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Washington, D.C. 20230

MEMORANDUM FOR THE GENERAL COUNSEL

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Subject: Questionable Corporate Payments Abroad--Adequacy of Existing Law

To aid the efforts of the Steering Committee on questionable payments abroad, you have asked me to review current law and regulations which address the problem, in one form or another, and to give you my assessment of the adequacy of these laws to deter improper payments in the future.

The first part of this memorandum summarizes existing law and practice bearing on questionable payments, chiefly federal securities, tax, and antitrust laws. The second part discusses the inadequacies of these laws as deterrents to the making of questionable payments.

Summary of Existing Legislation

1. Securities Laws

The securities laws are designed to protect investors from misrepresentation, deceit, and other fraudulent practices by requiring public disclosure of certain information pertaining to the issuers of securities. Such disclosure is accomplished, first, through the mechanism of a registration statement which is required to be filed with the Securities and Exchange Commission (the "SEC") as a precondition to a public offering of securities pursuant to the Securities Act of 1933, 15 U.S.C. §77a et seq. (1970), the "1933 Act;" and, second, through the annual and other periodic reports and proxy materials required to be filed by registered companies with the SEC pursuant to the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq. (1970), the "1934 Act."

There is no specific requirement that questionable payments to foreign officials be disclosed in registration statements filed pursuant to the 1933 Act or in the annual or periodic reports or proxy materials filed pursuant to the 1934 Act. However, in addition to the specific instructions and requirements incident to each of these filings, the SEC requires the disclosure of all material information concerning registered companies and of all information necessary to prevent other disclosures made from being misleading, e.g., 17 C.F.R. §§230.408, 240.12b-20, 240.14(a)-9(a)(1975). Thus, facts concerning questionable payments are required to be disclosed insofar as they are material.

Materiality has been defined by the SEC as limiting the information required "to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." Rule 405(1), 17 C.F.R. §230.405(1)(1975). The materiality of any fact is to be assessed, according to the courts, by determining:

> ". . . whether a reasonable man would attach importance [to it] . . . in determining his choice of action in the transaction in question. [Citation omitted]." (Emphasis supplied.) This, of course, encompasses any fact ". . . which in reasonable and objective contemplation might affect the value of the corporation's stock or securities . . . [Citation omitted]." (Emphasis supplied.) Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

Alternatively stated, the test is whether ". . . a reasonable man might have considered . . . [the information] important in the making of [his] decision." Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972).

The courts have not yet addressed the issue of whether and under what circumstances questionable payments made by a U.S. corporation to foreign officials would be material information which should be disclosed publicly.* Thus, the SEC, through its enforcement program and its voluntary disclosure program,* has been the sole arbiter as to the materiality of such payments.

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* The conviction of a director and chief executive officer of a company for bribing U.S. public officials has been held to be a material fact which should have been disclosed. Cooke v. Teleprompter Corp., 334 F. Supp. 467 (S.D.N.Y. 1971).

* In addition to its regular enforcement program, the SEC has established special procedures for registrants seeking guidance as to the proper disclosure of questionable foreign payments. These procedures, frequently referred to as the "voluntary disclosure program," provide a means whereby companies can seek the informal views of the Commission concerning the appropriate disclosure of certain matters. The program is intended to encourage publicly-owned corporations to discover, disclose, and terminate, on a voluntary basis, the making of questionable payments and related improper activities.

A staff study by the Subcommittee on Oversight and Investigations of the House Interstate and Foreign Commerce Committee on the SEC Voluntary Compliance Program (May 20, 1976) has concluded that there are significant deficiencies in the operation of the program. In particular, the staff believes that more detailed public disclosure is necessary as to all companies which have made any illegal payments (under the laws of the United States or any other nation), any substantial questionable payments, or any form of domestic or foreign political contribution, or which have maintained false or inaccurate books or records.

The extent of the Commission's activities with respect to both foreign and domestic payments and practices has created a great deal of uncertainty as to how the materiality standard applies to improper foreign payments. The SEC has not issued a release containing disclosure guidelines on this subject to date. However, in a report submitted to the Senate Banking, Housing and Urban Affairs Committee on May 12, 1976, the SEC has given some guidance as to its current position ("Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices" -- hereinafter referred to as the "SEC Report").

