



OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

The Honorable John E. Moss
Chairman
Subcommittee on Oversight and
Investigations
Committee on Interstate and
Foreign Commerce
House of Representatives
Washington, D.C. 20515

May 21, 1976

Dear Mr. Chairman:

On May 20, 1976, the Commission was provided copies of a report prepared by the staff of the Subcommittee on Oversight and Investigations concerning the Commission's program for voluntary corporate disclosure of questionable and illegal foreign payments and practices. Having examined the report of the staff of the Subcommittee, the Commission offers the following comments.

- I. THE STAFF REPORT RELIES ON AN UNDULY NARROW VIEW OF THE COMMISSION'S PROGRAM IN DETERMINING THAT THE VOLUNTARY DISCLOSURE PROGRAM HAS PRODUCED INADEQUATE DISCLOSURES OF MATERIAL FACTS

On May 12, 1976, the Commission submitted to the Senate Committee on Banking, Housing and Urban Affairs a thorough report, describing in detail its voluntary disclosure program and enforcement activities; setting forth a synopsis of the public facts that have been disclosed as a result of those activities; and proposing legislation to deal with the problems that we have identified. This report, a copy of which is provided for your consideration, represents a thorough and detailed account of the Commission's total activities to assure discovery and cessation of questionable and illegal foreign payments and practices and their adequate disclosure under the federal securities laws. Under our programs, approximately one hundred companies have made disclosures regarding such payments.

The Subcommittee's study, by contrast, relies on a limited and inadequate analysis of eight cases in which the Commission expressed its informal views regarding the adequacy of disclosure of certain matters as a basis for a broad conclusion that there are serious deficiencies in the voluntary disclosure program. Not only do we consider the analysis of these eight individual cases to be inadequate, we believe that the Subcommittee staff ignored the overwhelming successes of the voluntary disclosure program.

A. The Voluntary Disclosure Program Has Produced Substantial Public Disclosures of Questionable and Illegal Practices and Has Led To Their Cessation in a Significant Number of Cases

The Commission believes that the basis for the assertions of the Subcommittee staff should be examined more carefully in light of the totality of the Commission's activities and the results they have produced to date. Prior to isolating and analyzing eight individual cases, we feel that the Subcommittee should consider the total picture.

As mentioned previously, approximately one hundred companies have made some disclosure regarding questionable and illegal foreign and domestic payments and practices as of April 21, 1976. Of that number, approximately sixty consulted with the Commission staff regarding facts they had discovered during the course of their internal investigations into these matters, most frequently conducted by persons not suspected of involvement in the questionable activities. Those companies additionally pledged to provide the Commission's Division of Enforcement access to their corporate books and records and to their files and materials discovered or developed during the course of their investigation. An overwhelming majority of those companies either adopted or reissued corporate policies prohibiting the continuation of the practices they discovered, and many adopted new procedures to assure that these policies would be honored.

In addition, the Commission's programs and activities, and the public disclosures they produced, prompted many other corporations to examine their own activities and to make public disclosures similar to those required in the voluntary program without consultation with the Commission or our staff. Those public disclosures reflect the companies judgments as to what must be disclosed under the federal securities laws and, in many cases, what should be required as a matter of good shareholder relations. Similarly, when the Commission determined that disclosure may not be required, the Commission generally suggested that the staff advise the companies

that it felt that they should consider whether the information should be disclosed as a matter of good corporate relations. In many cases, the companies agreed and made disclosure of matters that neither we nor they regarded to be material under the federal securities laws. Accordingly, whether disclosure in a specific case is adequate as a matter of law may not easily be determined by comparison with disclosures undertaken voluntarily in other cases.

Of the some sixty corporations that sought the views of the Commission's staff regarding disclosure of certain matters, only twenty five were brought to the attention of the Commission itself for an expression of its views. Generally, these cases presented some of the most troublesome issues regarding the materiality of certain facts and of corporate obligations to make disclosures. In eight cases, the Commission determined that facts and circumstances involving enforcement considerations prevented us from expressing a view regarding the adequacy of disclosure of certain matters at that time. Of the remaining seventeen cases, the Commission required fourteen corporations to make disclosures. The material facts we required to be disclosed to investors and shareholders generally included:

1. The existence, amount of, duration, and purpose for the foreign payments;
2. the method of effecting the payments, including possible falsifications or inadequacies in corporate books and records;
3. the role of management in the payments;
4. their tax consequences, if any; and
5. information about the business or services.

