Cities Service Co., Form 8-K, Commission File No. 1-1093, Sept. 1975.
113. See notes 77-82 supra and accompanying text.
might fear doing business with Americans. They might choose, instead, to deal with companies from countries which posed no threat of revealing embarrassing information. Generic disclosure would take both the company executive and the SEC at their word. If business cannot be transacted without making these payments, this proposal would allow the practice to continue relatively free from harm to the company or host officials. If the SEC is genuinely concerned about protecting investors, limited disclosure would adequately inform the investor of the degree of risk involved. This alternative contains an inherent risk since it cannot guarantee anonymity to the bribe recipients. The limitation on the specificity of the disclosure may, however, lessen their fears of negotiating with Americans and cause no appreciable loss of business to companies of other industrial countries.

Under a system of generic disclosure, United Brands would have had to disclose that an extremely high official had been paid to prevent substantial harm to the company in a country where it derives a certain percentage of its earnings and where major holdings remain. It would, consequently, have had to warn investors what was at stake. Critics of generic disclosure contend that such an alternative is dangerous to the company and inadequate to serve the interests of the investor. Each is vulnerable because full disclosure of all the facts, including the name of the bribe recipient, may occur inadvertently—few transactions are absolutely secret. It is also possible that someone will correctly deduce which country and persons are involved. Alternatively,
if not enough is made known, disclosure will be obscure and offer little guidance. One group arguing this position has stated that:\footnote{Petition of Project on Corporate Responsibility, at 15, Dec. 10, 1975.}

[T]he consequences of short-term shielding for high-risk activity would be worse than early disclosure since the shielding might have only the effect of encouraging the activities through creating a false sense of security that would be only short-lived.

Short-lived or not, the SEC is neither responsible for, nor able to make, investments safe or risk-free. The requirement that the risks involved be disclosed will enable the investor to determine what course of action to take. As former Chairman Garrett has said: "If appropriate and complete disclosure has been made, the Commission’s role is, and should be, at an end."\footnote{FORTUNE, supra note 1, at 200.}

4. Inaccurate or Incomplete Financial Records

The materiality of foreign payments is most evident when analyzed by examining the accuracy and completeness of financial records. Payments have usually been made with monies from "slush funds"\footnote{Id. at 123.} created by kickback schemes,\footnote{Lockheed has admitted the use of kickback schemes; indeed it preferred to characterize the payments as kickbacks and not as bribes, on the theory that it may be able to deduct kickbacks from its taxes, while it may not deduct bribes. N.Y. Times, Oct. 10, 1975, at 53, col. 8.} phony billings for consultant and other services,\footnote{Ashland Oil Company made substantial payments overseas to consultants and legal representatives. The payments were later funneled back into the United States to be used for illegal political contributions. Washington Post, June 7, 1975, at A-1, col. 1. Northrop Corporation consented to an SEC complaint that the Company had laundered $476,000 through a French consultant for political contributions between 1961 and 1973. The SEC also charged that Northrop had inadequately accounted for $30 million in consultant fees which the company had spent between 1971 and 1973. Id. See also Report to the Board of Directors of Northrop Corporation on the Special Investigation of the Executive Committee, July 16, 1975, a copy of which is on file at the office of the Hofstra Law Review.} rebates,\footnote{See Prospectus of the Exxon Pipeline Co., Oct. 16, 1975, at 29-32.} and falsified expenditures.\footnote{Minnesota Mining and Manufacturing Company, for example, accumulated cash by making false entries in books and then used the money for domestic campaign contributions. SEC v. Minnesota Mining and Mfg. Co., 76 Civ. 29 (D.D.C. Jan. 10, 1975).} These kinds of activities are not likely to be included in publicly recorded financial records.

\footnote{See also Report to the Board of Directors of Northrop Corporation on the Special Investigation of the Executive Committee, July 16, 1975, a copy of which is on file at the office of the Hofstra Law Review.}
The integrity of books and records, like that of management, is an indication of the kinds of individuals leading the corporation. Falsification renders the financial accounting system necessarily unreliable and investors are frustrated if they attempt to evaluate the true financial picture. Several commissioners vigorously support this last test and indeed it is applicable to most bribery situations reported so far.\(^\text{125}\) SEC Chairman Hills, for example, would categorize all payments as material, including those which would otherwise be termed immaterial "if management has deliberately concealed a large sum of money from the board, from the stockholders or from the audit committee," thus creating a "distortion" of the financial reporting system.\(^\text{126}\)

The issue of how much is a "large sum" should not be determined by any strict quantitative test. The existence of a continuous pattern of activity may, for instance, be more revealing to the investor than the falsification or concealment of a particular amount.

The ramifications of inaccurate or incomplete recordkeeping extend to tax liability as well. Deductions improperly taken for spurious expenses could result in taxation and an imposition of penalties at a later time. At least two corporations have voluntarily come forward to the SEC to disclose tax violations.\(^\text{127}\)

**Materiality Must Be Rooted in Terms of Economic Significance**

The Commission recently outlined its views on the subject of disclosure of information relating to environmental protection, equal employment, and other "corporate social practices."\(^\text{128}\) This action was taken pursuant to an order by District Judge Charles Richey that the Commission carefully consider proposals to expand disclosure requirements.\(^\text{129}\)

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\(^{125}\) Loomis, *supra* note 61; Sommer, *supra* note 61.