In this Report, the SEC takes the position that questionable or illegal payments that are significant in amount or that, although not significant in amount, relate to a significant amount of business, are material and required to be disclosed. Other questionable payments may also be material, according to the Report, regardless of their size or the significance of the business to which they relate. Thus, the Report indicates (at page 15) that: ". . . the fact that corporate officials have been willing to make repeated illegal payments without board knowledge and without proper accounting raises questions regarding improper exercise of corporate authority and may also be a circumstance relevant to the 'quality of management' that should be disclosed to the shareholders."

Moreover, even if expressly approved by the board of directors, the Report states (at page 15) that " . . . a questionable or illegal payment could cause repercussions of an unknown nature which might extend far beyond the question of the significance either of the payment itself or the business directly dependent upon it" -- and for that reason might have to be disclosed.

It should be noted that the SEC believes that the current securities laws are adequate to require sufficient disclosure of questionable or illegal payments in order to protect the investor. The problem perceived by the SEC is the weakness of the corporate financial reporting system. The legislation proposed by Chairman Hills seeks to strengthen that system by imposing internal accounting controls on corporations regulated by the SEC designed to ensure that corporate transactions are executed in accordance with management's authorization, and that such transactions are reflected on company books and records so as to permit the preparation of financial statements in conformity with generally accepted accounting principles. The legislation proposed would make it a criminal offense to falsify corporate accounting records or to make false or misleading statements to company auditors.

2. <u>Tax Laws</u>

Section 162(c) of the Internal Revenue Code provides that bribes and kickbacks, including payments to government officials, cannot be deducted in computing taxable income if the payment (wherever made) would be unlawful under U.S. law if made in the United States. Thus, the tax law only reaches those transactions in which a questionable foreign payment is deducted as a business expense.

The principal mechanism for the detection of improper deductions is the corporate income tax return and, in the case of foreign subsidiaries and affiliates, certain information returns. Criminal and civil sanctions may be applicable if an improper payment is deducted from earnings. There are no cases currently pending in the Department of Justice.

The Internal Revenue Service (the "IRS") does not routinely require taxpayers to furnish information as to the payment of bribes or kickbacks. However, in August 1975, the IRS issued guidelines to its field examiners providing techniques and compliance checks to aid in the identification of schemes used by corporations to establish "slush funds" and other methods to circumvent federal tax laws. In April 1976, additional instructions were issued focusing on illegal deductions of questionable payments to foreign officials abroad. The IRS is now engaged in investigating hundreds of the nation's largest companies regarding possible improper deductions of such payments and related tax improprieties.

3. Antitrust Laws

The antitrust laws may impact on improper payments in a variety of ways. Depending on the factual circumstances, an improper payment could violate Sections 1 or 2 of the Sherman Act, 15 U.S.C. §§l, 2 (1970); Section 5 of the Federal Trade Commission Act, 15 U.S.C. §45 (1970); the "FTC Act;" or Section 2(c) of the Clayton Act, the so-called brokerage provision of the Robinson-Patman Act, 15 U.S.C. §13(c)(1970).

As a general rule, an American corporation which pays a bribe to gain favorable legislation abroad, or to facilitate a sale at the expense of a foreign competitor, will not be in violation of the U. S. antitrust laws. On the other hand, payment of a bribe by one U. S. company to assist its sales at the expense of another U. S. company may well be an unfair method of competition within the meaning of section 5 of the FTC Act.[*] A conspiracy among two or three U. S. companies to bribe a foreign official to keep another U. S. company out of an overseas market would probably violate section 1 of the Sherman Act; however, it is not clear that an improper payment involving one firm and one government official can constitute a conspiracy for purposes of this section. Bribes paid by one company for the purpose of monopolizing a foreign market might violate section 2 of the Sherman Act.

Section 2 (c) of the Clayton Act prohibits the payment of commissions or other allowances, except for services actually rendered, in connection with the sale of goods in which either the buyer or seller is engaged in commerce (including commerce with foreign nations). Section 2(c) encompasses commercial bribery and bribes of state government officials to secure business at the expense of U. S. competitors. Although there do not appear to be any section (2)(c) cases involving dealings with foreign governments, the statute might be applicable to the payment of a bribe by a U.S. corporation to a foreign official to assist its business at the expense of its U.S. competitor.

[*] Thus, for example, the Federal Trade Commission is examining allegations that General Tire & Rubber Company made payments in Morocco for the purposes of getting a permit to expand its plant there and preventing Goodyear Tire & Rubber Company from obtaining a permit to do business in Morocco.

