

THE SEC MANAGEMENT FRAUD PROGRAM

Russell B. Stevenson*

I. INTRODUCTION

Before I discuss the management fraud program and its implications, I would like to make some general observations about the Foreign Corrupt Practices Act (FCPA).¹ What we are talking about is a statute, some means of enforcing it, and possible legislative changes. I am struck by how this statute, its genesis, its implementation and enforcement, and now efforts to amend it represent a marvelous example of the legal process at work. The management fraud program started with a political scandal, investigated by the Justice Department, which perked up some ears at the Securities and Exchange Commission, which in turn launched a series of its own investigations that led to the opening of a Pandora's Box whose existence was unsuspected by anyone involved. The resulting political reaction led very quickly to the passage of the FCPA, a statute that everyone agrees suffers from some drafting problems and, therefore, some interpretational problems. You have heard how the ABA and representatives of the SEC have uttered conflicting interpretations.

What is interesting about all this is that it is all part of the law. What an ABA committee says a statute means, after numerous drafts and approvals up the chain of the ABA hierarchy, is law in a very real sense. By the same token, a speech by the Chairman of the SEC, or the Director of the Enforcement Division, putting a gloss on the statute is also law. After all, law is nothing more than a set of rules and interpretations of those rules that affect the way people behave, and what the ABA and the Chairman of the SEC say a statute means are both important in deciding the way people behave. With the philosophical introduction to what we are about here tonight, let me turn to the topic of our discussion.

* Professor of Law, George Washington University, National Law Center; Attorney-Fellow, Office of the General Counsel, Securities and Exchange Commission.

1. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, §§ 102-104, 91 Stat. 1494 (codified at 15 U.S.C. §§ 78a, 78m, 78dd-1, 78dd-2, 78ff (Supp. V 1981)), reprinted in Appendix I *infra*.

II. THE MANAGEMENT FRAUD PROGRAM

I have never quite understood where the term management fraud came from. I am told that it was coined by Stanley Sporkin, the Director of the Enforcement Division of the SEC. It has always struck me as something of a misnomer to say that the payment of bribes by a corporation involves "management fraud."

Whatever its name, however, the management fraud program is not without its significance today, even though the passage of the FCPA has rendered moot many of the issues that the program raised in the mid-1970s. To illustrate the importance of understanding the law developed prior to the management fraud cases, one need only refer to a more recent matter that has generated a certain amount of controversy; the decision of the SEC not to bring an action against Citicorp to compel it to correct certain filings with the Commission that failed to describe certain practices in connection with its foreign currency trading.

A. *The 1981 Citicorp Matter*

The staff of the Enforcement Division recommended to the Commission in December of 1981 that the Commission institute proceeding against Citicorp, the holding company of Citibank, alleging that Citicorp had violated the disclosure requirements of the securities laws by failing to disclose that several of its branches had engaged in what were called "parking transactions" in their international exchange operations. These parking transactions involved a practice whereby a branch, for example in Brussels, that was engaging in foreign exchange transactions found itself at the end of the day holding more of some currency than Belgian law permitted. Apparently one of the ways that the Brussels branch would handle that situation was to "sell" a portion of its possession to another branch, most often either in Nassau or New York in order that the position would be off the books of the Brussels Bank branch. The price at which these parking transactions took place was set artificially, sometimes outside the range of market prices. The effect was that the Brussels branch could shift profits to Nassau, where the effective tax rate was lower than in Belgium. There were also questions about whether Belgian banking and currency control regulations were violated. Similar patterns of transactions took place at several foreign branches. To make a long story short, the thrust of the allegations in the staff report on the matter was that Citibank and, ultimately, Citicorp were engaged in transactions

that may have violated the law in a number of foreign countries. Significantly, it was never adjudicated in any judicial or administrative forum that any of these transactions violated any law, but some of them may have.

The staff of the Enforcement Division said the practice of engaging in this sort of dealing should have been disclosed to the shareholders. The case was reminiscent of the foreign payments cases, although in those cases corporations did pay bribes to foreign officials overseas that clearly violated the domestic law of the countries in which the bribes were paid. In a very unusual development, the Director of the Enforcement Division filed a dissenting recommendation, disagreeing with the recommendation of his staff. The Office of General Counsel and the Division of Corporation Finance filed another memorandum also recommending that the case not be brought. The Commission ultimately decided not to bring the enforcement action.