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In only three instances, two of which were selected by the Subcommittee staff for examination and criticism, did the Commission concur in the corporations' view that no disclosure was required of matters presented to it. In one of those cases, however, the corporation decided to make some disclosure following staff communication of the Commission's view that corporate management should consider whether good corporate relations would best be served by some disclosure of those facts, notwithstanding our determination that the federal securities law did not require such disclosure.

The Commission believes that the efficacy of its entire program cannot fairly be assessed simply by listing the kinds of disclosures that have and have not been required in isolated cases. Single cases, or even small numbers of cases, are not indicative of the validity of the Commission's activities. Instead, we urge that the Subcommittee consider the totality of the facts that have been disclosed as a direct or indirect result of our activities. We further urge that the Subcommittee consider the significant number of cases in which corporations have pledged to cease the questionable or illegal payments and practices that their investigations discovered, and, moreover, the increased sensitivity to these problems in the business and professional communities and their increased determination to deal with them, all of which are discussed in detail in the accompanying report.

Judging the voluntary disclosure program in its totality, the Commission believes that it has been remarkably successful. The voluntary disclosure program and the Commission's enforcement activities are complementary. Together, they have produced significant discoveries and public disclosures of questionable and illegal foreign payments and practices. Similarly, they have led to the cessation of these practices in the vast majority of cases. The Commission believes that the Subcommittee must assess its staff's criticisms of our decisions in these eight individual cases in light of the

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obvious success of our overall program. The Subcommittee staff concludes:

"[T]here are serious shortcomings in the adequacy of the voluntary disclosure program."

The record does not support this conclusion, and we respectfully request that the productive efforts of the Commission and its staff not be so branded by this Subcommittee.

The Commission further believes that the draconian measures proposed by the Subcommittee staff are certainly not justified in the absence of some indication or evidence that the disclosures obtained to date under the voluntary program are inadequate. We presently have no such indications. Moreover, the structure of the voluntary program suggests that the record probably will not support such a determination. As previously indicated, a condition to participation in the voluntary program is that corporations agree to provide our Division of Enforcement access to their files and to the materials they have discovered and developed in their investigation. The Division of Enforcement has taken advantage of this access in certain cases, and will continue to do so in the future. This persuades the Commission that few corporations would be willing to risk compounding their possible problems by withholding information relating to major abuses from our staff when they consult regarding the appropriate disclosure of matters they have discovered. We can assure the Subcommittee that our Division of Enforcement has both the determination and the resources to deal with those cases if they arise.

II. THE SUBCOMMITTEE STAFF'S ANALYSIS OF THE EIGHT CASES IS SUPERFICIAL AND CANNOT SUPPORT MEANINGFUL CONCLUSIONS ON THOSE CASES, MUCH LESS SERVE AS A BASIS FOR CONDEMNATION OF THE ENTIRE PROGRAM.

It is important to understand that decisions regarding disclosure for purposes of the federal securities laws are based on judgments of materiality. Congress has given the Commission the responsibility to make these judgments on a case-by-case basis. Obviously, judgments in individual cases can be challenged. As we noted in our Report to the Senate Committee on Banking, Housing and Urban Affairs, there is no litmus test of materiality in an area as complicated as this. In that report, the Commission discussed at length some of the factors relevant in determining whether certain facts are material and should be disclosed.

Obviously, these are highly fact-specific cases, and matters on which reasonable men can and do differ. The staff of the Subcommittee disagrees with some of the Commission decisions in the eight cases reported in its study. There also have been differences between and within Divisions and Offices in the Commission in many of the particular cases selected by the Subcommittee staff, which, as previously noted, represent some of the most difficult confronted by the Commission. Moreover, there were differences of various degrees among members of the Commission in nearly every one of these cases.

The Commission is, however, the established body possessing the authority to make such judgments under the federal securities laws, and while a Subcommittee has the authority and responsibility to question, and in some cases to criticize the manner in which decisions are made, it would seem that members of Congress should take care to avoid supplanting individual decisions made by the Commission under the federal securities laws with their individual judgments, unless approved by Congress on other grounds.