4. Other Legislation

There are a number of provisions of limited application which come into play when a company takes advantage of particular programs sponsored by specific U.S. Government agencies. Thus, for example, where a sale of goods is financed in whole or in part by a credit established by the Export-Import Bank of Washington ("Eximbank"), the supplier must certify that it has not paid any commissions or fees except those regularly paid in the ordinary course of business to its sales agents or representatives. Several cases of possible fraud have been referred recently to the Criminal Fraud Section of the Justice Department.

The Agency for International Development ("AID") makes hard currency loans to foreign countries for procurement of goods produced in the United States. Companies making sales under this program must certify that they have not paid any commissions or fees except as regular compensation for bona fide professional, technical or comparable services. AID officials compare contract prices with current market prices and occasionally discover discrepancies requiring legal action, including referrals to the Department of Justice for possible fraud prosecutions. It has been held that a concealment of improper payments in AID forms constitutes a violation of the federal statute making it unlawful to conceal any matter within the jurisdiction of any United States department or agency, 18 U.S.C. §1001 (1970). U.S. v. Olin Mathieson Chemical Corporation, 368 F.2d 525 (2d Cir. 1966).

The International Security Assistance and Arms Export Control Act of 1976 (which was vetoed on May 7, 1976, but then reintroduced in altered form as S. 3439 and H.R. 13680) would add a new provision to the Foreign Military Sales Act, 22 U.S.C. §2751 et seq. (1970), to require reports to the Secretary of State, pursuant to regulations issued by him, concerning political contributions, gifts, commissions and fees paid by any person in order to secure sales under section 22 of the Foreign Military Sales Act. No such payment could be reimbursed under any U.S. procurement contract unless it was reasonable, allocable to the contract, and not made to someone who secured the sale in question through improper influence. Similar reporting requirements would be required with respect to commercial sales of defense articles or defense services licensed or approved under section 38 of the Foreign Military Sales Act. All information reported and records kept would be available to Congress upon request and to any authorized U.S. agency. It should be noted that even at the present time, the Defense Department requires disclosure of all fees and commissions paid in the sale of military equipment pursuant to the Foreign Military Sales ("FMS") program.

ANALYSIS

The issue presented is whether new legislation is required to deal with improper corporate payments or whether the existing legislative scheme-- the sum of all the laws and regulations described above-- obviates the need for new legislation. Another way to state the question is whether the company that would consider the making of an improper payment-- or the foreign official that would demand one-- will be deterred from doing so by the existing laws and regulations.

The dimensions of the improper payments problem may suggest the singular ineffectiveness of existing laws and regulations. Still, it may be asked whether the failure is more a function of enforcement policy on the part of the administrators. In other words, assuming that the SEC, the IRS, and the other agencies sharing jurisdiction in the area were to adopt a militant enforcement policy-- to exercise to the maximum possible extent their authority to deal with the problem-- is it reasonable to believe that this would put an end to it? And if that is a reasonable possibility, we would still have to ask whether it is desirable to entrust the solution of the problem to a zealous enforcement of laws and regulations which were not designed to deal with it and which only accidentally impact on it. As a matter of effective law enforcement, is there not some virtue in a legislative scheme which does not depend for its viability on the continued zeal or militancy of its administrators?

My personal assessment is that even the most vigorous enforcement of existing law would not be an adequate solution to the problem, and that the shortcoming of existing law is a function of statutory and jurisdictional limitations rather than one of enforcement policy.

Other papers prepared under the aegis of the Steering Committee as well as existing legislative initiatives (e.g., the bills introduced by Senators Church and Proxmire) suggest that there are essentially two kinds of meaningful deterrents, namely, criminal sanctions and public disclosure. The criminalization approach has been found wanting in several respects and for the purposes of this paper it is assumed that the disclosure approach is the preferred system.

Although some of the details are still being, formulated, it is assumed that any disclosure system would satisfy certain minimum objectives. First, it would apply to all U.S. corporations. Second, it would also apply to foreign government officials; that is, it would require disclosure of the names of those who demand improper payments. Third, it would require disclosure of information regarding the payments to the public (as opposed to the mere reporting of information to a government agency).

In reviewing existing law, it is clear that none of the “systems” described in the first part of this memorandum satisfy these criteria. Indeed, the system of disclosure administered by the SEC is the only one which, as a practical matter, requires detailed consideration. For ease of presentation, it may be useful to discuss first the laws and regulations of lesser significance.

