TESTIMONY OF THE HONORABLE HAROLD M. WILLIAMS, CHAIRMAN,
ON BEHALF OF THE
SECURITIES AND EXCHANGE COMMISSION
BEFORE THE
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE
OF THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

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Mr. Chairman, members of the Subcommittee:

I appreciate the opportunity to appear before you this morning to testify on the subject of H.R. 3815, the proposed Unlawful Corporate Payments Act of 1977, and other legislative approaches to the problem of questionable or unlawful corporate payments and transactions. Section 1 of H.R. 3815 would amend the Securities Exchange Act of 1934 by adding a new Section 30A prohibiting any issuer of securities subject to the Commission's jurisdiction from using the means of interstate commerce to make any payment designed to influence corruptly a foreign official, political party, or candidate. Violations of this new prohibition – like any other provision of the federal securities laws – would be investigated by the Commission's staff and could be made the subject of civil proceedings to enjoin further misconduct. Similarly, where appropriate, the Commission would refer its files to the Justice Department for criminal prosecution. Section 2 of the bill would enact a similar prohibition, as an independent provision of the criminal code, applicable to any domestic business not subject to Section 1. Section 2 would be enforced exclusively by the Justice Department.

I would also like to address a second legislative proposal in this area. The Senate Committee on Banking, Housing and Urban Affairs has voted to report favorably to the Senate S. 305, a bill which takes a somewhat broader approach to the problem of questionable corporate payments. S. 305 includes the same prohibitions – in slightly amended form – as does H.R.

3815, but also contains provisions which the Commission recommended to Congress last year to strengthen the system of corporate accounting and auditing. S. 305 would require issuers of securities to keep accurate books and maintain an adequate system of internal accounting controls. The bill would also make it unlawful to falsify corporate accounting records or to deceive an accountant in connection with an audit.

I should note, Mr. Chairman, that provisions very similar to those in S. 305 which I have mentioned are also embodied in H.R. 1602 which was introduced by Congressman Murphy and is pending before the Subcommittee.

The Commission believes that, from the standpoint of investor-protection, this broader legislation represents a more effective and meaningful approach to the types of corporate abuses which the Commission has uncovered during the past several years than does H.R. 3815. We do not, of course, oppose the enactment of direct prohibitions such as both H.R. 3815 and S. 305 incorporate and are ready to accept the expanded mandate which enforcement of those prohibitions would entail. The Commission does not believe, however, that prohibitions against bribery are the full answer. In our view, the long-term solution requires a fundamental strengthening of the record-keeping, auditing, and internal control systems which are at the foundation of the management of modern multinational business enterprises. For these reasons, I urge this Subcommittee to broaden its approach to the problem of questionable corporate payments and consider legislation comparable to S. 305 rather than only direct prohibitions against foreign bribery.

Need for Remedial Legislation

The Commission, beginning in 1973, as a result of information uncovered by the Watergate Special Prosecutor, became aware of a pattern of corporate conduct involving illegal domestic and political contributions. Subsequent investigations revealed that instances of undisclosed questionable or illegal corporate payments – both domestic and foreign – were widespread and threatened to have a corrosive effect on the integrity of our system of capital formation and on public confidence in American business. From the perspective of the Commission's Congressional mandate to protect the investing public, it quickly became clear that the dependence of certain businesses upon concealed payments of this nature, and the attendant diversion of assets to purposes nowhere reflected on the corporate records, were facts of significance to investors. Nondisclosure of these transactions can, therefore, entail violations of the existing antifraud provisions of the federal securities laws.

The Commission's response to these revelations was two-fold. First, the Commission commenced a vigorous enforcement program under the federal securities laws aimed at preventing the future concealment of transactions of this nature. In this litigation, the Commission, has obtained injunctive relief prohibiting further such concealment and ancillary relief requiring a full-scale investigation, by disinterested outside counsel, of the facts and circumstances concerning questionable transactions at the companies involved, appropriate disclosure of the results to shareholders, and the implementation of preventive measures designed to safe-guard repetition of this conduct.