\(^{126}\) N.Y. Times, Jan. 4, 1976, § 3 (National Economic Survey), at 33, cols. 1, 3.


\(^{129}\) Natural Resources Defense Council, Inc. v. SEC, 389 F. Supp. 689 (D.D.C. 1974). The petitioners were the Natural Resources Defense Council, Inc., the Project on Corporate Responsibility, Inc., and the Center on Corporate Responsibility, Inc. They claimed, and Judge Richey held, that the SEC had failed to comply with the Administrative Procedure Act when the Commission formulated and promulgated regulations concerning disclosure of environmental and equal employment practices. The earlier releases were SEC Securities Act Release Nos. 5235 and 5386.
ties Act Release No. 5627, reiterated the objective of the Act “[t]o provide full and fair disclosure.”130 The release noted that the Securities Acts and legislative history suggested 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.”131 The Commission also stressed the view that although its role is to require disclosure which is “necessary or appropriate in the public interest,”132 the SEC’s authority does not extend to permitting disclosure for the sole purpose of promoting social goals.133 These “social goals” would presumably include corporate morality.

For investors to make meaningful use of information disclosed for their benefit, there must be a limit on the quantity of material offered to them by publicly held corporations, and a greater emphasis on the quality and helpfulness of the data. In the Pentagon Papers case,134 Justice Stewart, in a concurring opinion, warned the Government that once “everything is classified, then nothing is classified.”135 Similarly, groups seeking the expansion of the concept of materiality must be cognizant of the real possibility that once everything is material, then nothing is material. In Securities Act Release No. 5627, the Commission recognized that “it is impossible to provide every item of information that might be of interest to some investor in making investment and voting decisions.”136 In fact, it is quite likely that too much disclosure serves to keep investors as much in the dark as does too little disclosure.137 The Commission was therefore correct in refusing to mandate the disclosure of some 100 new topics,138 largely pertaining to social matters, as requested by

131. Id. at 85,710. (emphasis added).
132. Id. at 85,711.
135. Id.
the public interest group Natural Resources Defense Council.\textsuperscript{139} One illuminating reason given was that petitioning groups would use the information primarily to determine how to vote their proxies and influence management policies, rather than how to make investment decisions.\textsuperscript{140} The SEC, one could conclude, concerns itself more with the fundamental question of whether there is adequacy of disclosure in order to buy or sell a security than with whether investors have access to information to influence the internal affairs of a company.

The Commission has rightfully refused to expand the seemingly limitless concept of materiality to areas which are not of principal economic concern to the investing public. Where the demand for information is, however, clearly based upon a need for financial data, the Commission has responded by proposing that such direct impact "upon the capital expenditures, earnings and competitive position"\textsuperscript{141} of the company involved be disclosed. If the SEC is to accept the new responsibility of providing information about public corporations on any and all matters, additional legislation must be sought in Congress. Until such time, it must concentrate on determining what basic information investors need to know for investment decisionmaking and seek to compel its disclosure.

The very function of materiality is to distinguish, for purposes of investment, the pertinent from the extraneous and the significant from the insignificant.\textsuperscript{142} Many facts concerning a company may be helpful or interesting yet they are not essential, and thus not material. Materiality must, therefore, be grounded first in terms of an economic function, for otherwise the item could not be said to be vital in the investment decisionmaking process.

Revelations regarding corporate expenditures for illegal and questionable purposes often result in greater harm to the corporation than the benefits that are sought. Adverse consequences are not limited to the country in which improprieties occur.\textsuperscript{143} Other

\textsuperscript{80,310, at 85,724-25 (Oct. 14, 1975).}

\textsuperscript{139. Some of the terms submitted included: charitable contributions, "good things a company has done," degree of commitment to a human community, any activity likely to lead to litigation, and all agency actions. Id. at 85,724 n.72.}

\textsuperscript{140. Id. at 85,721-22.}

\textsuperscript{141. CCH Fed. Sec. L. Rep. ¶ 31,103 at 22,054.}

\textsuperscript{142. I CCH APB ACCOUNTING PRINCIPLES, ¶ 1022.17 at 136 (1971).}

\textsuperscript{143. See note 102 supra and accompanying text.}
countries, concerned with their own image, may refrain from dealing with a company whose reputation has been damaged. As a result, the company and the shareholder suffer. Illicit payments, alluringly beneficial in the short run, may severely affect a company's good relations with the host country, impairing the stability, growth, and profits that investors seek. Bribery can therefore constitute a material matter of economic concern to persons weighing investment decisions.