B. Theories of Enforcement

On message of all this is that the same legal theories used by the SEC in the management fraud cases are at issue in the Citicorp matter, which has attracted much attention both in the press and among the securities bar. What then were the theories under which the management fraud cases were brought and to what extent are those theories still valid? There was a certain lack of clarity in those theories at the time the management fraud cases were brought, a lack of clarity that has echoes in subsequent judicial proceedings related to those cases.

One can begin the discussion with an introduction to what the securities law do, in fact, require. The basic reporting requirements of the securities laws are found in SEC regulations governing the content of periodic reports filed by publicly-held issuers with the Commission. These requirements do not mandate simply that a company report all material developments; that would be much too open-ended. The result would be infinite speculation about whether this or that fact is or is not material. Instead, the forms promulgated by the Commission specify in some detail what must be disclosed in so-called "line items." A failure to disclose a material fact called for by a line item violates the statute. A second obligation arises out of the requirement that what is disclosed must not be misleading because it omits facts necessary to tell the whole truth.

It could be argued, then, that the allegedly improper behavior of various Citibank branches had to be disclosed because it fell within some line item. But no line item specifically calls for information of this sort. The next question is whether some statement actually made was incomplete and therefore misleading. The argument was made that there are implied representations in any filing with the SEC, including the representation that management is honest and would not permit the company to violate the law.

Finally, it is clear that in many of the management fraud cases, the illegal payments were material in a traditional, economic sense. That is, if a company doing business abroad was procuring a large part of its business by paying bribes which created the risk that the business would be lost if the bribes were uncovered, it could be said quite properly that the bribery was a material fact that should be disclosed to shareholders. Otherwise the statements in disclosure documents about sales, income et cetera, would be misleading.

One of the most interesting aspects of this problem is the application of the concept of materiality to illegal or improper behavior by management. It is clear that some kinds of management conduct can be quantitatively material, in the sense, for example, that a foreign bribe can jeopardize a material amount of business. There is another notion, that of "qualitative materiality," that poses somewhat more difficult problems. Qualitative materiality grows out of the idea that it is important to shareholders to know that their management is honest.

This problem can be broken into three different kinds of cases. The first involves a management that is stealing from the company. In general, the courts have been willing to hold that such conduct is material to shareholders.

In the second kind of case, which is a little bit more difficult, a member of management has been adjudicated to have done something wrong. Determining that there is a disclosure obligation in such cases is usually relatively easy, because there is usually a line item that requires the reporting of recent convictions of wrongdoing by officers or directors of a sort relevant to their honesty in business affairs.

The third class of conduct is what might be called unadjudicated illegal conduct—that is, conduct that is illegal, but with respect to which no court or administrative tribunal has ever found there to have been a violation of law. To say that such conduct must be disclosed is to say that the management of a corporation

would be required to file a statement with the SEC accusing itself of doing something wrong.

That is obviously not going to happen in real life. Thus a disclosure requirement with respect to such conduct is merely to turn into a violation of the securities laws activities that already violate some other law. The only justification for such a rule is that the existing mechanisms for enforcing the law whose violation is said to give rise to a disclosure obligation are inadequate, *and* that it is preferable to rely on the enforcement of the securities laws to supplement the primary law enforcement mechanism rather than to improve that mechanism more directly.

What can one say about such a theory? I hesitate to quote myself, but do not know a more direct response to the question. Back in 1975, I wrote:

There is hardly any question that the SEC would be more capable of enforcing a ban on foreign bribery than any other obvious candidate for the job. But it nevertheless appears that the Commission would be a somewhat reluctant dragon in that role, to say the least. And, in the final analysis, it is probably not terribly well suited, in its present form, to take on the task. Indeed, so far is the policing of the overseas activities of American corporations from the Commission's traditional activities that, reasoning simply from institutional function, it would appear equally rational to give the job to the FTC, or the Anti-trust Division, or perhaps the Occupational Safety and Health Administration. They are all, after all, in the business of enforcing laws dealing with corporate behavior.

But the world is not so rational as all that; and it appears completely obvious to the involved, unobjective observer (including anyone who reads this journal) that the SEC is the one game in town. Which it is. And so it is that Congress, and it would seem the American people, continue to force the job of regulating corporate behavior onto an understaffed agency that persists in viewing the world through disclosure-colored glasses — with the result that the agency grown ever more schizophrenic. And so it will continue until Congress, and the American people, eventually awaken to the fact that they are sending a company of infantry (though a brave and willing one) out after an armored battalion and finally make the difficult decision whether to retrain the company and give it some tanks or to send it another unit.²

2. Stevenson, *The SEC and Foreign Bribery*, 32 BUS. LAW. 53, 72 (1976).