The abbreviated staff presentation of the facts considered in reaching decisions in the eight cases it has selected presents an inadequate basis from which to judge those decisions. Thus, the Commission has stated more

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fully the factors considered by the Commission in determining whether disclosure of certain facts was required under the federal securities laws. These statements, set forth in Appendix A, should provide the Subcommittee a better understanding of some of the factors the Commission considers relevant to these determinations.

To illustrate the point more carefully, the company discussed as entry C to Appendix A, and as the relettered entry C in the Staff Study, will be discussed herein.

Company C and its subsidiaries are engaged principally in manufacturing and marketing diversified lines of products. The company had net assets in 1974 of over \$4 billion and sales exceeding \$3 billion.

As a result of publicity generated by disclosures made by the Watergate Special Prosecutor's Office, the company's management in 1973 directed the Vice President and Treasurer to conduct an investigation to determine whether illegal political contributions had been made. The company's independent auditors were asked to give special attention to this subject during the course of their regular audit.

The company's investigation revealed no political contributions except those made in a foreign country where contributions were legal and never exceeded \$18,000.

The corporation then approved a policy of full disclosure of all political contributions by key company officials and Washington Home Office staff members, and in the same action the Board of Directors reaffirmed its long-standing policy prohibiting political contributions by the company. Information related to individual contributions is required to be filed in a public register maintained by the corporate secretary.

Subsequently, the company initiated a more extensive investigation, asking inside and outside auditors to focus on any suspicious payments exceeding \$500. This examination discovered the following practices

engaged in by some of the company's foreign subsidiaries:

1. Between 1973 and 1975, approximately \$360,000 was spent as follows:
 - (a) Less than \$26,000 spent in four separate incidents. On three occasions a local inspector or auditor threatened a large assessment or fine for alleged violations of rules. Payment of approximately \$8,000 stopped these threats.
 - (b) A local plant official was arrested by officers brandishing drawn pistols for alleged customs violations. The matter was settled following payment of \$18,000.
 - (c) In five different foreign countries certain employees responsible for procurement for government agencies insisted on certain payments. The largest payment made in response to these demands was \$31,000; the total over three years amounted to \$337,000.
2. Three other unusual situations involved total payments approximating \$230,000.
 - (a) A foreign subsidiary of the company hired government employees as sales consultants in two separate foreign countries. Each consultant was paid a sales commission in his respective country. Total commissions amounted to \$81,000 and were not known to officials of the parent company.
 - (b) A subsidiary of company C bid about \$160,000 to supply a product to a foreign government. An exporter accepted the bid with the understanding that a letter of credit for about twice that amount would be given to the subsidiary and that the difference of approximately \$150,000 would be "kicked back" to the export agent. No officials of the parent company knew of the transactions, at the time, and the practice had been terminated prior to their discovery of the matter.

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The company had a long standing policy prohibiting such payments, and it took strong measures to assure the cessation of future payments of this kind. Senior management allegedly was unaware of the payments. Moreover, the company has made available to the Commission all of its books and records so that the Commission can verify the accuracy of the representations made to it.

The total business related to all of these payments is estimated to be approximately 1/10 of 1% of the company's gross business. The company stated its position in the following manner:

"The Company is prepared to forego business opportunities rather than to engage in practices which are incompatible with the past and present policy. As indicated above, the potential loss of business is minimal in relation to the Company's total sales revenues."

The Commission believes that this presentation affords a far more balanced basis from which to judge the merits of its determination than does the Staff Study. The Commission determined that, under all of the circumstances, the payments need not be disclosed under the federal securities laws. However, it instructed the staff to advise the company that the Commission thought it should consider whether the maintenance of good corporate relations would not nonetheless suggest that some disclosure would be appropriate. The company apparently agreed, and some disclosure of these matters was in fact made.

III. THE STAFF CONCLUSIONS AND RECOMMENDATIONS
MISCONSTRUE THE NATURE OF THE COMMISSION'S
PRACTICES. THE COMMISSION SHOULD BE ALLOWED
TO CONTINUE ITS VOLUNTARY PROGRAM ESSENTIALLY
IN ITS PRESENT FORM.

The voluntary program has been not only a successful program but an evolutionary one as well. Our program is constantly being reviewed and revised as the Commission and staff gain experience in this area, and minor deficiencies are corrected as they are revealed. While the Commission welcomes

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active congressional oversight and assistance in the correction of deficiencies, the heart of a program of this nature necessarily must rest in agency discretion to deal with complicated problems as they arise. We therefore believe that the continued success of the voluntary program must rest on the flexibility that results from the sound exercise of administrative discretion, coupled with continued congressional oversight.