CONCLUSION

The determination of materiality is necessarily a complex question of judgment; not merely a mechanical process. While the Commission should refuse to allow the expansion of materiality to include noneconomic areas, it must also recognize that the notion of what is useful or necessary is not static, but susceptible to change. This becomes more apparent as investors devise new means to evaluate corporate prospects. Where the Commission is unsure of the importance to investment analysis that a new item may provide, the SEC must give more careful consideration to the desires of the ultimate user of the information—the investing public.

The controversial subject of bribery should not cause the perplexity that it has at the SEC and in the securities community. Viewing the issue in terms of traditional analyses—amounts in question, legality of the payments, or nonenforcement of antibribery laws by host countries—is inadequate. Even if data could be ascertained for these modes of analysis, the obtained facts would not be meaningful to investors and thus would not be useful. If approached with a more qualitative analysis—what do the payments reveal about the integrity and quality of management and corporate records, what is the economic consequence of a particular course of conduct, what does the investor need to know for intelligent investment analysis—answers can be

144. See note 103 supra and accompanying text.
145. The recent decision to initiate replacement-cost disclosure requirements to reveal the impact of inflation on the nation's largest companies is a significant and welcomed development. This proposed change represents a step away from historical-cost accounting which provides precise valuation, but it fails to recognize that inflation distorts the accuracy of any replacement-cost figure. John C. Burton, the SEC's Chief Accountant, praised the measure, and urged "greater tolerance for imprecision." Wall St. J., Mar. 25, 1976, at 6, cols. 2-3.
146. SEC Chairman Hills has acknowledged the present state of confusion. N.Y. Times, Jan. 4, 1976, § 3 (National Economic Survey) at 33, col. 2.
found and a service will be performed for the investor.

The more difficult problem facing the SEC is to determine what information investors need and how the Commission can best service those needs. Decline in the number of investors, coupled with an expected shortage of capital, portends a potentially graver crisis.

Professor Kripke may be correct when he calls for reassessment of the basic premises of the Act of 1933:

They [the economists] are telling us that the Commission’s rhetoric which appears in release after release is a myth—the idea that the individual investor can exercise an “informed investment judgment” on a single company if given “all the facts” in a prospectus. They are telling us that the disclosure system—the idea that the small investor or even the professional can pick securities that do better than others—does not work.

There is no doubt, however, that disclosure’s secondary function—affecting conduct—is more successful. Corporations in the center of the foreign payments storm are already replacing top management and vowing to abstain totally from previous practices. This may be a mere public relations effort, or perhaps a genuine attempt to rectify undesirable conduct. The oft-quoted comment by Justice Brandeis is again appropriate: “Sunlight is

147. See note 95 supra and accompanying text.

In his State of the Union message, President Ford proposed incentives to encourage low and middle income wage earners to buy common stocks. He would allow individuals or employers to establish stock-purchase plans in which the contributions would be tax deductible. Wall St. J., Jan. 20, 1976, at 3, col. 1.

150. Although several companies have discharged their top executives, many have retained the discharged officers as consultants or directors. Gulf Oil Corporation’s Board of Directors forced the resignation of its chairman, Bob R. Dorsey, although they said there was no basis to conclude that he was aware of all the illegality involved. Thomas V. Jones of the Northrop Corporation resigned as chairman, but remains as president and chief executive and is struggling against the board’s efforts to find a new president; Russel De Young resigned as Goodyear’s chairman, but still serves on an important committee. Fines were paid by board chairmen at Carnation Company and Braniff International. Time, Jan. 26, 1976, at 59.

151. Several companies—including Minnesota Mining and Manufacturing, Northrop, Gulf, Ashland, and Phillips—have agreed to cease violating the disclosure rules. The consent agreements which have been entered require the filing of public reports tracing illegal expenditures or payments which were improperly accounted for. Wall St. J., Sept. 9, 1975, at 1, col. 6.
said to be the best of disinfectants; electric light the most efficient policeman.”

The practice of making corporate payments to foreign officials, once overlooked or quietly tolerated, may become, in light of a changing national consciousness, a course of conduct no longer condoned. If the American people choose to impose strict standards of morality on business transactions abroad, appropriate substantive laws will have to be enacted by Congress. Should this path be taken, however, some countries will not fully appreciate our effort to “export morality.”

The SEC, established to assist investors by compelling disclosure of information necessary for investment decisionmaking, is not empowered to regulate conduct it deems undesirable. If, however, the process of revealing information pertaining to a company’s financial condition also results in the elevation of corporate morality, an additional valid purpose is served. To the extent that the Commission seeks information to enable investors to better evaluate the risk and quality of an issue, the SEC is not overstepping its authority, but, on the contrary, is performing its assigned role.

Charles M. Chernick

152. L. BRANDEIS, OTHER PEOPLE’S MONEY 62 (1933).
153. The State Department expressed the view that attempts to pass antibribery laws to protect Americans against the “sins of foreign countries” will be met in some countries with resentment. There is some suspicion in Central America that the Commission’s concern for disclosure is in reality a cover story. The SEC’s real interest, it is there believed, is to substitute itself for the CIA in overthrowing local governments, as the CIA is preoccupied at present with its own problems of allegations of impropriety. R. Garrett, supra note 61, at 16, 17.