MEMORANDUM

February 22, 1983

TO: Chairman Shad
Commissioner Evans
Commissioner Thomas
Commissioner Longstreth
Commissioner Treadway

FROM: Russell B. Stevenson, Jr.

RE: Proposed Testimony on S. 414

Attached is proposed testimony by the Commission on S. 414, which is the reintroduced Senate bill to amend the Foreign Corrupt Practices Act. This bill is identical to the Chafee bill as it passed the Senate in 1981. Since our testimony is scheduled for February 24, please provide me with any comments by 2:00 tomorrow so that the testimony can be finalized.

cc: John Daniels
Ethel Geisinger
John Fedders
Fred Wade
Dan Goelzer

2/22/83

WRITTEN STATEMENT OF THE HONORABLE JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS CONCERNING S. 414

February 24, 1983

I. Introduction

The Securities and Exchange Commission appreciates the opportunity to participate in these hearings concerning S. 414, the Business Accounting and Foreign Trade Simplification Act. The Commission supports the goals of that legislation, the simplification and clarification of the Foreign Corrupt Practices Act of 1977 ("FCPA"). S. 414 is consistent with the aims articulated by the Commission in its 1981 testimony on a predecessor bill, S. 708.[1] Like that bill, S. 414 would eliminate ambiguities and simplify the administration of the FCPA while preserving the goals that the Commission and the Congress sought to achieve when the law was enacted in 1977.

As the Commission's 1981 testimony indicated, "the Foreign Corrupt Practices Act has generated a substantial degree of consternation among business men of utmost good faith."[2] Most of the concerns expressed to the Commission have arisen from difficulty in interpreting the reach of the accounting provisions of the Act. This lack of certainty exists on the part of independent accountants, financial executives, the securities bar and members of the Commission's staff.

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1 See Statement of the Honorable John S.R. Shad, Chairman, Securities and Exchange Commission, before Joint Hearings of the Subcommittee on Securities and the Subcommittee on International Finance and Monetary Policy of the Senate Committee on Banking, Housing and Urban Affairs Concerning S. 708 (June 16, 1981). [Hereinafter "1981 Testimony"]

2 1981 Testimony at 5.

II. The Accounting Provisions

In response to such concerns, the Commission supported legislation in the last Congress which would have clarified the FCPA and eliminated ambiguities. In addition, it has provided guidance concerning its interpretation of the accounting provisions[3] and supported the Justice Department's efforts to afford guidance concerning the bribery prohibitions.[4]

Moreover, as will be shown in greater detail below, it does not appear that the Commission needs the tool of the FCPA to implement its traditional responsibilities for enforcing the disclosure and antifraud provisions of the securities laws. Since enactment of the FCPA, the Commission has brought 21 injunctive actions in which it has alleged violations of the FCPA's accounting provisions. However, all these actions also cited other sections of the Exchange Act, and all could have been brought and sustained without reference of Section 13(b)(2) (which was added by the FCPA). Thus, with or without the accounting provisions of the FCPA the Commission retains the ability to enforce full disclosure of material information to the investing public.

A. The Purpose of the Accounting Provisions

The accounting provisions of the Act, which are contained in Section 13(b)(2) of the Securities Exchange Act, require issuers: (a) "to make and keep books, records, and

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[3] Securities Exchange Act Release No. 17500 (Jan. 29, 1981), 46 F.R. 11544 (Feb. 9, 1981), 21 SEC Docket 1466 (Feb. 10, 1981) (hereinafter "the Commission's 1981 Policy Statement"). See also Securities Exchange Act Release No. 15570 (Feb. 15, 1979), 44 F.R. 10964 (Feb. 23, 1979), 16 SEC Docket 1143 (Mar. 6, 1979); Securities Exchange Act Release No. 15772 (Apr. 30, 1979), 44 F.R. 26702 (May 4, 1979), 17 SEC Docket 421 (May 15, 1979); Securities Exchange Act Release No. 16877 (June 6, 1980), 45 F.R. 10134 (June 13, 1980), 20 SEC Docket 310 (June 24, 1980).