The Subcommittee staff has made several recommendations relating to the operation of the voluntary program. They suggest, for example, that the Commission "corroborate the accuracy of all published corporate disclosures"; that the Commission should conduct "follow up" investigations to assure that cessation has in fact occurred as declared by the companies and that the Commission request substantial supplementary appropriations for these purposes.

These recommendations reflect a lack of confidence in the statements and "good faith" efforts of corporate officials, and the legal and accounting professions that we do not share. The Commission generally has relied and will continue to rely on the integrity of the independent auditors and attorneys that advise corporate management as to its obligations under the federal securities laws, just as we now have placed substantial reliance on the integrity of the independent review committees that are assigned to investigate questionable or illegal corporate payments and practices.

While the Commission regards as very important the fact that we have access to the books and records of corporations and to the work product of the independent review committees and does, in fact, conduct follow-up investigations where appropriate, we do not believe that we could corroborate the accuracy of all published disclosures or assure that no further payments are made in any cases. Even to attempt to achieve this without reliance on the private sector would require the Commission to more than duplicate the activities now being conducted by the professional communities with respect to more than 9000 corporations. We are unable to estimate the number of employees or the budgetary commitment required to assume this monumental new responsibility. There is no question, however, that it would be many times the

present budgetary expenditures. To illustrate the point, it has been stated that the review conducted by the Gulf Oil Corporation cost that company in excess of \$3 million. Gulf is by no means the largest of the 9,000 corporations whose disclosures the Commission would be required to investigate under the recommendation of the Subcommittee staff.

Implementation of the recommendations of the staff not only would require an astronomical increase in the Commission's staff and budget, but would, in our judgment, not produce the desired results. The Commission's experience, reported more fully in the accompanying report submitted to the Senate, has led us to the conclusion that the most effective remedy for the problems we have discovered is to establish mechanisms that insure the increased assumption of initiative and responsibility on the part of the private sector rather than to supplant the important role of that sector with our own independent efforts.

IV. THE SUBCOMMITTEE SHOULD REFRAIN FROM
IDENTIFYING THE NAMES OF THE EIGHT
COMPANIES DISCUSSED IN THE STAFF REPORT.

Release of the Subcommittee staff study with the names of the companies prior to the opportunity for discussion between the Commission and the Subcommittee is indeed premature. Moreover, the Commission is concerned that this precipitate action could substantially and unnecessarily impair the effectiveness of the voluntary program.

A. Temporary Deletion of Corporate Identities Will Not
Hinder the Oversight Examination

Although some of the companies named in the Staff Study previously have made some public disclosures, the study attributes previously confidential information, revealed only to the Commission, to those companies. Thus, the juxtaposition of the names and the confidential information may compromise the integrity of the Commission's program. The Subcommittee staff bases its assertion that the names of these companies and previously undisclosed information be made public on its contention that the Commission has been derelict in its job. Such disclosure effectively deprives the Commission of the chance to offer a meaningful defense of its activities and preserve the integrity of its programs. The Commission returns the Study with the names deleted

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and other matters altered slightly to minimize the likelihood that they otherwise will be identified. We are confident that the Commission's decisions with respect to these companies can be discussed in a meaningful fashion with the edited version of the Staff Study as with the original version. If the Subcommittee determines after discussion and consideration that its staff is correct, the full report can be published without a significant loss of time or impact.

B. Revelation of the Identities of These and Other Corporations and Circumstances in this Context Will Seriously Impair the Commission's Voluntary Program

The Commission's voluntary program has contributed to the disclosure of questionable and illegal payments and practices by scores of corporations. Without this program, the American public would never have understood the serious nature of the problem as quickly as it has. The Commission firmly believes, however, that release of the identities of the corporations in the Staff Study could seriously impair this program.

Companies that voluntarily disclose such practices do so with the understanding that their contacts with the Commission will be made on a confidential basis, subject to our obligations to the Congress and under the Freedom of Information Act. Should they now believe that communications they regarded as confidential are subject to public disclosure, the chilling effect could be substantial. The Commission believes that this effect would contribute to increasing reluctance on the part of corporations to come forward voluntarily and candidly reveal conduct of the nature previously disclosed.