With respect to taxation and antitrust, both systems are theoretically applicable to all U.S. corporations doing business abroad but only to the extent that the making of a questionable payment also results in a violation of certain statutory prohibitions.

In the case of the tax laws, they only reach those transactions in which a questionable payment is deducted as a business expense. If a company making an improper payment does not take a deduction, the only source of potential liability arises from the maintenance of "slush funds" to circumvent federal tax laws generally.

Although the IRS could require reporting of questionable payments, the information obtained could not be disclosed to the public because of the confidentiality of tax administration. Moreover, the mission of the IRS in the area of questionable payments abroad is to administer and enforce the tax law. All of the procedures and programs which the IRS has adopted, or might adopt in the future, are designed to accomplish that central objective-- the enforcement of the tax statutes.[*]

As for the antitrust laws, they are generally inapplicable to an improper payment unless it can be shown that there is an anticompetitive effect on U.S. foreign commerce, for example, where a bribe is paid to exclude the product of a U.S. competitor or to monopolize a foreign market. Also, the doctrine of sovereign immunity and the act of state doctrine create serious problems in cases involving payments to foreign government officials, and the actual initiation of a case would be seriously hampered by legal and policy inhibitions on the exercise of extraterritorial enforcement.

Moreover, the utility of the Sherman Act and the FTC Act in deterring improper payments abroad is further diminished by the fact that there are no disclosure requirements by which improper payments are systematically brought to the attention of the Justice Department or the FTC. The principal source of information (apart from reports filed with the SEC) would be aggrieved American competitors.

With respect to the Eximbank, AID, and FMS programs, each of them has a very limited application, that is, they only apply to companies taking advantage of these particular programs. Moreover, none of them at the present time require public disclosure. They are designed merely to ensure that the Government does not aid in the financing of questionable payments. In the case of the FMS program, pending legislation (as noted above) would provide for disclosure to the Congress but, in any case, it would still be limited to companies making sales of military equipment. Thus, as a practical matter, all of these programs taken together only impact on a limited number of companies doing business abroad and the FMS program, through its disclosure requirement (assuming passage of the new legislation) is the only one which contains a deterrent element.

Turning now to the securities laws, there are several reasons why the SEC disclosure requirements are inadequate to deter improper payments. First, they only apply to public companies, <u>i.e.</u>, to companies with securities registered under the 1934 Act or to companies making public offerings. Second, they only apply to the extent that the questionable payment is "material" within the meaning of the law. Third, as a general rule, they do not (and could not)

[*] Letter dated May 13, 1976, from Donald C. Alexander, Commissioner, IRS, to John D. Lange, Jr., Deputy Director, Office of International Investment, Department of the Treasury.

require disclosure of the names of recipients of questionable payments. Fourth, they are not designed to protect the same interests that would be served by new disclosure legislation.

Nonetheless, the utility of the SEC disclosure requirements must be examined in some detail. For, as mentioned previously, the Commission itself believes that current securities laws are adequate to require sufficient disclosure of questionable payments and that the problem is to be solved by strengthening the corporate financial reporting system.

First, with respect to the coverage of the SEC program, there are at present approximately 9,000 corporations which regularly file documents with the Commission, not all of which do business abroad. On the other hand, there are some 30,000 U.S. exporters and an additional number of U.S. firms doing business abroad which do not export from the United States. Indeed, some of the most important U.S. firms doing business abroad are private companies which are not subject to the SEC disclosure requirements.

Second, the Commission's authority to require disclosure is limited in that an improper payment must be reported only if it is "material information." There are serious problems with the view (set forth at page 15 of the SEC Report) that any payment, regardless of amount, may be "material" because it can lead to "repercussions of an unknown nature" or reflect on the quality or integrity of management.

It would seem that the concept of materiality advanced by the SEC in its Report is at substantial variance with discussions of materiality only recently espoused by the Commission. For instance, in facing the issue whether a company is required to report unlawful discrimination in employment, the SEC stated -- in a release issued less than one year ago -- that:

> "The Commission's experience over the years in proposing and framing disclosure requirements has not led it to question the basic decision of the Congress that insofar as investing is concerned the primary interest of investors is economic. After all, the principal, if not the only reason, why people invest their money in securities is to obtain a return. A variety of other motives are probably present in the investment decisions of numerous investors; but the only common thread is the hope for a satisfactory return, and it is to this that a disclosure scheme intended to be useful to all must be primarily addressed."[*]

In the same release the Commission stated that "there is no distinguishing feature which would justify the singling out of equal employment from among the myriad of other social matters in which investors may be interested." The release then listed 100 so-called social matters in which investors may be interested (including "activities which would be illegal in the U.S. but which are conducted abroad") but which, presumably, are not material per se. As stated not long ago by then Chairman Ray Garrett:

[*] Securities Act Release No. 5627, October 14, 1975, p. 37.