[4] Securities Exchange Act Release No. 17099 (Aug. 28, 1980), 45 F.R. 59001 (Sept. 5, 1980), 20 SEC Docket 1258 (Sept. 16, 1980).

accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;" and (b) "to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that * * *" certain statutory objectives are met.[5]

B. Accounting Provision Amendments

Amendments to the accounting provisions should accomplish two goals in addition to ensuring that the statutory objectives of the FCPA are met. First, they should provide greater certainty in order that persons subject to the Act know what it permits and what it prohibits. Second, amendments should reduce compliance requirements that are not necessary to the accomplishment of the statutory objectives. These goals remain the appropriate ones in any efforts to amend the FCPA. The Commission recognizes that there may be a variety of ways to achieve them. Its analysis of S. 414 indicates that this bill does address all of the relevant concerns while still preserving the principal objectives of the FCPA.

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[5] These objectives are reasonable assurances that:

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the record accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

1. Achievement of Greater Certainty

Meaningful and cost-effective compliance requires that the law be understandable and unambiguous. The law should reduce uncertainty, not compound it.

S. 414 would eliminate the existing requirement that reporting companies "make and keep records which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." That recordkeeping requirement has been one of the greatest sources of ambiguity and interpretative difficulty in the statute. The elimination of this requirement, however, would not sacrifice the goals underlying the FCPA.

The legislative history of the FCPA shows that the books and records provisions and the internal controls provision were intended to be coordinate. S. 414 would continue to hold management responsible for providing reasonable assurances that corporate transactions are recorded accurately and in reasonable detail.

As Statement on Auditing Standards No. 1 reflects, "The objective of accounting control with respect to the recording of transactions requires that they be recorded at the amounts and in the accounting periods in which they were executed and be classified in appropriate accounts."[6] Moreover, the Senate bill would prohibit the knowing circumvention of a system of internal accounting controls. This would include the deliberate falsification of books and records or other conduct calculated to evade the internal accounting controls requirement.

Thus, S. 414 effectively addresses the difficult problem of statutory ambiguity and preserves the goals of the statute.

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[6] Section 320.38.

In a further step in the direction of certainty, S. 414 adopts the Commission's 1981 recommendation that "reasonable assurances" be defined as those that would "satisfy prudent individuals in the conduct of their own affairs, having in mind a comparison between benefits to be obtained and costs to be incurred in obtaining such benefits."[7]

The cost-benefit test is presently contained in the legislative history of the Act, but is not set forth in the statute. The test is consistent with the auditing standard which recognizes that "the cost of internal control should not exceed the benefits expected to be derived."[8] The auditing standard also recognizes that "[t]he benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of accounting control."[9]

The prudent person standard is new. It would provide a benchmark for assessing the reasonableness of management judgments concerning systems of internal accounting controls.

2. Reduction of Compliance Costs

The proposed legislation would reduce undue compliance costs by making clear, in the language of the statute, that no criminal liability will result solely from failure to comply with the accounting provisions. If a violation of the accounting provisions should be associated with criminal violations of other provisions of the securities laws, a criminal prosecution could be brought on the basis of those other provisions.

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[7] 1981 Testimony at 10-12.

[8] Statement on Auditing Standard No. 1, Section 320.32.

[9] Id.

The bill would also make clear that no civil injunctive relief may be imposed with respect to an issuer for failing to comply with the accounting provisions "if it can show that it acted in good faith in attempting to comply with the internal accounting controls requirement." This is consistent with the Commission's 1981 testimony, which made clear the Commission's view that it is inappropriate to hold a corporation liable for recordkeeping or internal accounting controls violations by low or middle level employees, in the absence of involvement by senior officials.[10]

Persons other than an issuer would only be subject to civil injunctions if they knowingly cause an issuer to fail to devise or maintain an adequate system of internal accounting controls. While this amendment has no counterpart in the present law, it is also consistent with the Commission's 1981 testimony.

The proposed legislation would also clarify the extent to which issuers may be held responsible when they hold 50 percent or less of the voting power of a subsidiary. The bill would require that an issue proceed in good faith to use its influence, to the extent reasonable under the issuer's circumstances, to cause such a firm to comply with the internal accounting controls requirement. This provision is also consistent with the Commission's 1981 testimony, which proposed that the 50 percent or less standard refer to voting power, instead of equity capital (as originally proposed in S. 708).