The Commission also believes it inappropriate to discuss confidential facts disclosed to us by companies that have not completed their investigations and filed final reports. Such disclosure, particularly in cases in which the staff has not had the opportunity to test the disclosures contained in the reports, would not only heighten the concerns and reluctance of participating companies, it also might adversely effect the conduct of future investigations, thereby curtailing the scope of disclosures that may ultimately be made.

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The Commission firmly believes that the Subcommittee can adequately evaluate our activities and the charges of the Subcommittee staff without making specific reference to the identities of companies participating in the voluntary program. The Subcommittee can examine our decisions and practices and make appropriate suggestions and criticisms without crippling the voluntary disclosure program. We strongly urge that it follow this course of action rather than that set forth by its staff.

V. REFERENCES TO COMMISSION STAFF
RECOMMENDATIONS ARE HARMFUL AND
INCOMPLETE

The Commission believes that the Subcommittee staff has erred in focusing such attention on the differences between our staff's recommendations and the final decisions of the Commission. As previously mentioned, the issues of disclosure of matters of this kind are difficult ones over which reasonable men can and do differ. We have acknowledged that differences exist with respect to some of the cases under examination. We do not, however, feel that focusing on these differences is a productive course for the Subcommittee to pursue.

A. Reference to Staff Recommendations Is Incomplete

Several Offices and Divisions comment on matters that come to the Commission under the voluntary disclosure program. The Divisions of Enforcement and Corporation Finance usually comment both in writing and extensively in oral discussions before the Commission. In addition, the Offices of the Chief Accountant and the General Counsel frequently discuss matters before us at length, generally without prior submissions or written comments.

Substantial discussions take place inside each of these Divisions and Offices and, in many cases, those discussions are extensive.

In sum, the true nature of staff views, recommendations, and advice cannot adequately be understood from the

brief references made in the Staff Study.

B. Focus on Staff Recommendations Is Harmful

We believe that individual staff recommendations to the Commission are of questionable relevance to the matters now before the Subcommittee. The Commission is fully prepared to explain and justify its actions. Focus on the staff recommendations cannot provide much assistance to this endeavor and, in the long run, could be detrimental to the effective workings of the Commission.

The Commission is concerned that focus on recommendations of our staff could cause them in the future to temper the candor of their remarks and the expression of their views before the Commission. The value of this candor and openness is beyond measure; it is of paramount importance that internal communications within the Commission not be impeded in any manner.

We do not challenge the right of this Subcommittee to examine and consider the recommendations of our staff. We seriously question, however, the wisdom or purpose of disclosing them publicly or dwelling on them in the oversight hearings.

The Commission therefore requests that references to these recommendations be deleted from the Staff Study, and that these matters not be detailed in public hearings.

VI. CONCLUSION

The Securities and Exchange Commission is universally recognized to be the federal agency that has played the paramount role in surfacing the entire issue of questionable and illegal foreign payments and practices. The diligent and successful efforts of the Commission and staff have largely contributed to the present climate that demands effective solutions to these problems.

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The voluntary disclosure program is essential to the Commission's successes. Even with a staff four times the size of our present staff, we would have been unable to obtain the kinds and volume of disclosures presently obtained without the voluntary program.

The Commission anticipates that future problems will arise that will call for programs of this nature. We respectfully request that this Subcommittee recognize that release of the non-public information concerning these companies, coupled with their identities, can seriously impair a program that has served so well to date, and that may be needed in the future. Finally, we wish to point out that we are not attempting to cover-up the identities of companies that have engaged in questionable or illegal practices. Five of the companies at issue made disclosures regarding their practices at the Commission's insistence. Two made some disclosure, notwithstanding our determination that they were not compelled to do so by law. The eighth company has not completed its investigation and may yet make some disclosure. The differences between the Subcommittee staff and the Commission thus relate to differences in means and degrees of disclosure.

The principle that concerns this Commission, and one that we must insist upon, is that the legitimate confidentiality of our processes and the integrity of our programs not be needlessly compromised. Without these programs, Congress and the public would be far from our present knowledge regarding questionable and illegal foreign payments and practices. Let us not needlessly sacrifice the progress we have made.

Sincerely,

Roderick M. Hills,
Chairman

cc: Members of
Subcommittee on Oversight
and Investigations