In addition, the Commission instituted its so-called voluntary disclosure program. This program is an outgrowth of procedures traditionally open to any registrant facing a novel disclosure question. Companies which believe that some type of a payment problem has not been properly disclosed to investors may come to the Commission's staff, discuss the situation, conduct an internal investigation, and make appropriate disclosure in Commission filings. While participation in this program does not immunize a company against Commission enforcement action, it does generally obviate the need for such proceedings.

The combined results of these two programs have been large in magnitude and disturbing. To date, the Commission has brought injunctive actions against 31 corporations on account of questionable or illegal payments. In addition, more than 300 corporations have made disclosure of such payments voluntarily. All told, these registrants include some of the largest and most widely held public companies in America. The abuses which these companies have disclosed have run the gamut from bribery of high foreign officials in order to secure some type of favorable, discretionary action by a foreign government to so-called facilitating payments allegedly necessary in order to insure that low-level functionaries will discharge ministerial duties – such as delivering the mail – which they are already obligated to perform. In addition, we have learned of instances of commercial bribery entailing excessive sales commissions, kick backs, political contributions and a variety of other transactions involving off-book or disguised expenditures of corporate assets.

On May 12, 1976, the Commission prepared its Report on Questionable and Illegal Corporate Payments and Practices which discusses in detail the disclosures which the Commission had obtained to that date. While the number of companies which have reported abuses has tripled since last May, the type of conduct disclosed has not significantly changed. Accordingly, I believe that that report, which has previously been transmitted to this Subcommittee, constitutes the best existing empirical foundation for legislative action in this area.

The key point, I believe, to be drawn from the Commission's experience in this area is that illicit payments of the type which H.R. 3815 would prohibit almost necessarily involve frustration or circumvention of the system of internal corporate control. Internal control systems are designed, in part, to insure that shareholders assets are utilized for legitimate business purposes pursuant to management's instructions, and that the resulting transactions are recorded on the corporate records. Those records must also be maintained in such a way that independent auditors can ascertain whether financial statements drawn from them fairly represent the results of operations and the financial position of the business. In this connection, the Commission, in its May 12 Report, observed that

> "the almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is a proper accounting of the use of corporate funds in the documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts."

For this reason, although the individual abuses uncovered in our enforcement and voluntary programs are serious, the more fundamental problem, and the one on which we believe a legislative solution must focus, is the defiance or circumvention of the system of corporate accountability on which the securities laws – and indeed our system of capital formation – rest. Some argue that, since past misconduct has entailed defiance of the existing system, legislation designed to strengthen that system would be useless. It is, of course, true that accounting measures designed to prevent concealed or disguised payments may sometimes be successfully circumvented by determined wrong-doers, just as prohibitions will, in some instances, be ignored. I believe, however, that measures which create an environment making possible the continuation of these abuses only if the improper payments are accompanied by related violations of record-keeping and auditing statutes are likely to prove effective in dramatically reducing the incidence of such activities.

Legislative Approaches

A. Commission recommendations

In the May 12 Report, the Commission proposed remedial legislation based on its experience with questionable corporate payments. That legislative recommendation embodied four goals:

(1) Require issuers to make and keep accurate books and records.

(2) Require issuers to devise and maintain a system of internal accounting controls meeting the objectives already articulated by the American Institute of Certified Public Accountants.

(3) Prohibit the falsification of corporate accounting records.

(4) Prohibit the making of false, misleading, or incomplete statements to an accountant in connection with an examination or audit.

These proposals constitute Section 102 of S. 305, which in those respects is very similar to legislation the Senate unanimously passed during the 94th Congress. The Commission continues to believe that these four proposals represent the most effective solution to the problem of questionable or illegal corporate payments, and that these proposals would alleviate the underlying conditions which have permitted the abuses we have seen in the past.