C. The Commission's Enforcement of the Accounting Provisions

The Commission has brought 24 enforcement actions under the accounting provisions since the FCPA was enacted in 1977, including 21 injunctive actions and 3

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[10] 1981 Testimony at 15-18.

administrative proceedings. Sixteen of these actions, or two-thirds, have been brought during the past year and one-half.

Violations of the accounting provisions have all been uncovered in connection with inquiries into other possible violations of the securities laws. Each of the injunctive actions has involved allegations that the corporate defendant violated one or more disclosure requirements of the federal securities laws. These include the antifraud provisions contained in Sections 10(b) of the Securities Exchange Act, the reporting requirements set forth in Section 13(a), and the proxy provisions contained in Section 14(a) of the Act, and applicable rules. Thus, each of these injunctive actions could have been prosecuted without reference to the FCPA accounting provisions. Two of the three administrative proceedings were based solely upon the accounting provisions.[11]

To date, there have been no judicial interpretations to clarify the accounting provisions. The defendants or respondents in the _____ cases that have been settled have consented to the entry of permanent injunctions against future violative conduct or other relief without admitting or denying the Commission's allegations. The remaining _____ cases are pending.

The cases brought to enforce the accounting provisions have involved improper accounting with respect to four broad categories of conduct: (a) questionable or illegal payments; (b) exaggeration of company sales and assets, or the failure to keep adequate records of business transactions; (c) misappropriation or diversion of corporate assets in

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[11] In the Matter of Telex Corporation (Admin. Proceeding File No. 3-6123, Securities Exchange Act Release No. 18694, commenced Apr. 29, 1982); In the Matter of Government Securities Management Company, Inc. (Admin. Proceeding File No. 3-6153, Investment Advisers Act Release No. 814, commenced July 21, 1982).

cases that have not involved questionable or illegal payments; and (d) unauthorized management perquisites.

III. The Anti-Bribery Provisions

The FCPA also charges the Commission with responsibility for civil enforcement of the prohibition against the bribery of foreign government officials by issuers. This prohibition contained in Section 30A of the Securities Exchange Act was added by the FCPA. It has been a less important part of the Commission's enforcement authority. To date, the Commission has brought two enforcement actions under this provision.[12] Each of these cases also included allegations of antifraud and disclosure violations and thus could have been maintained under the federal securities laws without reliance on Section 30A.

The Commission's mandate is to protect investors through full disclosure. The Commission made it clear, prior to enactment of the FCPA, that the prohibition of foreign bribery raised important issues of national policy unrelated to the objectives of the securities laws. Former Commission Chairman Hills recommended to the Senate Banking Committee that, if Congress chose to outlaw such transactions, it should not do so under the securities laws.[13] Congress decided, however, to assign responsibility for civil enforcement of the prohibitions applicable to issuers to the Commission, and assigned criminal enforcement to the Justice Department.

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[12] SEC v. Katy Industries, et al. (N.D. Ill., Civil Action No. 78C-3476, commenced Aug. 30, 1978); SEC v. Sam P. Wallace, Inc., et al. (D.D.C., Civil Action No. 81-1915, commenced Aug. 13, 1981).

[13] Testimony of Roderick M. Hills, Chairman, Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs, p. 9 (Mar. 16, 1977).

Because the Commission's primary mission is disclosure, not substantive regulation of day-to-day commercial transactions, repeal of Section 30A would not impair the Commission's ability to administer the securities laws. In instances where foreign bribery involves a failure to disclose information which is material to investors, the Commission would retain its authority to take appropriate action. For these reasons, the Commission would not oppose the proposed amendment which would transfer all enforcement authority with respect to Section 30A to the Department of Justice. In addition, consistent with its 1981 testimony, the Commission defers to the Department of Justice with respect to the substance of the proposed amendments to the anti-bribery provisions.

IV. Conclusion

While the legislative process may result in further refinements of the proposed legislation, the bill as introduced is a constructive and responsible measure. The enactment of S. 414 would clarify the law, eliminate ambiguities and reduce uncertainties. The Commission is pleased to support the bill.