> " . . . as you can see, if you require disclosure of all violations of law against bribery or political contributions on the ground that illegal payments are material per se, we may be hard pressed to explain that other illegal corporate acts are not equally material for the same reason."**

The Commission's current position with respect to questionable payments, however, seems to suggest the emergence of a new theory, namely, that with respect to illegal conduct the illegality itself is of consequence-- regardless of the nature of the offense and of its effect upon the value of the stockholder's investment. Indeed, with respect to questionable payments, it does not even appear to matter to the SEC whether they are actually illegal, that is, whether subject to indictment by prosecuting authorities in the United States or abroad. It is submitted that the Commission's enforcement policy in this area-- as represented in the SEC Report-- may be based on tenuous legal grounds. At the very least, given the extent of the Commission's enforcement activity, there is a good possibility that the matter will be presented to the courts.

The remarks of Chairman Garrett underscore the fact that the Commission's policy is a function of its composition at any particular time. It is presently reported that there is a split on the Commission, with two Commissioners urging a more moderate posture on the question of improper payments, but that Chairman Hills has been willing to act forcefully on the problem. New Commissioners may be disposed to take different interpretations. Thus, even assuming the legality or propriety of the views espoused by the present Commission, it is uncertain whether this will continue to be SEC policy. There may be virtue in a legislative scheme which does not depend for its viability on the continued zeal or militancy of its administrators. Indeed, the Congressional report of May 20, 1976, on the SEC voluntary compliance program (described above) has already revealed serious questions as to the evenhandedness of the Commission's enforcement policy.

Third, the SEC does not require disclosure of the names of the recipients of questionable payments, and it is hard to see how it could do so, at least in most cases, even under the most expansive interpretation of the materiality doctrine. In addressing S. 3133 (the "Proxmire bill")-- which requires disclosure of the names of recipients-- the SEC Report states that while, in some cases, disclosure of the identity of the recipient might be important to an investor's understanding of the transaction, more frequently his identity may have little or no significance to the investor. Since any disclosure system should have as a principal purpose the deterrence of extortion by government officials, the SEC system is deficient in that respect as well.

More generally, the SEC system of disclosure is simply not designed to protect the same interests that would be served by new disclosure legislation. The questionable payments problem is an area of national policy with sensitive foreign relations implications. Whatever definition of materiality is given by the Commission or the courts, the SEC disclosure requirements are designed to protect the interests of the prudent investor. It is not an appropriate mechanism to deal with the full array of national concerns caused by the problem of questionable payments.

** Freeman, "The Legality of the SEC's Management Fraud Program," 31 Bus. Law. 1295, 1301 (March 1976).

Moreover, it may be asked whether the Commission, in its zeal to test the outer limits of the materiality doctrine, has not raised serious questions as to the purpose and scope of the securities laws and the statutory role of the Commission. In remarks delivered in December 1975, then Commissioner Sommer urged the Commission to go slowly in expanding the area in which disclosure becomes a substitute for the enforcement of other substantive laws. In particular, he pointed out that:

> " . . . Materiality is a concept that will bear virtually any burden; it can justify almost any disclosure; it can be expanded all but limitlessly. But we must constantly bear in mind that overloading it, unduly burdening it, excessively expanding it may result in significant changes in the role of the Commission, the role of other enforcement agencies, and our ability to carry out our statutory duties." SEC News Digest, December 12, 1975.

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In reviewing existing law, the largest single defect appears to be the absence of a comprehensive disclosure system. Disclosure is not required by the tax or the antitrust laws, and the Eximbank, AID, and FMS programs have a very limited application. Thus, as a practical matter, the SEC program is the only significant disclosure system. However, because of the limitations described above, it is not a viable alternative to new legislation. What is required is a system which will extend to all American firms doing business abroad, regardless of whether they are registered with the SEC and irrespective of whether the payments are "material" from the perspective of a prudent investor.