Enactment of legislation of this nature would create a climate which would significantly discourage repetition of these improper payments and would demonstrate a strong and affirmative congressional endorsement of the need for accurate corporate records, effective internal control measures, and management candor in connection with the work of independent auditors. Such an endorsement would end any debate concerning the Commission's proper role in the solution to the problem of questionable payments. Finally, this legislation would furnish the Commission and private plaintiffs with potent new tools to employ against those who persist in concealing from the investing public the manner in which corporate funds have been utilized.

As the Committee may be aware, on January 19, 1977, the Commission issued a notice of proposed rulemaking in this area. In that release the Commission announced that it was considering the promulgation, with certain changes, of the essentials of Section 102 of S. 305 as Commission rules. I should like to submit, for your record, a copy of that notice which sets forth the rationale for the proposals in some detail. While the Commission has the authority, under existing law, to adopt rules of this nature, the Commission, as it stated in its release proposing these rules,

> "continues to believe that congressional action on the legislation which it proposed in the May 12 Report would be the most desirable means of demonstrating a national commitment to ending the types of corporate misconduct, in defiance of the recordkeeping systems on which disclosure under the Securities laws is premised, which the Commission's investigations have uncovered."

Accordingly, although the Commission will proceed expeditiously with its rulemaking, we urge the Congress to take early and favorable legislative action which would eliminate the need for administrative regulations.

Before turning specifically to H.R. 3815, I would like to address briefly some criticisms which have been leveled at the proposals in Section 102 of S. 305. First, it has been suggested that requiring companies to maintain accurate books and records is unrealistic, since accuracy is an unattainable standard in the context of accounting records. I find this objection somewhat perplexing in light of the fact that the IRS presumably expects that the same information be "accurately" reflected in corporate tax returns. In any event, we understand that the Senate report on this legislation will make clear, as does the text of the Commission's release announcing its rulemaking proposals, that the term "accurately" does not mean exact precision as measured by some abstract principle. Rather it means that issuer records must reflect transactions in conformity with accepted methods of recording economic events. Thus, for example, inventories are typically valued on either the assumption that costs are released on a first-in, first-out or a last-in, last-out basis. Both theories, if correctly and honestly applied, produce "accurate" records, even though each may yield considerably different results in terms of the dollar value of inventories.

Second, similar objections have been voiced concerning the proposed requirement that the corporate system of internal accounting controls be "adequate" to provide reasonable assurance that certain objectives are accomplished. Again, this standard is hardly novel since the accounting profession has long required that auditors judge the adequacy of a client's internal control procedures in the context of determining the scope and nature of their auditing procedures. Moreover, the accounting literature from which this proposal is drawn makes clear that the concept of "reasonable assurance" entails the balancing of the costs against the benefits for any particular internal control measure.

Finally, it has been suggested that the Commission, or a private plaintiff in an implied action, ought to be required to show that any deception of auditors or falsification of accounting records was knowingly committed. The inclusion of a particular mental state as an element of these offenses is, in the Commission's judgment, unwise, since investors can easily be injured by the incompetent and careless as by the devious. Nevertheless, the version of S. 305 which has been ordered reported to the Senate does include a requirement that the falsification of records or the deception of auditors be done "knowingly." I understand the Senate Banking Committee's report will make clear, however, that the knowledge required is merely that the defendant was aware he was committing the act alleged to constitute a violation – not that he necessarily have known or intended that the act was unlawful.

B. H.R. 3815

As I have indicated, while the Commission does not oppose prohibitions such as those in H.R. 3815, we do believe that those prohibitions alone are an inadequate response to the problem of questionable payments. Correspondingly, in the past, the Commission has expressed some concerns over whether it should be responsible for the enforcement of those prohibitions – even as to its own registrants – since those prohibitions seem to arise from Congressional objectives not strictly related to investor protection. In this vein, the Justice Department has suggested that prohibitions such as those in Section 1 of H.R. 3815 might best be codified separately from the securities laws and committed exclusively to the Department's investigatory and prosecutorial responsibility.

Since Section 1 of H.R. 3815, as it is presently drafted, would enact these new prohibitions as Section 30A of the Securities Exchange Act of 1934, the Commission would be empowered to enforce the antibribery provisions of the bill in the case of Commission registrants, just as the Commission enforces other provisions of the Act. The Commission's responsibilities would extend to conducting investigations, bringing civil injunctive actions, commencing administrative proceedings if appropriate, defending lawsuits against the Commission and its staff arising out of the Commission's obligations under this Act, and referring cases to the Justice Department for criminal prosecution where warranted. The Justice Department, on the other hand, would have responsibility for enforcing Section 2 of the bill, which applies to domestic firms not registered with the Commission, and for prosecuting all criminal actions arising from either Section 1 or Section 2.

The solution to the question of whether the Commission should be primarily responsible for the enforcement of the prohibitions in proposed Section 30A requires a weighing of several factors. If the prohibitions in Section 1 become part of the securities laws, to the extent criminal prosecutions against Commission registrants would be premised on those prohibitions, the investigatory responsibility would generally rest with the Commission while the prosecutorial function would be discharged by the Department of Justice which is responsible for conducting all criminal actions arising under any federal statute. There may, at least in theory, be draw-backs to this type of shared responsibility, which would be avoided by wholly excluding the Commission from the process of enforcing the bill. I think it important, however, to recognize that, in this respect, Section 30A would stand on no different footing than any other provision of the securities laws. Willful violations of any of those statutes or the Commission's rules are criminal offenses, and, as such, are prosecuted by the Department – usually after the

Commission has referred to it the results of its investigation. I believe that the Commission and the Department have worked together extremely effectively in the past, and undoubtedly that cooperation will continue in the future.

There are other factors which must be considered and which may militate in favor of including the prohibitions in proposed Section 30A in the federal securities law. First, the investigation and litigation of cases arising under proposed Section 30A would require the type of expertise and experience which the Commission has developed over the past 40 years in enforcing the existing federal securities laws. The development of cases involving fraud and or similar misconduct on the part of the management of large corporations requires the investigatory and accounting abilities which the Commission already possesses, and to duplicate that expertise in another segment of the government would be costly and inefficient. Moreover, the distinction between enforcing the requirement that there be disclosure of material questionable corporate payments and enforcing prohibitions against those payments may be more theoretical than practical since the kind of foreign bribe prohibited by H.R. 3815 would usually be a material fact to investors. The Commission's enforcement staff will, therefore, have a continuing responsibility in this area whether or not bribes are made illegal per se under the Securities Exchange Act of 1934. Thus, any "expansion" of the Commission's mandate which would result from the enactment of Section 30A as part of the Securities Exchange Act may, in fact, be insubstantial.

In addition, I believe that a further reason for vesting enforcement jurisdiction in the Commission arises from the fact that, under our existing enforcement program, in many cases the threat of criminal prosecution (for failure to make material disclosures) has induced management to cooperate with the Commission's so-called voluntary disclosure program. I expect that a direct prohibition would give our enforcement staff an additional effective tool for deterring further improper conduct, since an offender would risk prosecution – not just for failure to report a payment where the payment could be shown to be material – but also for utilizing the jurisdictional means in making the proscribed payment.

In the final analysis, the weighing of these factors and the balance to be struck is a matter committed to Congress's judgment. Let me stress that the Commission will, of course, vigorously discharge whatever responsibilities Congress chooses to confer upon it in this or any other area.

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The problem of corrupt and concealed payments made by American business to obtain favorable treatment in foreign commerce is complex and disturbing. The Commission believes that the legislation which it proposed last May represents an effective and reasonable approach to that problem. Moreover, the Commission is prepared to play a vigorous role in the enforcement of legislation directly out-lawing questionable payments, although that role would, at least in part, transcend our traditional mandate to protect investors through the mechanism of disclosure. I welcome this Subcommittee's consideration of these matters and appreciate the opportunity to assist in that process here this morning.

I will be pleased to answer any questions the Subcommittee may have.